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LIST OF ACRONYMS

ACCA	Association of Chartered Certified Accountants
ADB	Asia Development Bank
BDD	Basic Data and Directions
BoP	Balance of Payments
CCG	Chamber of Control of Georgia
CHU	Central Harmonisation Unit
CPI	Consumer Price Index
DCFTA	Deep and Comprehensive Free Trade Area
DCI	Development Cooperation Instrument
DG DEVCO	Directorate-General for Development and Cooperation — Europeaid
DG ECFIN	Directorate-General for Economic and Financial Affairs
DPO	Development Policy Operation
EBRD	European Bank for Reconstruction And Development
EEAS	European External Action Service
EIDHR	European Instrument for Democracy and Human Rights
ENP	European Neighbourhood Policy
ENPI	European Neighbourhood Partnership Instrument
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
FISIM	Financial Intermediation Services Indirectly Measured
GDP	Gross Domestic Product
GEL	Lari
GFCF	Gross Fixed Capital formation
GFSM	Government Finance Statistics Methodology
GIZ	Gesellschaft für Internationale Zusammenarbeit
GoG	Government of Georgia
GVA	Gross Value Added
HC	Harmonisation Centre
IAU	Internal Audit Unit

IDA	International Development Association
IDP	Internally Displaced Person
IFC	International Finance Corporation
IIA	Institute of Internal Auditors
IMF	International Monetary Fund
INSC	Instrument for Nuclear Safety Cooperation
INTOSAI	International Supreme Audit Institution Guidelines
IPSAS	International Public Sector Accounting Standards
ISSAI	International Standards of Supreme Audit Institutions
JNA	Joint Needs Assessment
MFA	Macro Financial Assistance
MoF	Ministry of Finance
NACE	Classification of Economic Activities in the European Community
NATO	North Atlantic Treaty Organisation
NBG	National Bank of Georgia
NGO	Non-Governmental Organization
NIR	Net International Reserves
OECD	Organisation for Economic Co-operation and Development
OSCE	Organisation and Cooperation In Europe
PEFA	Public Expenditure and Financial Accountability
PFM	Public Finance Management
PFMS	Public Financial Management System
PIFC	Public Internal Financial Control
SBA	Stand-By Arrangement
SDR	Special Drawing Rights
SIDA	Swedish International Development Cooperation Agency
SIGMA	Support for Improvement In Governance and Management
SPA	State Procurement Agency
TAIEX	Technical Assistance and Information Exchange Instrument
USAID	United States Agency for International Development
USD	United States Dollar
WB	World Bank

GEORGIA: KEY FACTS

Area:	69 700 sq.km
Population:	4.47 million (as of 1 January 2011)
Capital:	Tbilisi
Currency:	Lari (GEL)
GDP per capita:	2 623 USD (2010)
Administrative divisions:	9 regions, 9 cities, and 2 autonomous republics of Ajaria and Abkhazia
Border countries:	Armenia 164 km, Azerbaijan 322 km, Russia 723 km, Turkey 252 km
Major ethnic groups:	Georgian 83.8%, Azeri 6.5%, Armenian 5.7%, Russian 1.5%, other 2.5% (2002 census)
Religions:	Orthodox Christian (official) 83.9%, Muslim 9.9%, Armenian-Gregorian 3.9%, Catholic 0.8%, other 0.8%, none 0.7% (2002 census)
Languages:	Georgian (official) 71%, Russian 9%, Armenian 7%, Azeri 6%, other 7% (note: Abkhaz is the official language in Abkhazia)
Independence:	9 April 1991 (from Soviet Union)
Constitution:	Adopted 24 August 1995
Legal system:	Based on civil law system
Form of state:	Republic with executive, legislative and judicial branches
Executive branch:	The president (head of state); the prime minister (head of government); Cabinet of Ministers
National legislature:	A unicameral Parliament consisting of 150 members (75 elected by party list and 75 by single-member districts)
Judicial:	Supreme Court and Constitutional Court
Government:	The President appoints the cabinet, subject to approval by the legislature
President:	Mikheil Saakashvili (since 25 January 2004)
Prime Minister	Nika Gilauri (since 6 February 2009)
National elections:	5 January 2008 (presidential); 21 May 2008 (legislative); next elections October 2012 (parliamentary) and 2013 (presidential)
Major political parties:	United National Movement (currently in power), New Rights, Republican Party, Free Democrats, Labour Party, Conservative Party, Christian Democratic Movement, People's Party, Democratic Movement-United Georgia, Republican Party, National Forum

Sources: Geostat; CIA World Factbook; Economist Intelligence Report Country Report for Georgia (December 2011).

MAP OF GEORGIA

Map No. 3780 Rev. 5 UNITED NATIONS
August 2004

Department of Peacekeeping Operations
Cartographic Section

EXECUTIVE SUMMARY

This Report presents the results of the *Ex-post Evaluation of the Macro-Financial Assistance to Georgia*. The evaluation was commissioned by the Directorate-General for Economic and Financial Affairs (DG ECFIN) in July 2011. The work was undertaken by GHK Consulting in association with Cambridge Econometrics and with inputs from Fiscus (Public Finance Management experts) and the Policy and Management Consulting Group (Local experts based in Georgia).

Background to the MFA Operation

The EU provided Macro-Financial Assistance (MFA) of EUR 46 million to Georgia in 2009-10. This assistance was part of a comprehensive package of EU support of up to EUR 500 million, pledged at the October 2008 International Donors Conference. The International Donors Conference was jointly organised by the European Commission and the World Bank to mobilise external assistance to support Georgia's economic recovery, following the August 2008 conflict with Russia. Although the conflict had an immediate impact on investor confidence and economic output, the Georgian economy started showing signs of recovery towards the end of 2008. Moreover, generous donor support and, in particular, the front loading of assistance by the International Monetary Fund (IMF), the World Bank and the United States in conjunction with Eurobond proceeds[1], helped comfortably to finance Georgia's fiscal deficit (arising from a countercyclical fiscal policy) and the balance of payments gap (stemming from a decline in private inflows) in 2008. In view of an improving economic situation, a relatively positive outlook for the future and a fear of damaging investor confidence in the country, the Georgian authorities decided not to draw down the second tranche of the IMF Stand-By Arrangement (SBA) in December 2008. Consequently, the preparation of the MFA decision was put on hold by the European Commission as, according to the rules, EU MFA can only be provided as complementary financing to IMF funding.

Georgia's post conflict economic recovery was however, short-lived and severely hampered in 2009 by the global financial crisis. Deteriorating economic conditions prompted the Georgian authorities to return to the IMF and also to take full advantage of undisbursed donor support committed at the 2008 Donors Conference. It was in a context of Georgia's worsening economic situation and fiscal and external imbalances that the MFA was approved in November 2009.

The MFA was disbursed in two instalments: the first instalment of EUR 23 million was disbursed in two tranches of EUR 15.3 million (December 2009) and EUR 7.7 million (January 2010); and, the second instalment of EUR 23 million was disbursed in August 2010.

[1] In April 2008, Georgia successfully floated a dollar denominated US$500 million Eurobond issue. In the fourth quarter of 2008, the government used US$130 million of the Eurobond proceeds that were deposited in a NBG account ; the remainder of the Eurobond proceeds held in sovereign wealth funds (US$ 370 million) were to be used in 2009. Source: IMF Country Report No. 08/328, October 2008. [online] Available at: http://www.imf.org/external/pubs/cat/longres.aspx?sk=22403.0

The Memorandum of Understanding accompanying the Grant Agreement signed between the European Commission and the Government of Georgia included the following conditions:

- The IMF SBA being on-track, and,
- A second set of conditions focusing on four key fields of PFM: internal control, external control, public procurement and budget process.

Box 1 MFA Conditionality relating to PFM Reforms

Overall PFM Reforms

Condition 1: In the framework of the Reform Policy Vision 2009-2013, the Ministry of Finance prepares and makes available to the wider public the Action Plan for 2010 that provides a clear roadmap for monitoring of the PFM reforms, including consultations with all relevant stakeholders.

Responsibility: Ministry of Finance, Georgia

Internal Control and Internal Audit

Condition 2:

(2a) The Parliament of Georgia adopts the Law on Internal Audit and Inspection.

(2b) In the framework of the PIFC Policy Paper and the Law on Internal Audit and Inspection, the Government endorses, and the Ministry of Finance makes available to the wider public an Action Plan on internal audit for 2010.

Responsibility: Ministry of Finance, Georgia

External Audit

Condition 3: The Chamber of Control (CCG) adopts and makes available to the wider public a capacity development plan that elaborates on organisational needs and resources of the Chamber of Control for 2010-2011 (human resource, training, and equipment needs).

Responsibility: Chamber of Control

Public Procurement

Condition 4:

(4.a) The State Procurement Agency (SPA) prepares an Action Plan for the implementation of the e-procurement system.

(4.b) The SPA implements the e-procurement system in the sequence prescribed by the amended Public Procurement Law.

(4c) The SPA provides training on the amended Public Procurement Law to the personnel of the Agency and to the personnel of the selected line Ministries on the basis of the training strategy

Responsibility: State Procurement Agency

Budget Process

Condition 5: The Parliament of Georgia adopts the Budget Code with provisions on program-based budgeting.

Condition 6: The Ministry of Finance prepares and makes available a timetable for the implementation of program-based budgeting.

Responsibility: Ministry of Finance, Georgia

Objectives and Scope of the Evaluation

The overall objectives of this evaluation were as follows:

(1) To determine the short term macroeconomic impact of the MFA operation;

(2) To analyse the impact of the MFA operation on Georgia's long term external sustainability;

(3) To examine the role of MFA in promoting structural reforms;

(4) To assess the added value of EU intervention;

(5) To draw out key lessons which could be applied to the design and implementation of future MFA operations.

The evaluation was based on a mixed-methods approach. Four key methods were used to collect and analyse evidence: in-depth desk research; macroeconomic modelling; stakeholder consultations; and, focus group discussions.

Main Findings and Conclusions

Impact of the MFA on Short-term Macroeconomic Stabilisation

To determine the net impact of the MFA on Georgia's economy, the following counterfactual scenarios were modelled:

Scenario 1: no MFA i.e. the MFA grants in 2009 and 2010 are not disbursed

Within this scenario, two alternative sub-scenarios were developed:

- Alternative A: reduced public spending by the Government of Georgia in 2009 and 2010. The Government faces a borrowing constraint and consequently, the non-availability of MFA grant to Georgia leads to a corresponding reduction in government revenue, and thus expenditure.
- Alternative B: reduced public spending in 2009, but no change in spending in 2010 i.e. the government is able to maintain its expenditure in 2010 without the MFA by incurring more domestic debt (in place of the lost grant revenue). Net borrowing is higher in 2010 compared to the baseline and domestic debt increases accordingly.

Scenario 2: no MFA and no SBA i.e. the MFA grants and IMF credit in 2009 and 2010 are not disbursed

Scenario 2 models the additional effect of the IMF-SBA provided to Georgia. The extent to which IMF financing was used for (a) reserve accumulation and (b) deficit financing was an important consideration in the modelling of scenario 2. Data shows that a majority of the SBA disbursed in 2009 was used to bolster Georgia's foreign exchange reserves (SDR 131.5 million out of a total of SDR 220.8 million ~ 60 per cent) and the IMF funds disbursed in 2010 were entirely used to finance a higher deficit.

Within this scenario, the following alternative sub-scenarios were developed:

- Alternative A: in 2009, the absence of SBA leads to a reduction in the government's available deficit financing (i.e. net borrowing) and a marked reduction in reserve accumulation. In 2010, the government's access to deficit financing falls by the full amount of the SBA in that year.
- Alternative B: reduced public spending, and reserves accumulation in 2009 but, no change in spending in 2010 i.e. the government is able to maintain its

expenditure in 2010 without the MFA and SBA by incurring more domestic debt.

The results of the modelling exercise are summarised below.

Scenario 1

The effects of the MFA were as follows, although the size of these effects is small (less than 0.5 per cent):

- An improvement in the current account, although by less than the value of the MFA;
- Higher accumulation of foreign exchange reserves;
- An increase in government revenue, by more than the value of the grant, owing to multiplier effects;
- An expansion of the domestic money supply (and modest inflationary effects);
- A reduction in public debt, assuming that Georgia would have issued bonds had it not received the MFA (Alternative B only);
- Higher GDP growth;
- Higher employment/lower unemployment.

The MFA thus, made a marginally positive contribution towards stabilisation of Georgia's economy in the short to medium term.

Scenario 2

Some of the effects of the SBA appear similar to those of the MFA, although the scale of the effects is different:

- An increase in government financing and revenue (particularly in 2010), exceeding the size of the loan owing to multiplier effects and facilitating higher expenditure;
- An expansion of the money supply;
- Higher GDP growth;
- Higher employment/lower unemployment;
- A possible decrease in public debt, if the country would have issued bonds had it not received the MFA.

Overall, the results of the modelling exercise show that the net effect of MFA on Georgia's economy was positive, albeit tiny: the impact on real GDP ranging from -0.2 per cent to +0.2 per cent under the two sub-scenarios. The MFA had a bigger impact in conjunction with the IMF-SBA: the impact on real GDP ranging from -1.0 per cent to -1.3 per cent under the two sub-scenarios.

External Sustainability

In the short term, MFA along with other IMF/ donor support helped improve Georgia's external financing situation. However, given the small size of the effects relative to Georgia's economy and its balance sheet items, it is difficult to argue convincingly, from the model results, that the MFA contributed substantially to averting a crisis through improved external sustainability, although the modelling fails to capture confidence-boosting effects that may well have longer-term implications for the country's economic trajectory. The model results present a somewhat clearer case for the SBA helping to avert a crisis.

The MFA which was provided in grant form did not add to Georgia's external indebtedness. In contrast, the SBA led to:

- An increase in foreign debt, but this is arguably offset by improved short-term economic performance that may have helped to avert a crisis;
- A deterioration of the current account.

The external situation of Georgia remains vulnerable. FDI has been slow to recover and is expected to remain far below pre-crisis levels in the short to medium term. In such a context, Georgia's economy will have to rely on other types of capital inflows or draw down on its foreign exchange reserves to finance its current account deficit which remains high (11.5 percent of GDP in 2010).

Structural Reforms

The MFA operation consisted of a narrow set of conditions focusing on acknowledged areas of weaknesses in Georgia's PFM system. Moreover, within the area of PFM reform, the conditions were quite modest in scope. The conditions concentrated heavily on relatively simple reform activities such as preparation and approval of action plans, capacity development plans, and to provide training on the amended Public Procurement Law. Additionally, the MFA included two conditions relating to programme-based budgeting. This narrow focus of conditionality on simpler reforms was relevant and appropriate, given the need for quick disbursement of support and the scale of the assistance.

All conditions were fully met technically, as the Georgian authorities implemented the necessary actions. However, the Commission, in its assessment of compliance, noted that there was some scope for improvement, for example the clarity and quality of the action plans and capacity development plans that were produced by the Georgia authorities could be improved.

The added value and reinforcing effect of EU support was most clearly evident in the case of internal audit reforms. In other areas, the added value of EU support was less obvious due to existence of strong domestic ownership and/or other donor support. For example, there was strong domestic commitment to the implementation of an e-procurement system. As regards the conditions on programme-based budgeting (that represented harder and more basic reforms), these were reinforced by both the IMF and the World Bank conditionality. Moreover, reform in the area of budget execution has been supported by a US Treasury Resident Adviser and technical assistance project to Ministry of Finance over many years. In these areas, it is quite possible that the EU-MFA supported and accelerated domestic reform efforts and the efforts of other donors by providing a useful second voice and a clear timetable for implementation (linked to disbursement the second instalment of the MFA grant); however, the evaluation did not find any concrete evidence to confirm or refute this theory.

Although it is too early to assess the full impact of PFM reforms supported by the MFA operation, some benefits can be observed, such as costs savings through the implementation of e-procurement system, greater transparency in Government expenditure (2012 budget); and the enhanced efficiency, reputation and credibility of the Chamber of Control.

A final observation to be made is that the reinforcing effect of EU promoted reforms would be greater if the media and civil society organisations were also engaged in the reform process. Media and civil society can play an important role in promoting PFM reforms through advocacy, training, capacity development and by improving public access to information. They can promote transparency and democratic accountability and also help build momentum for the reform process in several ways, for example by monitoring and reporting the progress of reforms and taking government to account in case of slow progress or backtracking; by monitoring public spending against budget; by publicising the findings of external auditors and pressurising the government to follow-up on audit recommendations.

Design and implementation

The size of the MFA was based on the IMF's assessment of Georgia's external financing needs. The MFA was expected to cover approximately 13 per cent of Georgia's estimated cumulative residual financing gap for the period 2009 to 2010. The decision to provide the assistance in grant form was justified on both, political and economic grounds. It was based on a consideration of Georgia's geo-political significance for the EU. Moreover, the EU did not want to add to Georgia's debt burden by providing assistance in loan form.

As regards implementation, a lengthy and uncertain approval process, lack of visibility of the instrument, formulation of conditionality relating to legislative enactments and lack of clarity regarding some of the softer conditionality are some of the issues potentially constraining the effectiveness of the instrument.

Added value

The availability of assistance in grant form which did not burden the country with repayment was the main added value of the operation. The evaluation did not detect any discernible confidence-boosting effect of the MFA.

Lessons Learned

The three main lessons learned from this evaluation are as follows:

- The European Commission could be more specific in formulating conditionality and be precise about its expectations, especially in the case of softer actions such as development of action plans.
- Generally speaking, conditionality relating to adoption of laws by the Parliament should be avoided as such conditionality can be seen as intrusive by the recipient country, creates uncertainty regarding disbursements (as the adoption of laws by the Parliament cannot be guaranteed), and could potentially have a perverse effect by exerting pressure on the recipient Government to rush through poorly-conceived laws (particularly in countries with weak opposition).
- The European Commission should take steps to improve the visibility of the MFA instrument in the recipient country. This would enhance transparency, raise general awareness among citizens of EU assistance and EU promoted reforms; and contribute to EU's image abroad.

1 INTRODUCTION

The European Commission provided macro-financial assistance of EUR 46 million to Georgia in 2009-10. This assistance was part of a comprehensive package of EU support of up to EUR 500 million, pledged at the October 2008 International Donors Conference. The International Donors Conference was jointly organised by the European Commission and the World Bank to mobilise external assistance to support Georgia's economic recovery following the August 2008 conflict with Russia.

This Report presents the results and conclusions of the ex-post evaluation of the macro-financial assistance provided to Georgia. The evaluation was commissioned by the Directorate-General for Economic and Financial Affairs (DG ECFIN) in July 2011. The work was undertaken by GHK Consulting in association with Cambridge Econometrics and with inputs from Fiscus (Public Finance Management experts) and the Policy and Management Consulting Group (Local experts based in Georgia).

1.1 Objectives and Scope of the Evaluation

Article 27.4 of the Financial Regulation[2] requires all Commission programmes and activities which entail a significant expenditure (> EUR 5 million) to be evaluated on an ex-ante and an interim and/or ex-post basis. Accordingly, each Macro Financial Assistance (MFA) operation is subject to an ex-post evaluation. Guidelines published by DG ECFIN[3] provide a broad framework for conducting these ex-post evaluations. As per these guidelines, the general objectives of an ex-post evaluation of an MFA are as follows:

- To analyse the *economic impact of the MFA* on the economy of the recipient country;
- To determine the impact of the MFA operation on the *sustainability of the country's external position;* and,
- To assess the *added value of EU intervention*.

The specific issues to be addressed by each evaluation are set out in its Terms of Reference. For this particular assignment, DG ECFIN specified seven evaluation questions (Table 1:1).

[2] COUNCIL REGULATION (EC, Euratom) No 1605/2002 of 25 June 2002 on the Financial Regulation applicable to the general budget of the European Communities. Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:248:0001:0048:EN:PDF .

See also Article 21 of the implementing rules : COMMISSION REGULATION (EC, EURATOM) No 1248/2006 of 7 August 2006 amending Regulation (EC, Euratom) No 2342/2002 laying down detailed rules for the implementation of Council Regulation (EC, Euratom) No 1605/2002 on the Financial Regulation applicable to the general budget of the European Communities. Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:227:0003:0021:EN:PDF

[3] DG ECFIN (2010) Guidelines for the Ex-post Evaluation of Macro-Financial Assistance and Balance of Payments Assistance Operations.

1.2 Evaluation Approach and Methodology

The evaluation was based on a structured and systematic approach to collecting, analysing and presenting evidence. Table 1:1 summarises the approach and methods used to address the evaluation questions set out in the Terms of Reference.

Table 1:1 Overview of Evaluation Approach and Methodology

Evaluation Questions	Approach	Methods
Evaluation Theme: Short-term macroeconomic impact of the MFA		
Q.1 How would the economy of Georgia have evolved in the absence of MFA assistance?	Specification and modelling of counterfactual scenarios	▪ Desk research ▪ Stakeholder interviews ▪ Macroeconomic modelling
Q.2 To what extent has the MFA assistance been effective in terms of the short-term macroeconomic stabilisation of Georgia?	Estimation of net macroeconomic impact i.e. actual outcomes *less* counterfactual outcomes	▪ Desk research ▪ Stakeholder interviews ▪ Macroeconomic modelling
Impact of MFA on Georgia's external sustainability		
Q.3 To what extent has the MFA contributed to returning the external financial situation of Georgia to a sustainable path over the medium to longer-term?	Analysis of trends in key external indicators: ▪ Before and after MFA ▪ With and without MFA	▪ Desk research ▪ Stakeholder interviews ▪ Macroeconomic modelling
Impact on structural reforms		
Q.4 To what extent has the MFA assistance been effective in terms of supporting structural reform in Georgia?	Assessment of relevance, durability, additionality and impact of MFA reforms	▪ Desk research ▪ Stakeholder interviews ▪ Focus Group Discussions
Q.5 What have been the indirect and/ or unexpected effects of the MFA assistance?	Elaboration of *ex-ante* intervention logic to identify potential direct and indirect effects *Ex-post* verification of intervention logic Identification of unusual patterns/ unintended outcomes	▪ Desk research ▪ Stakeholder interviews ▪ Focus Group Discussions
Design and implementation of the MFA		
Q.6 How has the way in which the MFA operation was designed and implemented conditioned its effectiveness and efficiency?	The extent to which the scale and form of MFA was appropriate in relation to Georgia's financing needs Timeliness of disbursements	▪ Desk research ▪ Stakeholder interviews ▪ Focus Group Discussions
Q.7 To what extent has EU added value been maximised?	Assessment of financial and non-financial added value of EU support e.g. Confidence boosting effect, impact on EU-Georgia relations and public opinion	▪ Desk research ▪ Stakeholder interviews ▪ Focus Group Discussions

As illustrated in Table 1:1, a combination of quantitative and qualitative research methods was utilised to build a comprehensive evidence base for the evaluation and to provide the basis for triangulation of results. These methods are described below.

1.2.1 Desk Research

This entailed an in-depth review and analysis of the following documentation, literature and data:

- *European Commission files relating to the MFA operation* which comprised documents such as the initial request for assistance submitted by the Government of Georgia (GoG) to the EU; the Commission's proposal for a Council Decision providing MFA to Georgia; Council Decision approving the operation; ex-ante evaluation statement prepared the Commission; the Memorandum of Understanding between the EU and GoG; MFA Grant Agreement; mission reports prepared by the Commission; compliance statement and documentation submitted by the GoG etc.;
- *EU Policy documentation* such as European Neighbourhood Policy (ENP) country reports, EU-Georgia Action Plan and progress reports;
- *European Commission documents* r*elating to Sector Policy Support Programmes* supporting reforms in the area of Public Finance Management (PFM);
- *Documentation published by the Georgian authorities* such as economic strategies, reform programmes, action plans and progress reports;
- *IMF documents* namely, the Letters of Intent submitted by the GoG to the IMF and IMF Country Reports;
- *World Bank documents* such as Country Partnership Strategies, program documents relating to the Bank's Development Policy Operations in Georgia, documents relating to projects supporting PFM reforms;
- *Academic and grey literature* on political and economic developments in Georgia and its progress with the implementation of structural reforms (particularly PFM reforms);
- *Macroeconomic data and statistics* on Gross Domestic Product (GDP) and its components, Balance of Payments (BoP), public finances, exchange rates, inflation, unemployment etc.;
- *Other literature and data* such as reports and data published by the European Bank for Reconstruction and Development (EBRD) and by other bilateral/ multilateral donors such as USAID on their activities in Georgia.

Annex 1 provides a full list of the documentation and literature reviewed by the study team.

1.2.2 Semi-structured Interviews

A series of semi-structured interviews was carried out with key informants notably, European Commission officials, representatives of relevant Georgian authorities and IMF/ WB officials. All interviews were carried out face to face. The purpose of these interviews was to collect additional background and contextual information relating to the operation.

Table 1.2 provides an overview of the interviews carried out in the context of this evaluation. The list of interviewees is available in Annex 2.

Table 1:2 Overview of semi-structured interviews carried out as part of the evaluation

Stakeholder Group	Key Informants	No. of Interviews
European Commission	▪ DG ECFIN ▪ DEVCO	4
European External Action Service (EEAS)	▪ EEAS Central Asia Division ▪ EU Delegation to Georgia	5
Georgian Authorities	▪ Project Administrative Office (PAO) in charge of coordination of the Twinning, TAIEX and SIGMA projects ▪ National Bank of Georgia (NBG) ▪ Ministry of Finance (MoF) ▪ State Procurement Agency (SPA) ▪ Chamber of Control of Georgia (CCG)	16
Bretton Woods Institutions	▪ IMF ▪ World Bank	3
Total Number of Interviews		28

1.2.3 Focus Group Discussions

Two focus group discussions were also organised in Tbilisi to gauge wider stakeholder perceptions of Georgia's reform efforts and the specific role of the EU in promoting better economic governance in the country. The first focus group comprised PFM experts and included representatives of the IMF, World Bank, bilateral donors namely, Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) and the Swedish International Development Cooperation Agency (SIDA), Transparency International, a USAID contractor and an independent expert. The second focus group comprised representatives of businesses, think tanks and civil society organisations. Reports of the two focus group discussions are available in Annexes 3 and 4.

1.2.4 Macroeconomic Modelling

A model based approach was used to determine the net economic impact of the MFA, i.e. the difference between actual macroeconomic outcomes (what actually happened) and potential 'counterfactual' scenarios (what could have happened in the absence of the MFA).

The macroeconomic model used for the present evaluation shares many of the features of the models used in previous MFA evaluations for the European Commission, drawing upon the principles of 'flow of funds' and financial-programming approaches used, for example, by the IMF.

The model links the following key economic and financial variables:

- GDP (and its components);
- Government finances (revenue, expenses, deficit financing/debt);
- Georgia's Balance of Payments (trade flows, transfers, changes in reserves etc).

The model also includes indicators of money supply (the banking system) and a simple treatment of employment (linked to economic activity) as auxiliary components.

The basic structure of the model is illustrated in Table 1:3 and further detailed in Annex 5.

Table 1:3 Structure of the Model

Element	Key Indicator or Balance
The Real Economy	GDP = Private Consumption + Gross Investment + Government Spending + Exports - Imports
The Labour Market	Unemployment = Labour Supply – Employment
The External Sector	BoP = Current Account – Capital Account – Reserves
The Government	Government Budget = Government Receipts – Government Expenditure
The Banking System	Money Supply = Net Foreign Assets + Government Credit + Net Domestic Assets

As previously mentioned, the model is based on a 'flow of funds' approach. In such a model, a flow of funds from one sector (expenditure) must either show up as a flow of funds to one or more other sectors (receipts) or alter the stock of a particular asset. For example, when domestic firms receive revenue from household domestic expenditure, funds flow from households to firms. An example of a change in a stock is government deficit-financing. In years when the Government spends more than it receives, it must make up the gap by running a deficit; the Government's stock of debt must increase. Thus, changes in trade patterns, transfers and finance alter an array of other economic variables, simply by accounting definition.

Accounting identities and ratios make up the majority of the model framework and, combined with assumptions about sources (and limits) of financing and a small number of behavioural equations, yield an internally-consistent picture of the counterfactual scenarios.

The model produces annual projections over recent history (up to 2010) and we have compiled the model's database, and calibrated it to Georgian economics statistics and data published by the IMF (principally the International Finance Statistics publication).

1.2.5 Strengths and Limitations of the Methodology

Table 1:4 critically assesses the information sources used and the validity of the data collected as part of this evaluation. Although each method has its strengths and limitations, the various methods taken together helped build a rich evidence base for the evaluation and provided the basis for cross-validation of findings.

Table 1:4 Strengths and Limitations of the Research Methods

Research Method	Strengths	Limitations and caveats
Desk research	A rich source of facts; statistical data; and, recorded information on the MFA operation. Helped provide first answers to the evaluation questions.	Desk research only provided part of the evidence base for the evaluation; it was necessary to update, cross-check and complement the information collected from secondary sources through primary research. While desk research was useful in developing a preliminary outline of the potential counterfactual scenarios, these needed to be validated and elaborated through stakeholder interviews.
Stakeholder interviews	Provided additional context and insights. Helped fill the gaps in the evidence base. Stakeholder interviews were also useful for confirming the accuracy of the information collected from other sources and corroborating what had been established from other sources.	Interviews covered stakeholder groups which were closely involved in the implementation of the assistance. The evaluation team detected some bias in their responses to the evaluation questions - particularly those relating to the relevance and impact of the financial assistance and the PFM reforms promoted by the MFA.
Macroeconomic modelling	Was used to quantify the net macroeconomic impact of the MFA. A key advantage of a quantitative model is that it is explicit in its framework, economic logic and assumptions, allowing for scrutiny and testing of the results it produces. A quantitative, model-based approach has clear economic logic and assumptions. Changes in exogenous assumptions generate concomitant changes in the endogenous variables in the model, yielding an internally-consistent simulation of states of the world with and without MFA. A model based approach thus, provided an explicit framework for scrutiny and testing of results. Given the small scale of the assistance, it is obvious that the macroeconomic impact of MFA would be marginal, at best. However, modelling helps quantify the scale of the impact.	The specification of counterfactual was challenging and essentially based on subjective judgement and educated guesses as to what might have happened in the absence of the MFA. The time span of the available statistical data for Georgia is relatively short (official statistical series are available 1996 onwards), making estimates of behavioural parameters difficult and subject to some uncertainty. Given the uncertainty in the economic climate when the MFA was provided, it is important to interpret the model results with care; the results rely on a number of assumptions and so the direction and orders of magnitude of the effects are to be interpreted with more certainty than the precise point estimates.

Research Method	Strengths	Limitations and caveats
Focus Groups	Focus group discussions provided a forum to collect the views and opinions a of wider group of stakeholders i.e. those ‘outside’ the Government and not directly involved in the operation . The group dynamic (in the first Focus Group with PFM experts) was particularly useful in triggering an objective discussion on the reform process and its outcomes. Focus group discussions provided an indication of the visibility of the MFA among wider stakeholder groups and their perceptions of the role of MFA in promoting reforms. Focus group discussions were also useful in determining if the MFA had any confidence boosting effects and / or impact on EU-Georgia relations, public opinion of the EU.	The scope of the Focus groups discussions was limited by definition. The first Focus group focussed on structural reforms; while, the second focussed on issues such as visibility of EU support and its role in promoting reforms.

1.3 The Structure of this Report

This Report continues in the following sections:

- Section 2 describes the background to the MFA operations, its main characteristics and intervention logic;
- Section 3 examines the macroeconomic impact of the operation;
- Section 4 assesses the impact of the MFA on Georgia’s external sustainability;
- Section 5 looks at the role of the MFA in promoting structural reforms;
- Section 6 highlights design and implementation constraints of the instrument and considers its added value;
- Section 7 sets out the draft conclusions and recommendations emerging from this evaluation.

The main report is supplemented by a Technical Annex which is structured as follows:

- Annex 1 provides a list of references;
- Annex 2 lists the officials and stakeholders consulted;
- Annexes 3 and 4 contain the two focus group discussion reports;
- Annex 5 provides a detailed description of the macroeconomic model.

2 MFA OPERATION IN GEORGIA

This section describes the sequence of events that triggered the MFA operation in Georgia and the main characteristics of the operation by way of background information for the evaluation.

2.1 Background to the MFA Operation

The main trigger for the MFA operation in Georgia was the country's engagement in an armed conflict with Russia in August 2008. The conflict had an immediate impact on investor confidence and economic output, but towards the end of 2008, Georgia's economy started showing signs of recovery. Georgia's post conflict economic recovery was however, short-lived and severely hampered in 2009 by the global financial crisis. It was in a context of Georgia's deteriorating economic situation and worsening fiscal and external imbalances that the MFA was approved in November 2009.

2.1.1 Political Context: The 2008 Armed Conflict with Russia

Relations between Georgia and Russia have remained tense since Georgia seceded from the Soviet Union and declared independence in 1991. Tensions between the two countries however, rapidly escalated after Mikheil Saakashvili came to power in January 2004, following the so-called "rose revolution". President Saakashvili pledged to regain Central Government authority over the two separatist regions of Abkhazia and South Ossetia, and followed a more pro-western policy, expressing interest in joining the North Atlantic Treaty Organisation (NATO) and pursuing closer ties with the EU.

The period from 2004 to 2008 was marked by security and diplomatic incidents between Georgia and Russia, and troubles in the outbreak region of South Ossetia (see Table 2:1). Following a series of inflammatory actions from both sides, a five day war broke out between Georgia and Russia on 8 August 2008. Georgia entered the Russian supported outbreak region of South Ossetia in order to reclaim it and, in retaliation, Russian troops invaded Georgia. The conflict resulted in an economic shock, 100,000 internally displaced people[4], and damage to Georgia's physical infrastructure.

Table 2:1 Chronology of Key Events leading to the 2008 Armed Conflict between Georgia and Russia

Timing	Event
Jul 2005	▪ Russia starts to withdraw its troops from two Soviet-era bases in Georgia (to be completed in 2008)
	▪ President Saakashvili announces a peace plan for South Ossetia that offers substantial autonomy and a three-stage settlement consisting of demilitarisation, economic rehabilitation, and a political settlement
Oct 2005	▪ South Ossetian "president" Eduard Kokoiti rejects the plan, asserting that "we [South Ossetians] are citizens of Russia"
Dec 2005	▪ The Georgian peace plan receives backing by the Organisation and Cooperation in Europe (OSCE) Ministerial Council
Jan 2006	▪ Georgian gas and electricity supplies are cut from the Russian side following a number of explosions on the Russian side of the border
Mar 2006	▪ Russia bans Georgian wine
May 2006	▪ Russia bans Georgian mineral water

[4] Foresti M., Welton G., and Jijelava D. (2010) Review of international assistance to political party and party system development, case study report: Georgia. Overseas Development Institute, August 2010. [online] Available at: http://www.odi.org.uk/resources/download/5539.pdf

Timing	Event
Jul 2006	▪ Baku (Azerbaijan)-Tbilisi (Georgia)-Ceyhan (Turkey) pipeline formally opens
Oct 2006	▪ Russian army officers detained on spying charges; Russia imposes sanctions on Georgia
Nov 2006	▪ South Ossetia endorses split with Tbilisi in an unrecognised referendum; Georgia accuses Russia of stirring things up
Apr 2007	▪ Georgia's parliament approves a law to create a temporary administration in South Ossetia, further raising tensions with Russia
Jun 2007	▪ South Ossetians claim that Georgia had attacked Tskhinvali, but Tbilisi denies this
Oct 2007	▪ Breakdown of talks between South Ossetia and Georgia organised by the OSCE
Apr 2008	▪ South Ossetia insists on full independence and rejects a deal of autonomy ▪ Georgia's bid to join NATO is deferred. Russia responds by recognising the independence of South Ossetia and Abkhazia
Jun 2008	▪ Abkhazia cuts all contact with Georgian government, blaming them for a series of attacks. Georgia denies this claim
July 2008	▪ An Ossetian village police chief is killed by a bomb and the head of the pro-Georgian "government" in South Ossetia, Dmitriy Sanakoyev, escapes injury by a roadside mine. The same night, both the Georgians and South Ossetians exchange artillery fire
	▪ A bomb blast in Tskhinvali, South Ossetia, kills one person. A few days later, both sides again exchange artillery fire
	▪ Five Georgian police are injured by a bomb blast
Aug 2008	▪ On the evening of 7 Aug 2008, South Ossetia accuses Georgia of launching a "massive" artillery barrage against Tskhinvali, while Georgia reports intense bombing of some Georgian villages in the conflict zone ▪ Georgia starts sending ground forces into South Ossetia
	▪ On 8 Aug 2008, Russian President Medvedev denounces Georgia's incursion into South Ossetia ▪ Russia launches large-scale air attacks in the region and elsewhere in Georgia. It quickly dispatches seasoned professional (serving under contract) troops to South Ossetia
	▪ Georgia tries to retake South Ossetia, in fights with by Russian-supported rebels
	▪ Russia launches a counter attack, claims its troops were responding to the assault. Russia and Georgia are at war
	▪ The two countries sign an EU brokered cease-fire agreement (13 Aug 2008), but Russia recognises South Ossetia and Abkhazia as independent states

Sources: BBC Georgia timeline, Reuters, Federation of American Scientists

Following the conflict, the EU and the World Bank jointly organised an International Donors Conference in October 2008 to mobilise external assistance to support Georgia's post-war reconstruction and recovery efforts. Prior to the conference, a Joint Needs Assessment (JNA) was carried out by the World Bank and the United Nations[5], with the EU delegation actively participating in the process. The JNA provided estimates of the financial assistance required to address Georgia's immediate and core investment needs. The actual physical damage and economic loss resulting from the conflict was limited; however, the JNA included estimates for additional investment/fiscal stimulus required to put Georgia back on its pre-conflict growth trajectory. Overall, Georgia's needs were estimated to be in the order of US$ 3.15 billion (c.EUR 2.14 billion[6]) over a three year period (see Table 2:2).

[5] Georgia: Summary of Joint Needs Assessment Findings prepared for the Donor's Conference of October 22, 2008 in Brussels. [online] Available at: http://siteresources.worldbank.org/INTGEORGIA/Resources/301645-1224598099977/GEJNA2008.pdf

[6] Based on annual average exchange rate for 2008: 1EUR = 1.4708 USD (source: European Central Bank)

Table 2:2 Joint Needs Assessment - Georgia's Funding Needs (October 2008), *all figures in US$ millions*

	1 Immediate Needs (to March 2009) *	2 Core Investment (to March 2010)	3 Core Investment (to Sept. 2011)	4=(1+2+3) Total: Immediate plus Core	5 Included in Budget/ Budget Support**	6=(4-5) Total Funding Needs
I. BUDGET SUPPORT	480	450		930		930
II. SOCIAL SECTOR	294	448	506	1,248	251	996
Return, Relocation & Resettlement	169	268	359	796	220	576
Social Protection	45	42	35	122	31	91
Education	19	16	18	53		53
Health	29	59	87	175		174.6
Agriculture & Livelihood	28	53		80		80
Employment	5	11	7	22		22
III.INFRASTRUCTURE	99	300	874	1,273	315	858
Transport	61	262	707	1,030	295	735
Energy	38	38	167	243	20	223
IV. URBAN AND MUNICIPAL	20	118	119	257		257
Water Supply and Wastewater	1	7		9		9
Urban and Municipal Roads	17	18	72	107		107
Urban Infrastructure Development,	1	81	35	117		117
Management contract related		12	12	24		24
V. ENVIRONMENT	2	2	3	7		7
TOTAL	**895**	**1,317**	**1,502**	**3,715**	**566**	**3,148**
BANKING SECTOR FUNDING* **	**500**	**200**		**700**		**700**

Source: JNA Staff Calculations .Included in Georgia Joint Needs Assessment Progress Report. June 30, 2009. Available at:
http://siteresources.worldbank.org/INTGEORGIA/Resources/JNAProgreessReport.pdf . Memo: Exchange rate of 1.405 Lari per US dollar used in converting estimates that were provided in Lari.
**Post-conflict damage related needs. **Corresponds to those items in columns 1 to 4 that have been identified as already funded through the regular budget or as included in donor budget support.*
**** Needs assessment relating to the banking system were in the nature of contingent costs.*

The October 2008 Donors Conference was a huge success - the total pledges made by donors (US$ 4.5 billion or c.EUR 3.06 billion) far exceeded expectations (US$ 3.15 billion c.EUR 2.14 billion). The largest bilateral pledges were made by the Governments of the United States (US$ 1 billion) and Japan (US$ 200 million)[7]. The EU pledged up to EUR 500 million (see Tables 2.2 and 2.3).

Table 2:3 Overview of Donor Pledges, US$ million

Donor	Pledge
World Bank	530
European Bank for Reconstruction and Development (EBRD)	927
Asia Development Bank (ADB)	300
International Finance Corporation (IFC)	350
European Investment Bank	330
USA	1,000
European Union	638
Japan	200
Bilateral pledges – EU Member States	178
Other bilateral donors	88
Total	4,535

Source: http://www.eeas.europa.eu/georgia/conference/donor_eur_en.pdf

Table 2:4 Details of EC pledges, by instrument, in EUR million

Instrument	2008	2009	2010	Total
ENPI	**105.4**	**84.9**	**44.7**	**235.0**
Of which additional funding (reinforcement)	62.1	50	0	112.1
Other non-crisis instruments (DCI, EIDHR, INSC)	**6.6**	**5**	**6**	**17.6**
Crisis instruments *of which:*	**70.5**	**83**	**78**	**231.5**
Humanitarian Aid	9	2	2	13
Macro Financial Assistance	11.5	46	46	103.5
Stability Instrument	15	15	15	45
Common Foreign and Security Policy (European Union Monitoring Mission)	35	20	15	70
Total	**182.5**	**172.9**	**128.7**	**484.1**

Source : Report on European Commission (EC) assistance to Georgia, December 2009. Available at: http://ec.europa.eu/europeaid/where/neighbourhood/country-cooperation/georgia/documents/report_on_european_commission_assistance_to_georgia_2009_en.pdf

Note: MFA of EUR 11.5 million (2008) represents the final tranche of the previous MFA operation(MFA 1) in Georgia (2006 to 2008) – this tranche was not disbursed as the condition relating to the Chamber of Control Law was not fulfilled on time by the Georgian authorities. MFA of EUR 46 million (2009) represents the operation which is the subject of this evaluation (MFA 2). MFA of EUR 46 million (2010) represents the third operation which is currently in the pipeline.

[7] Source: http://www.eeas.europa.eu/georgia/conference/donor_eur_en.pdf

In parallel to the above efforts, the IMF's Executive Board approved a US$ 750 million (c.EUR 510 million) Stand-By Arrangement (SBA) for Georgia in September 2008. These borrowing terms, above normal limits, reflected exceptional access and implied increased scrutiny from the IMF[8]. The primary objective of the IMF intervention was to counter the effects of the August 2008 armed conflict by supporting Georgia in its efforts to implement macroeconomic policies which would rebuild gross international reserves and bolster investor confidence[9]. The main elements of the IMF package were: limitation of the fiscal deficit; adherence to a cautious monetary policy (floor on net international reserves associated with a ceiling on net domestic assets); and, strengthening of the financial sector, notably via the reinforcement of the Financial Supervisory Agency[10].

The approval of the IMF-SBA opened the possibility of allocating the MFA budget line to Georgia. However, the timetable for the MFA operation was delayed due to changes in Georgia's economic situation (see section 2.1.2). Towards the end of 2008, the Georgian economy showed signs of recovery. Moreover, generous donor support and, in particular, the front loading of assistance by the IMF, the World Bank and the US in conjunction with Eurobond proceeds,[11] helped comfortably finance Georgia's fiscal deficit (arising from a countercyclical fiscal policy) and the balance of payments gap (stemming from a decline in private inflows) in 2008. In view of an improving economic situation, a relatively positive outlook for the future and a fear of damaging investor confidence in the country, the Georgian authorities decided not to draw the second tranche of the SBA upon completion of the first IMF review in December 2008 – see Table 2:5. As a result of this decision by the Georgian authorities, the preparation of the MFA decision was put on hold by the European Commission (according to the rules, EU MFA can only be provided as complementary financing to IMF funding). In 2009 however, Georgia's economy took a turn for the worse as the full impact of the global financial crisis became known (which had been far more severe than initially anticipated). Deteriorating economic conditions prompted the Georgian authorities to return to the IMF, and also to take full advantage of undisbursed donor support committed at the 2008 Donors Conference. Following its third review in August 2009, the IMF decided to extend the SBA until June 2011 and boost it by a further US$ 420 million (c. EUR 286 million). This paved the way for the approval of the MFA by the EU in November 2009[12].

The MFA was disbursed in two instalments: the first instalment of EUR 23 million was disbursed in two tranches of EUR 15.3 million (December 2009) and EUR 7.7 million (January 2010); and, the second instalment of EUR 23 million was disbursed in August 2010.

[8] IMF (2011) Factsheet dated 16 September 2011. [online] Available at http://www.imf.org/external/np/exr/facts/pdf/sba.pdf

[9] IMF (2008) IMF Executive Board Approves US$750 Million Stand-By Arrangement for Georgia. Press Release No. 08/208 dated 15 September 2008. [online] Available at : http://www.imf.org/external/np/sec/pr/2008/pr08208.htm

[10] ibid. See also: IMF Country Report No. 09/267. [online] Available at: http://www.imf.org/external/pubs/cat/longres.aspx?sk=23213.0

[11] In April 2008, Georgia successfully floated a dollar denominated US$500 million Eurobond issue. In the fourth quarter of 2008, the government used US$130 million of the Eurobond proceeds that were deposited in a NBG account ; the remainder of the Eurobond proceeds held in sovereign wealth funds (US$ 370 million) were to be used in 2009. Source: IMF Country Report No. 08/328, October 2008. [online] Available at: http://www.imf.org/external/pubs/cat/longres.aspx?sk=22403.0

[12] EC (2009) Council Decision of 30 November 2009 providing macro-financial assistance to Georgia. 2009/889/EC. [online] Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:320:0001:0002:EN:PDF

Table 2:5 Timeline for Approval and Disbursement of IMF and MFA Support

Timing	Event
03 Sep 2008	Following a request by the Georgian authorities for IMF support, an IMF mission reaches Agreement in Principle on a Stand-By Arrangement with Georgia for SDR 477.1 million (approximately $750 million, equivalent to 317.4 percent of Georgia's IMF quota)
09 Sep 2008	Georgian authorities submit a Letter of Intent to the IMF for financial support totalling SDR 477.1 million in the form of an 18-month SBA
12 Sep 2008	Georgian authorities submit a request to the European Commission to release the final tranche of MFA1 (EUR 11.5 million) and to approve a new MFA (EUR 46 million)
18 Sep 2008	IMF Executive Board approves SDR 477.1 million SBA for Georgia to support the Georgian authorities' macroeconomic policies, aiming to rebuild gross international reserves and bolster investor confidence. An amount equivalent to SDR 161.7 million (US$250 million) is released to Georgia
22 Oct 2008	An international donors conference is organised by the European Commission and the World Bank to mobilise external assistance in support of Georgia's post war recovery and reconstruction Donors pledge EUR 3.44 billion of financial assistance to Georgia
21 Nov 2008	U.S. Government transfers US$ 250 million (or 25% of the total support pledged by the U.S. at the donors conference) to the Government of Georgia[13]
01 Dec 2008	IMF completes first review under the SBA; instalment of SDR 63.1 million not drawn
23 Mar 2009	IMF completes second review; disbursement of SDR 126.2 million (about US$186.6 million)
06 Aug 2009	IMF completes third review under the SBA; disbursement of SDR 94.6 million IMF also approves an augmentation of the SBA by SDR 270 million (about US$423.5 million), and the SBA's extension to June 14, 2011. Altogether, the SBA represents SDR 747.10 million or USD 1,170 million (c. EUR 811 million) made available over approximately three years
30 Nov 2009	Approval of EUR 46 million MFA to Georgia (MFA 2)
11 Dec 2009	IMF completes fourth review under the SBA; disbursement of SDR 97.3 million
31 Dec 2009	EC disburses the first tranche of the first grant instalment[14] of MFA 2 amounting to EUR 15.3 million
15 Jan 2010	EC disburses the second tranche of the first grant instalment of MFA 2 amounting to EUR 7.7 million
19 Mar 2010	IMF completes fifth review under the SBA; disbursement of SDR 47.3 million
10 May 2010	The Georgian Minister of Finance requests the activation of the second part of the Commission pledge of MFA, amounting to EUR 46 million (MFA 3)
09 Jul 2010	IMF completes sixth review under the SBA; ; disbursement of SDR 50 million The Georgian authorities decide to treat the arrangement as precautionary going forward
05 Aug 2010	The second instalment of MFA 2 (EUR 23 million) is disbursed
12 Jan 2011	IMF completes seventh and eighth reviews under the SBA
13 Jan 2011	The Commission adopted a proposal for a Decision by the European Parliament and the Council to provide further macro-financial assistance amounting additional

[13] http://georgia.usaid.gov/news/press-releases/2008/11/21/351

[14] The first instalment of EUR 23 million was released in two tranches in December 2009 and in early January 2010

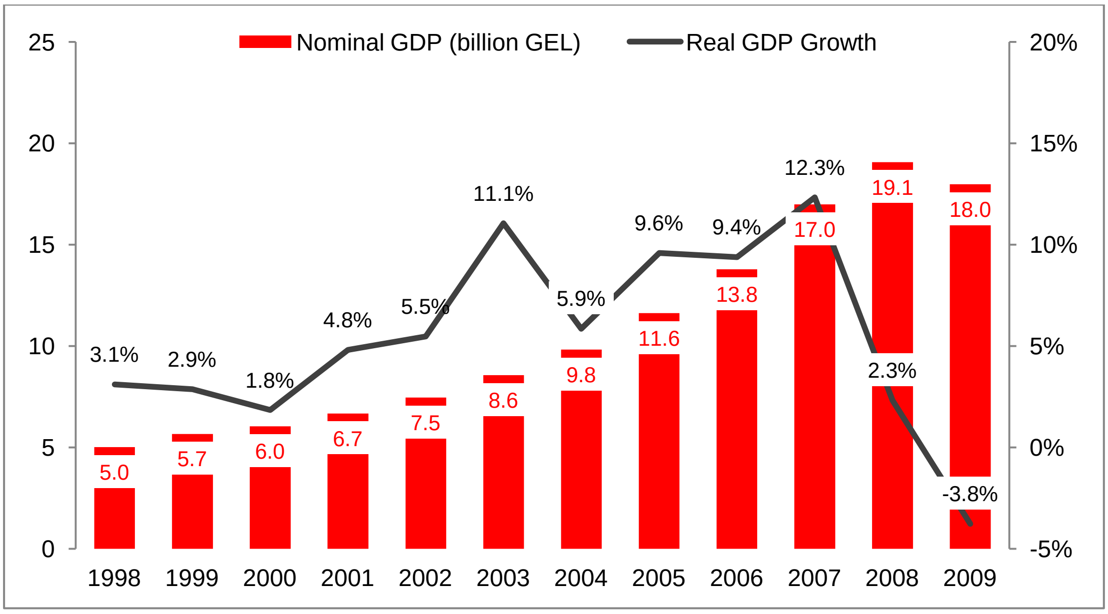
Timing	Event
	EUR 46 million to Georgia, with EUR 23 million in the form of a grant and EUR 23 million in the form of loan (MFA 3)
7 Apr 2011	The Georgian government successfully raises money from the international markets, issuing a US$ 500-million Eurobond at, according to the IMF, very favourable terms (10-year maturity and 7.125 per cent yield)
09 Jun 2011	IMF completes ninth and final review under the SBA
14 Jun 2011	The IMF 18-month SBA program expires as scheduled. Total drawings under the SBA come to SDR 577.10 million (about US$930 million – i.e. 77% of amount approved)

Source: IMF, EC documents

2.1.2 Economic Context: Deepening Recession in 2009

Georgia experienced solid economic growth prior to the armed conflict with Russia and the global financial crisis. Georgia's real GDP grew at an average annual rate of 6.6 per cent during the period 1998 to 2007, with growth rate peaking at 12.3 per cent towards the end of that period (Figure 2:1). This impressive growth in GDP was fuelled by strong domestic consumption (both, government and household spending) and large capital inflows, particularly Foreign Direct Investment (FDI) as investors responded positively to the post 2003 reforms which *inter alia* included liberalising the tax system, deregulation, making the process of starting a business much easier and privatisation of state owned enterprises, along with public sector reforms that included eliminating corruption, decreasing the number of government agencies and downsizing those that remained. Key international indices have reflected the success of these reforms: on the Doing Business Index Georgia's ranking improved from 137 in 2004 to 15 in 2008 (out of 181 economies)[15] and on the Corruption Perception Index its position rose to 67th place in 2008 (from 133rd in 2004)[16].

Figure 2:1 Nominal GDP and Real GDP Growth Rates, 1998 to 2009



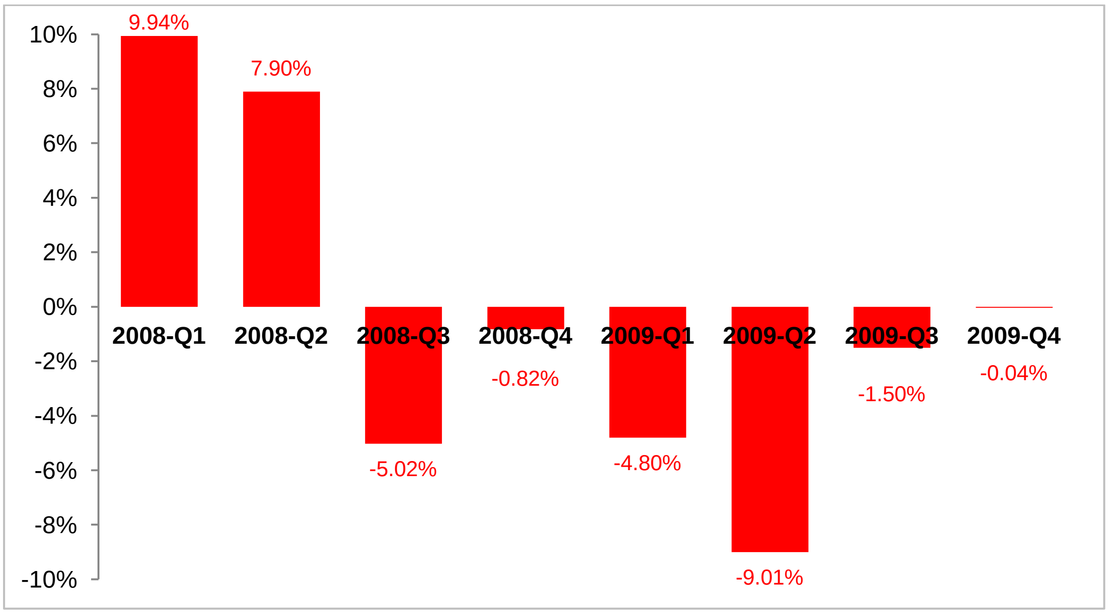
Source: Geostat

[15] International School of Economics at TSU - Doing Business in Georgia. Available at: http://www.iset.ge/files/doing_business_in_georgia.pdf

[16] http://www.transparency.org/policy_research/surveys_indices/cpi

Following a period of strong economic growth, Georgia's real GDP contracted in the third quarter of 2008, as a result of the armed conflict with Russia in August 2008 (Figure 2:2).

Figure 2:2 Quarterly GDP Growth Rate, 2008 to 2009



Source: Geostat; Note: change over same quarter previous year

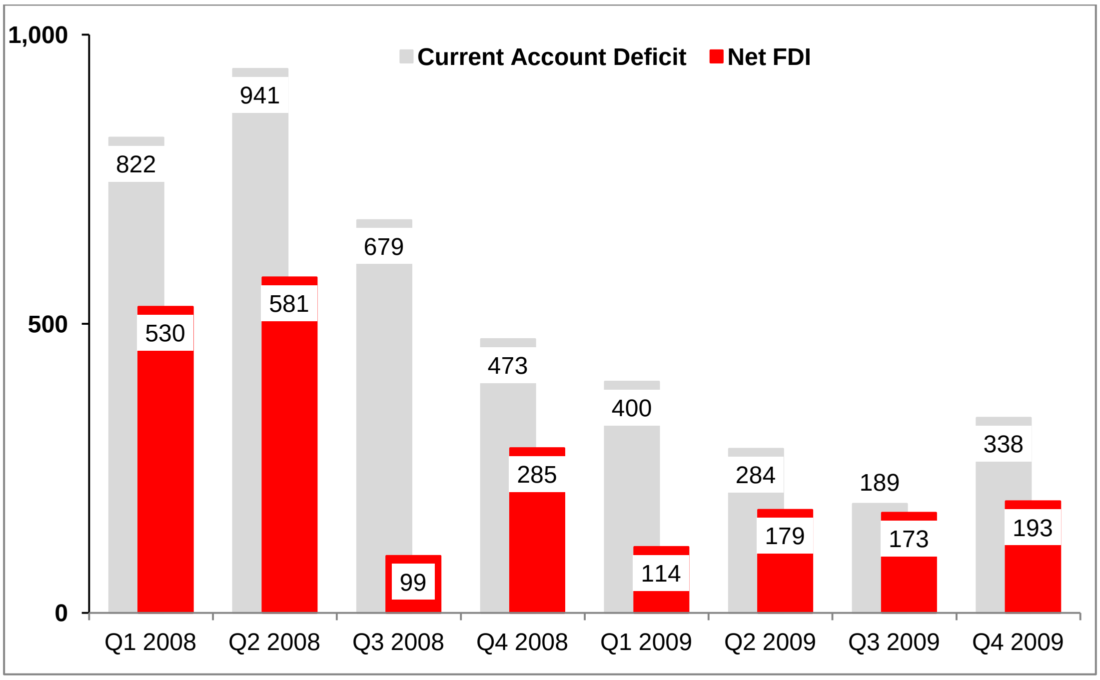
The immediate economic consequences of the armed conflict were (a) disruption of Georgia's transport infrastructure which hindered economic activity; and, (b) loss of investor confidence which led to a rapid fall in foreign investment (Figure 2:3). In parallel, there was a significant decline in the demand for Georgian exports (Figure 2:4). The overall drop in net foreign inflows put pressures on the exchange rate[17] (Figure 2:5) and contributed to a sharp fall in foreign exchange reserves – which declined by U$ 330 million (23 percent) between 6 August (the day before the conflict) and 31 August[18].

The loss of private sector confidence led to bank deposit withdrawals and a contraction in bank lending. Deposits held by commercial banks dropped by 13 percent in August 2008 in relation to the previous month, creating strong pressures on bank liquidity and constraining commercial lending to enterprises and households (Figure 2:6).

[17] During the August 2008 conflict, the authorities had announced a temporary peg of the Lari to the US dollar in order to provide a confidence-boosting anchor.

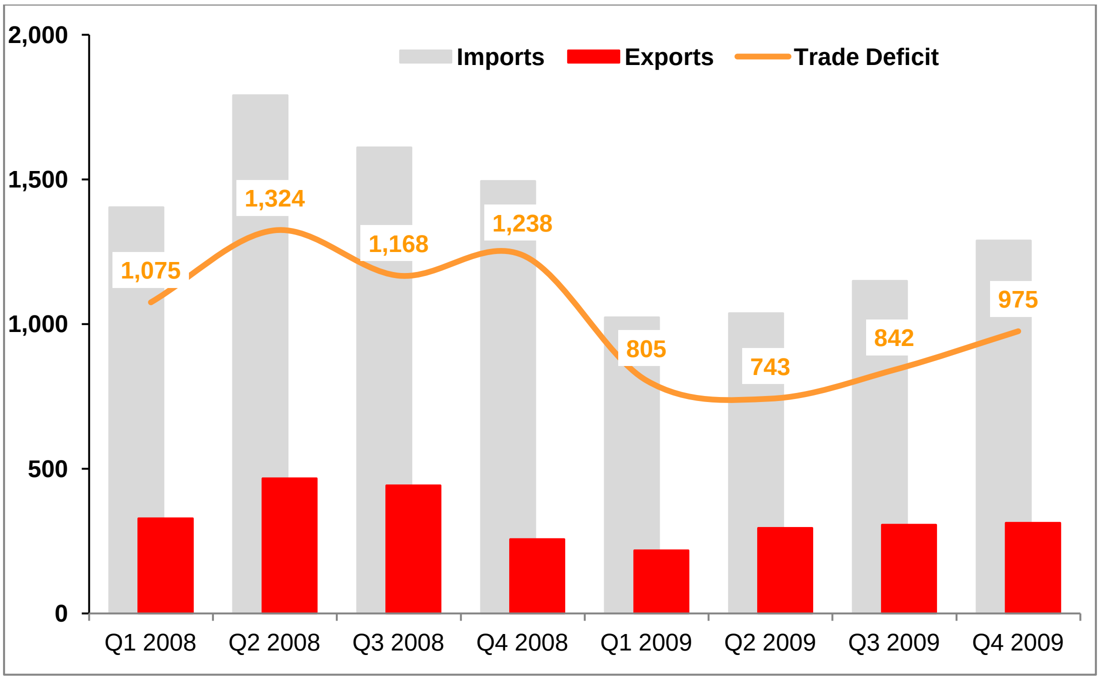
[18] IMF Country Report No. 09/267

Figure 2:3 Current Account Deficit and Net Foreign Direct Investment, US$ million, 2008 to 2009



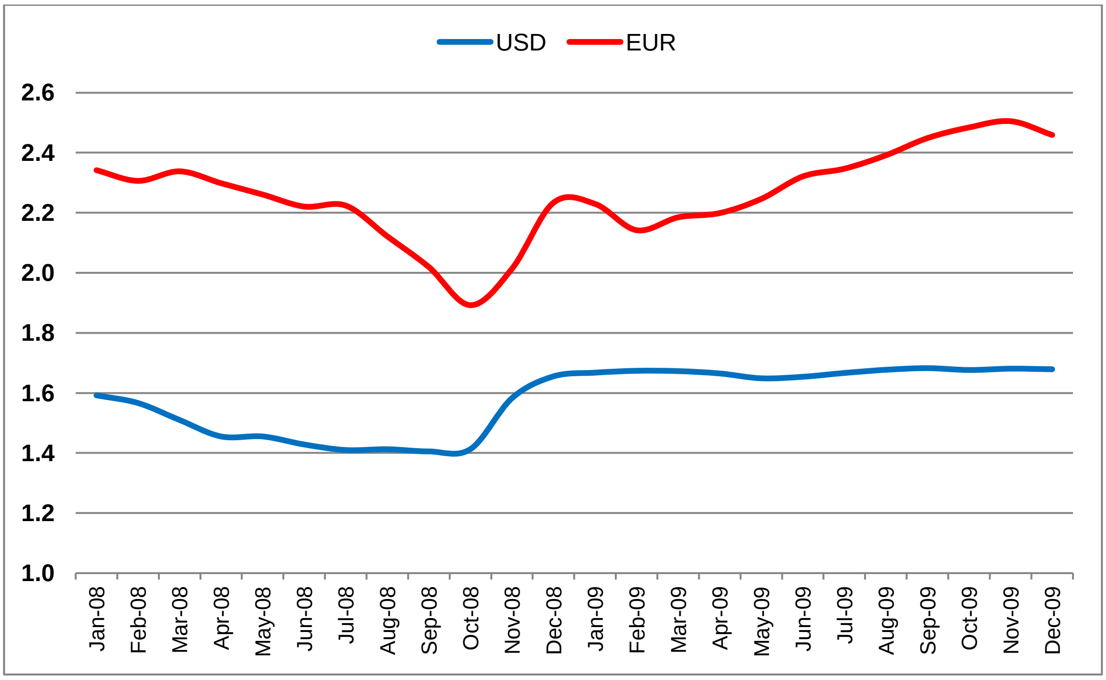
Source: National Bank of Georgia

Figure 2:4 Exports, Imports and Trade Deficit, US$ million, 2008 to 2009



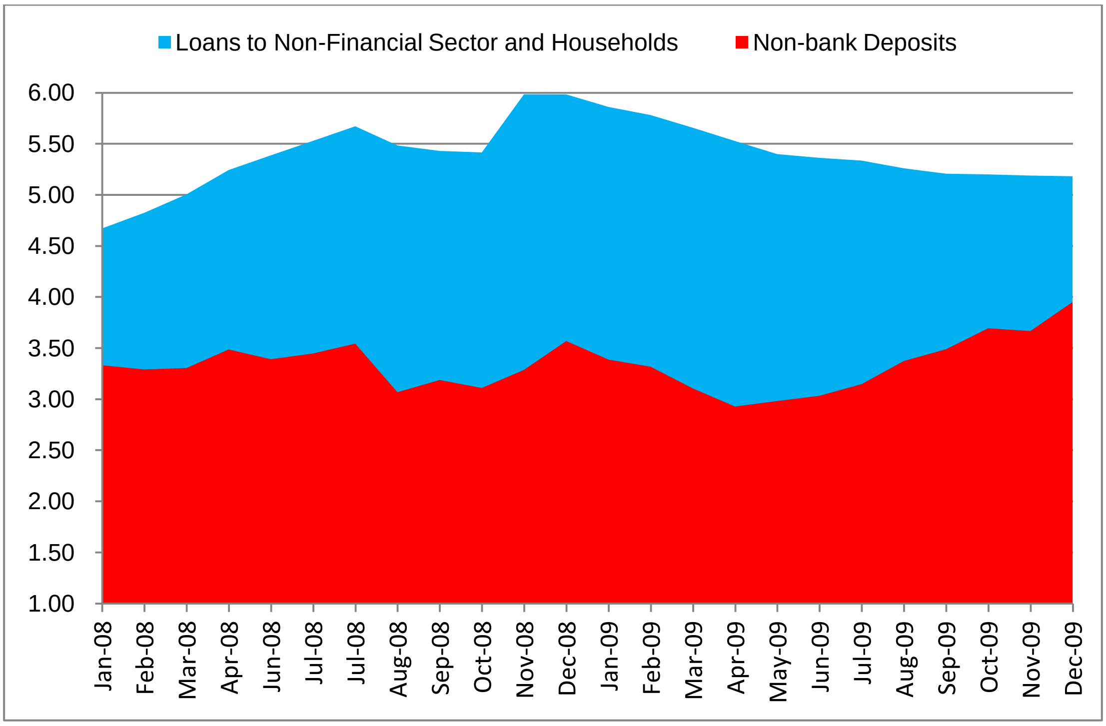
Source: National Bank of Georgia

Figure 2:5 GEL Monthly Average Exchange Rate, 2008 to 2009



Source: National Bank of Georgia

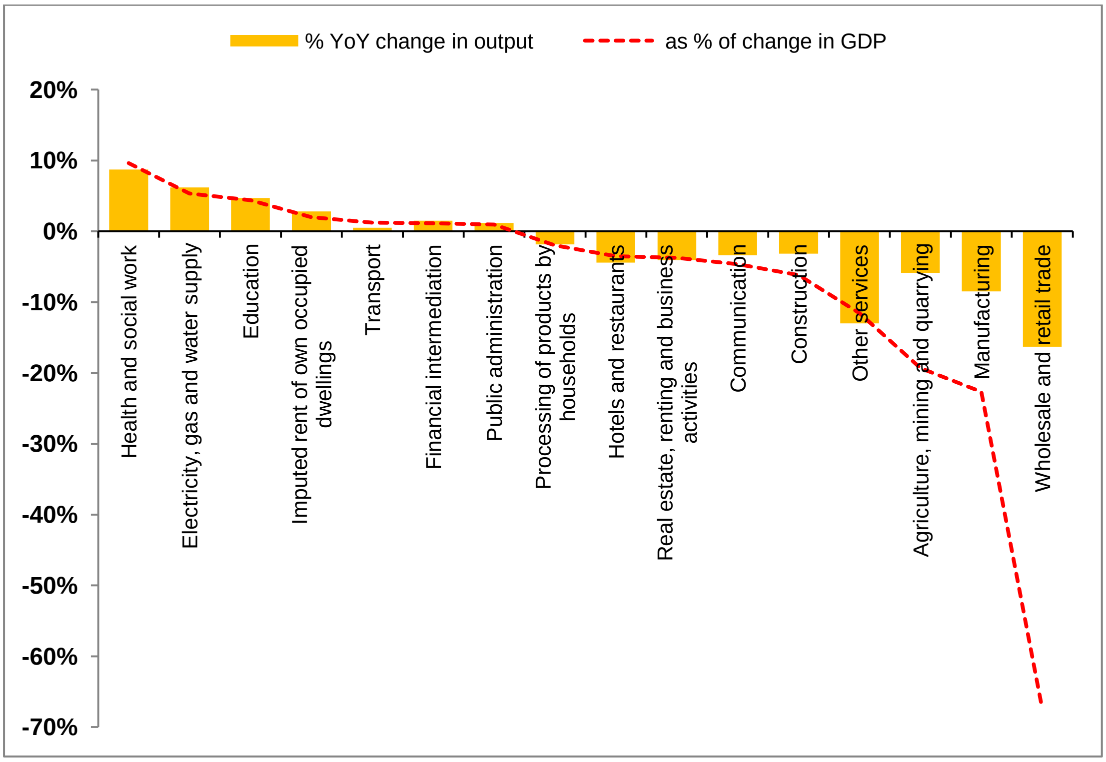
Figure 2:6 Commercial Bank Deposits and Lending, billion GEL, 2008 to 2009



Source: National Bank of Georgia; Notes: (a) Non-bank Deposits consist of deposits made by non-financial sector enterprises, households and the Government. (b) Data as of end of period

Uncertainty relating to the post-conflict security situation and the unfolding international financial crisis tipped the Georgian economy deeper into recession in 2009. While the contraction affected most sectors of the economy, retail trade, manufacturing and agriculture contributed most to the overall decline in economic output (Figure 2:7).

Figure 2:7 Change in Real GDP by Sector between 2008 and 2009



Source: Geostat

In November 2008, GoG announced a fiscal stimulus package of GEL 2.2 billion for 2009 to stimulate the economy via employment generating infrastructure projects, tax cuts and stronger safety nets (Table 2:6).

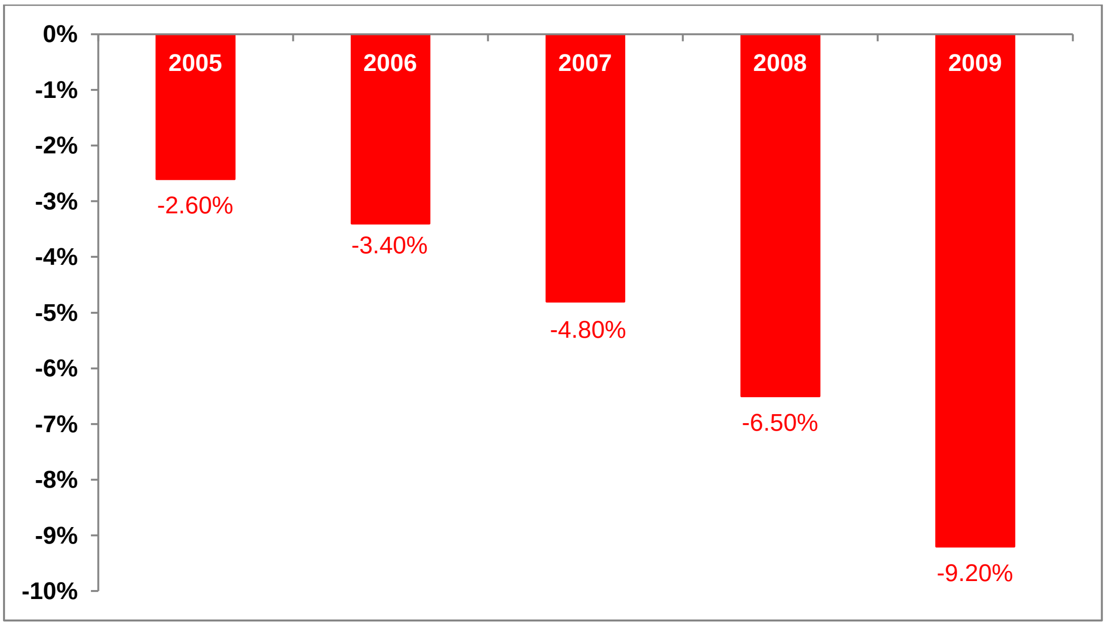
Table 2:6 Government of Georgia's November 2008 Fiscal Stimulus Package, GEL million

Key Element	Amount
Infrastructure Financing from State Budget	**1,450**
Comprising:	
Main roads (road dept.)	*520*
Other roads (MCG, MDF)	*180*
Water utilities	*120*
Regional projects	*150*
IDP housing	*140*
Educational infrastructure	*80*
Irrigation, river border construction	*30*
Other	*230*
Tax decrease	**250**
Donor financing, outside of budget	**500**
Total	**2,200**

Source: Ministry of Finance

The countercyclical fiscal policy pursued by the Government generated a fiscal deficit equivalent to 6.5 per cent of GDP in 2008 and 9.2 per cent of GDP in 2009 (Figure 2:8). The ability of the Government to maintain this fiscal deficit was crucially dependent on the availability of external financing, including MFA (see next section).

Figure 2:8 Fiscal Deficit (Cash Basis) as Percentage of the GDP, 2002 to 2009



Source: Ministry of Finance, Georgian Economy Overview (December 2011)

2.2 Main Characteristics of the MFA Operation

2.2.1 Size and Form of the MFA

In its initial assessment, the IMF estimated a total external financing gap of US$ 1.4 billion for the period 2008 to 2010 and a residual financing gap of US$ 650 million (Table 2:7). This assessment constituted the basis for the EU's MFA pledge which was expected to cover approximately 13 per cent of the cumulative residual financing gap for the period 2009 to 2010 (US$ 450 million)[19].

Table 2:7 Georgia's External Financing Requirements, US$ million, 2008 to 2010

	2008	2009	2010
Total financing needs*	**-3,251**	**-2,331**	**-2,602**
Current account balance	-2,757	-2,618	-2,513
Capital outflows: repayment of long term debt	-494	287	-89
Available funds	**2,701**	**1,681**	**2,402**
Capital inflows	2,567	2,165	2,598
of which:			
FDI	*1,237*	*1,198*	*1,452*
Private sector net inflows	*577*	*641*	*779*
Project grants	*138*	*234*	*186*
Disbursements to the public sector	*615*	*92*	*181*
Change in reserves	131	-485	-196
Financing	3	1	0
Debt rescheduling/ pre-payment	*3*	*1*	*0*
Financing gap	**-550**	**-650**	**-200**
IMF SBA	350	325	75
Residual financing needs	**-200**	**-325**	**-125**

*Source: IMF Country Report; * =current account balance + capital outflow*

The MFA was exceptionally provided entirely in grant form in view of the difficult circumstances facing Georgia and its geo-political significance for the EU, as reflected in the framework of the European Neighbourhood Policy and the Eastern Partnership (Figure 2:9).

[19] 13% X US$ 450 million = US$ 58.5 million ~ EUR 42 million

Georgia ranks high among EU's external priorities: among the countries covered by the Eastern Partnership (which includes Georgia, Armenia, Azerbaijan, Belarus, Moldova and Ukraine), it is one of the front runners.

There are several factors explaining this, most notably:

- Since the 'Rose revolution', Georgia has pursued closer ties with the EU. The EU has shown reciprocity, to match Georgia's expectations and to support democracy in the region.
- Georgia is considered an ally by the EU Member States.
- Georgia is an increasingly important transit country for oil and gas from the Caspian basins, which also benefits the EU. It is in the EU's economic interest to continue to maintain close relations with Georgia as it contributes to the EU's goal of energy security.

The deepening and broadening of relations under the Eastern Partnership (EaP) framework took a step forward in July 2010 with the launch of negotiations on an EU-Georgia Association Agreement (AA). These negotiations are progressing well. So far, six rounds of negotiations have take place and a new round is expected to be launched in October 2012. This new Agreement will imply a Deep and Comprehensive Free Trade Area (DCFTA) and a comprehensive programme of approximation to EU acquis. The negotiations on a DCFTA were launched in December 2011.

Figure 2:9 Framework for EU-Georgia Relationship

Overall objective: To promote stability, security and well-being in the region, in the mutual interest of the EU and its neighbours, through commitments to shared values and the encouragement of effective implementation of political, economic, social and institutional reforms in partner countries.

Strategic framework:

European Neighbourhood Policy:
Provides a framework for the relationship between the EU and its new neighbours following the fifth enlargement.
Strategy adopted in 2004

Eastern Partnership:
Provides a framework for the relationship between the EU and the countries in Eastern Europe and the Southern Caucasus
Launched in 2009

Implementing tools:

EU-Georgia Action Plan
Identifying priorities in line with partner countries' economical and political reform strategies
Monitored by the bodies created under the PCA Cooperation Council, Cooperation Committee and subcommittees)
Periodically reviewed by the EC (progress reports)
Approved in 2006 for a period of five years.
Following expiration, succession document to be adopted

1999 Partnership and Cooperation Agreement:
Promoting political dialogue, trade & investment, and cooperation in the economic, legislative, judicial and cultural areas.
1996: conclusion of the PCA
1999: entry into force of the PCA

Under the Eastern Partnership, a new generation of Association Agreements is foreseen
2010: Launch of negotiations with Georgia

Financial instruments/technical assistance:

European Neighbourhood and Partnership Instrument (ENPI - successor of the TACIS Programme), delivered via:
- Country programme
- Multi-country programmes
- Thematic programmes

In synergy with:
- Horizontal thematic programmes such as Stability Instrument or the European Initiative for Democracy and Human Rights (EIDHR)
- EIB's lending via its 2007 - 2013 Mandate, Eastern Partners Facility, Energy Sustainability and Security of Supply Facility

2.2.2 Stated Objectives of the MFA Operation

According to Council Decision 2009/889/EC and the accompanying Memorandum of Understanding, the objective of the MFA operation was to *'support Georgia's efforts of post-war economic recovery'* and in particular, '*to help the Country's government address residual external financing needs'*.

2.2.3 Policy Conditionality

The Memorandum of Understanding accompanying the Grant Agreement signed between the European Commission and the Government of Georgia included the following policy conditionality:

- The IMF SBA being on-track (for both instalments), and
- Satisfactory progress in reforms in the field of Public Finance Management (PFM) (for the second instalment).

The second set of conditions focused on four key fields of PFM: internal control, external control, public procurement and budget process (see Box 2:1).

Box 2:1 MFA Conditionality relating to PFM Reforms

Overall PFM Reforms

Condition 1: In the framework of the Reform Policy Vision 2009-2013, the Ministry of Finance prepares and makes available to the wider public the Action Plan for 2010 that provides a clear roadmap for monitoring the PFM reforms, including consultations with all relevant stakeholders.

Internal Control and Internal Audit

Condition 2:

(2a) The Parliament of Georgia adopts the Law on Internal Audit and Inspection.

(2b) In the framework of the PIFC Policy Paper and the Law on Internal Audit and Inspection, the Government endorses, and the Ministry of Finance makes available to the wider public an Action Plan on internal audit for 2010.

External Audit

Condition 3: The Chamber of Control (CoC) adopts and makes available to the wider public a capacity development plan that elaborates on organisational needs and resources of the Chamber of Control for 2010-2011 (human resource, training, and equipment needs).

Public Procurement

Condition 4:

(4.a) The State Procurement Agency (SPA) prepares an Action Plan for the implementation of the e-procurement system.

(4.b) The SPA implements the e-procurement system in the sequence prescribed by the amended Public Procurement Law.

(4c) The SPA provides training on the amended Public Procurement Law to the personnel of the Agency and to the personnel of the selected line Ministries on the basis of the training strategy

Budget Process

Condition 5: The Parliament of Georgia adopts the Budget Code with provisions on programme-based budgeting.

Condition 6: The Ministry of Finance prepares and makes available a timetable for the implementation of programme-based budgeting.

Source: Annex 1 to the Memorandum of Understanding between the European Commission representing the European Union and Georgia

Documentary evidence and interviews with Commission officials suggest that MFA conditionality was based on a consideration of the following issues:

- MFA, by design, is a quick disbursing crisis instrument. The primary purpose of an MFA operation is to fill a financing gap. A secondary consideration is to introduce or reinforce structural reforms in the recipient country. Therefore, any conditionality relating to structural reforms needs to be based on a realistic assessment of what can feasibly be implemented within the timescales available for the MFA operation.
- The Commission services had worked closely with the Georgian authorities on PFM reforms in the context of the previous MFA operation, Food Security Programme and sector budget support under the ENPI (Table 2:8). The MFA conditionality thus represented continuity of previous reform efforts.
- The World Bank and the European Commission had financed a joint Public Expenditure and Financial Accountability (PEFA) assessment in Georgia in 2007-2008. The PEFA was published in November 2008 although the analysis and assessment was undertaken in the main mission held during May-June 2007 (providing mid-2007 as the baseline) [20]. In parallel, and based on the PEFA findings, the Finance Ministry prepared its own Reform Policy Vision 2009-2013 and Action Plan for 2009 on public finance management. These documents highlighted the remaining challenges in Georgia's PFM system and provided the basis for selecting MFA conditionality.
- Negotiations with Georgian authorities to identify areas where there was domestic ownership of reform.
- Lessons learned from previous MFA operations which highlighted the need to streamline conditionality and focus on select areas of reform.
- The desire on part of the European Commission to focus on areas where they could have a meaningful policy dialogue with the Georgia authorities.

[20] World Bank (2008), WB Report No. 42886-GE, Georgia Public Expenditure and Financial Accountability (PEFA), Joint World Bank-European Commission Public Financial Management Assessment, November 2008

Table 2:8 Overview of EU Sector Policy Support Programmes in Georgia focusing on PFM Reforms

	Food Security Programme (2005-2007)	Macro Financial Assistance (2006-2008)	EU Sector Policy Support Programmes Phase I (2007 – 2009)
EU Support:	EUR 20 million	EUR 33.5 million	EUR 16 million of which: ▪ Budget support: EUR 15 million ▪ Technical Assistance: EUR 1 million
Conditionality:			
Overall planning and monitoring of the PFM Reform Agenda	▪ SC (2005): Approval of the Basic Data and Directions (BDD) Document, produced through the MTEF process and in consultation with pilot line ministries ▪ SC (2006): Significant progress in MTEF elaboration and use ▪ SC (2006): a detailed programme based MTEF for FY2007-9 for the MoA submitted to Parliament with the budget for FY2007		▪ Preparation of PFM Action Plan with time bound result-based indicators (2008) ▪ Implementation, monitoring, evaluation, reporting and consultation on PFM reform agenda by GoG and making information available to wider public (2009)
Treasury reforms – improvement in Accounting System	▪ SC (2005): Implementation of the Treasury Single Account as part of the completion of the Treasury Reform process	▪ Adoption and initiation of a strategy to produce annual consolidated financial statements in accordance with international accepted accounting and reporting standards ▪ Complete centralisation of the Treasury Service of the MoF database and implementation of Treasury general ledger, incorporating GFS 2001 compliant budget classification ▪ Establishment of a database of all LEPLs and definition of their financial and performance reporting requirements	▪ Making operational the Treasury General ledger incorporating GFSM 2001 budget classification (2008) ▪ Preparation of State Budget 2008 execution report pursuant to GFSM 2001 standards (2009)
Development of External Audit		▪ Amendment of draft law on CCG to elevate its mandate and responsibilities to a supreme audit institution in line with INTOSAI standards	▪ Submission of draft law to the Parliament on the transformation of Chamber of Control (CCG) into a supreme external audit institution in line with international standards i.e. INTOSAI principles and

	Food Security Programme (2005-2007)	Macro Financial Assistance (2006-2008)	EU Sector Policy Support Programmes Phase I (2007 – 2009)
		▪ Satisfactory implementation of new legislation on the CCG and its reorganisation plan ▪ Development of a modernised set of audit instructions and audit methodology fully compliant with INTOSAI standards for CCG auditors	standards (2007) ▪ Preparation and adoption of Audit Management Policy and Procedure Guidelines by the CCG (2008) ▪ Adoption of law on CCG (2008) ▪ Approval of CCG Audit Management Policy and Procedure Guidelines which are fully aligned with INTOSAI standards (2009)
Improvement in public finance internal control systems and internal audit		▪ Development of a strategic note on the appropriate organisation and functions of internal audit in the Central Government ▪ Development of a strategic note with a clear time plan for the introduction of appropriate internal control frameworks within budget organisations, starting with the elaborations of generic minimum requirements	▪ Approval by the Government of a policy paper and action plan for the gradual introduction of a harmonised public finance internal control system (managerial accountability and internal audit) (2008) ▪ Preparation and submission of a draft law to the Parliament on public finance internal control and internal audit compliant with international best practices and EU standards (2009)
Improvement in public procurement			▪ Establishment of a Public Procurement Working Group to assess options for developing a Public Procurement Management Framework and policies (2007)
			▪ Approval by the Cabinet of an action plan – based on Working Group recommendations – aimed at restructuring the legal and regulatory framework for public procurement (2008) ▪ Submission to the Parliament of an enhanced public procurement legal and regulatory framework in line with international best practice (2009)

	Food Security Programme (2005-2007)	Macro Financial Assistance (2006-2008)	EU Sector Policy Support Programmes Phase I (2007 – 2009)
			▪ Preparation of SPA Public Procurement management Policy and Procedure guidelines (2009)
Strengthening revenue service			▪ Further development and approval of the Revenue Service Corporate Strategy and Procedure Guidelines for all aspects of customs control and tax payers audit service based on risk analysis (2008) ▪ An Internal Audit function in MoF is operational, monitoring the implementation of rules and documentation of all organisational units describing the scope of responsibilities, authorities, accountabilities, objectives and procedures written to new standards and approved by the MoF (2009)
Budget process		▪ Development and implementation of a MTEF-based budgetary process involving an increasing number of line ministries ▪ Improving policy content of annual budget preparation and execution ▪ Strengthening of capacities in the Ministry of Finance and in line ministries to support interaction process in the MTEF/budget preparation and management	

Source: DEVCO, European Commission (Document References: Matrix PFM EC AP 2007, Ex-post Evaluation of MFA operations in Georgia)

2.2.4 Ex-ante Intervention Logic of the MFA Operation in Georgia

Figure 2:10 illustrates the *ex-ante* intervention logic of the MFA operation in Georgia. The MFA grant provided to Georgia was intended to induce a number of macroeconomic effects. The intended short-term effect of the MFA was to help ease a financing gap i.e. a fiscal deficit and BoP difficulties. For Georgia, the assistance was provided as a grant i.e. a transfer of funds from overseas to the Government (not requiring repayment). The initial (first-round) effect of such a financial transfer, other things being equal, would normally be as follows:

- An immediate improvement in the current account (and, in turn, the BoP); and,
- An increase in government revenue.

However, the extent to which these effects would actually materialise as intended would depend on the economic response to the intervention, specifically:

- How government finances were restructured or reallocated i.e. did the MFA help to reduce the fiscal deficit (the intended effect) or was it used to finance incremental public expenditure and thus, maintain the fiscal deficit. Indirectly, changes in expenditure may lead to changes in output/income that would in turn affect the level of government tax revenue.
- The trade response i.e. the extent to which other BoP items such as imports and flows of foreign exchange reserves changed as a result of MFA. An increase in the former would lead to a greater BoP deficit (cancelling out some of the improvement from the original transfer). A combination of the two is likely i.e. it would be surprising if the entire transfer was cancelled out by an increase in imports.

The MFA was relatively small in size, suggesting a small first-round effect; however, the contribution of the secondary effects on the Georgian economy (which may compensate for some of the initial effects) is also an important consideration when assessing the MFA.

In the longer term, the MFA was intended to alter (stabilise) the trajectory of the Georgian economy, through the following channels:

- Improved access to credit/ money supply, easing the financial conditions in the economy;
- Lower levels of debt (relative to GDP) and lower debt-servicing requirements; and,
- Improved public finances.

Moreover, in the long term, the above effects would also bolster confidence in the economy, further stimulating growth in the real economy and alleviating BoP difficulties.

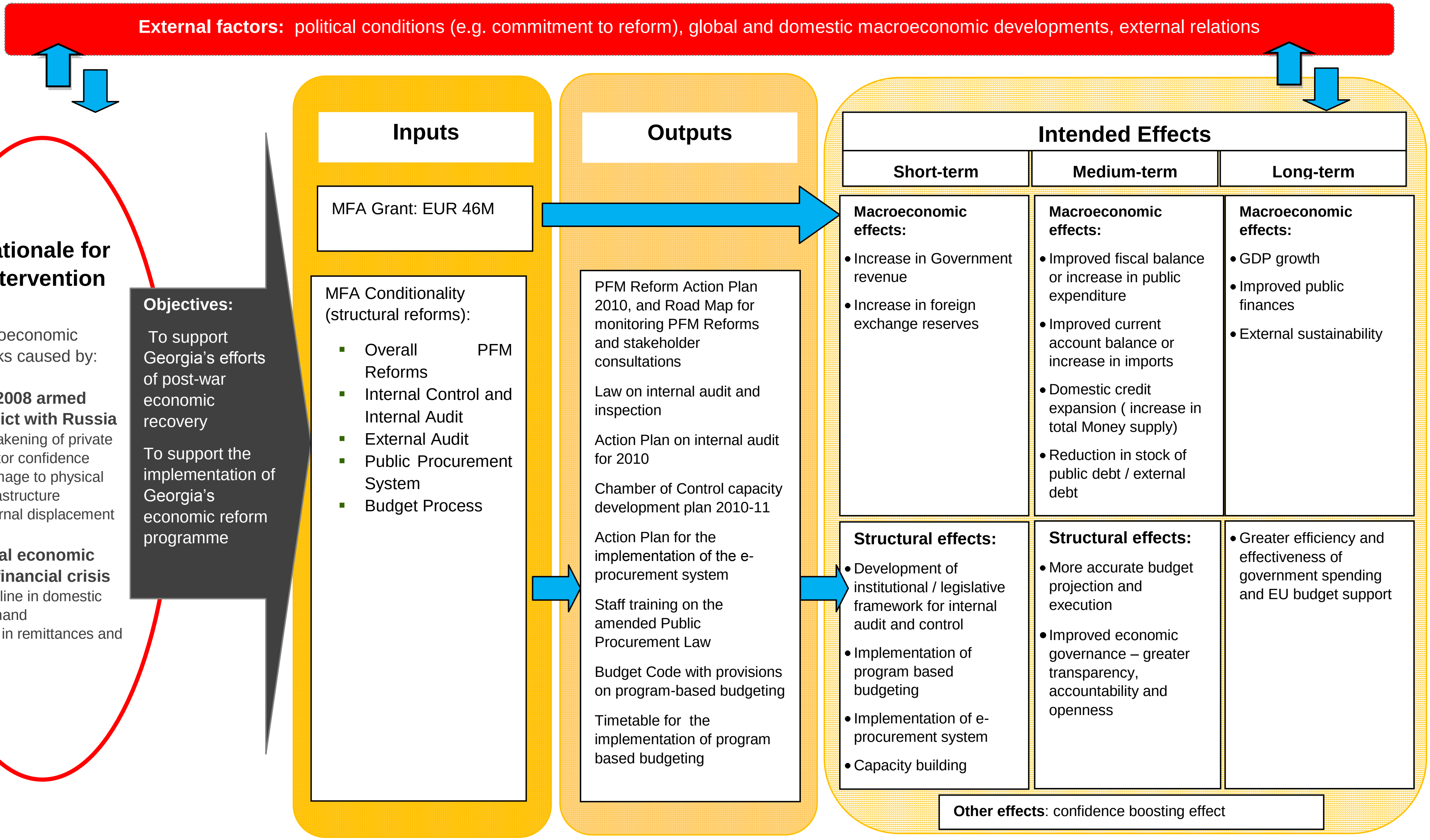
As regards the effects of PFM reforms, the intervention logic reflects that:

- MFA conditionality was intended to have some reinforcing effect on GoG's commitment to PFM reforms;
- Given the nature of the conditionality, it would be reasonable to assume that the short-term effects of the MFA specific conditionality would be limited to the development of institutional / legislative framework for internal audit and control; implementation of programme-based budgeting; implementation of e-procurement system; and, capacity building in the areas of external audit and public procurement;
- In the medium term, these reforms could be expected to improve budgeting processes and economic governance within the country;
- PFM reforms did not have the potential to generate macroeconomic effects within the short to medium term;

- In the longer term, PFM reforms could be expected to contribute to improved efficiency and effectiveness of public spending and budget support.

The subsequent sections of the Report verify the extent to which the actual effects of the MFA intervention reflect the outcomes hypothesised above (and as depicted in the intervention logic).

Figure 2:10 Ex-ante Intervention Logic of the MFA Operation in Georgia



3 SHORT-TERM MACROECONOMIC IMPACT OF THE MFA

This section addresses the following two evaluation questions: (1) how would the economy of Georgia have evolved in the absence of the MFA? (2) to what extent has the MFA assistance been effective in terms of the short-term macroeconomic stabilisation of Georgia? In order to answer the first question, it is necessary first to understand what actually happened as observed in the macroeconomic data. This provides the context for defining the potential counterfactual scenarios and outcomes, and determining the net impact of the MFA on short-term macroeconomic stabilisation of Georgia as the difference between the actual and counterfactual outcomes.

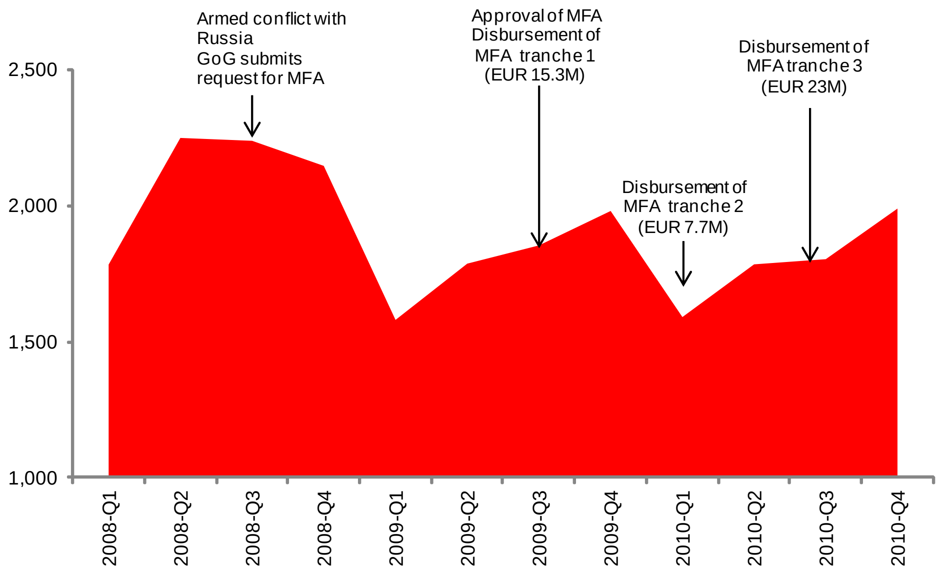
3.1 Actual Macroeconomic Outcomes

This section describes the actual macroeconomic outcomes over the period of the MFA operation (2009 to 2010).

3.1.1 Economic Output and Growth

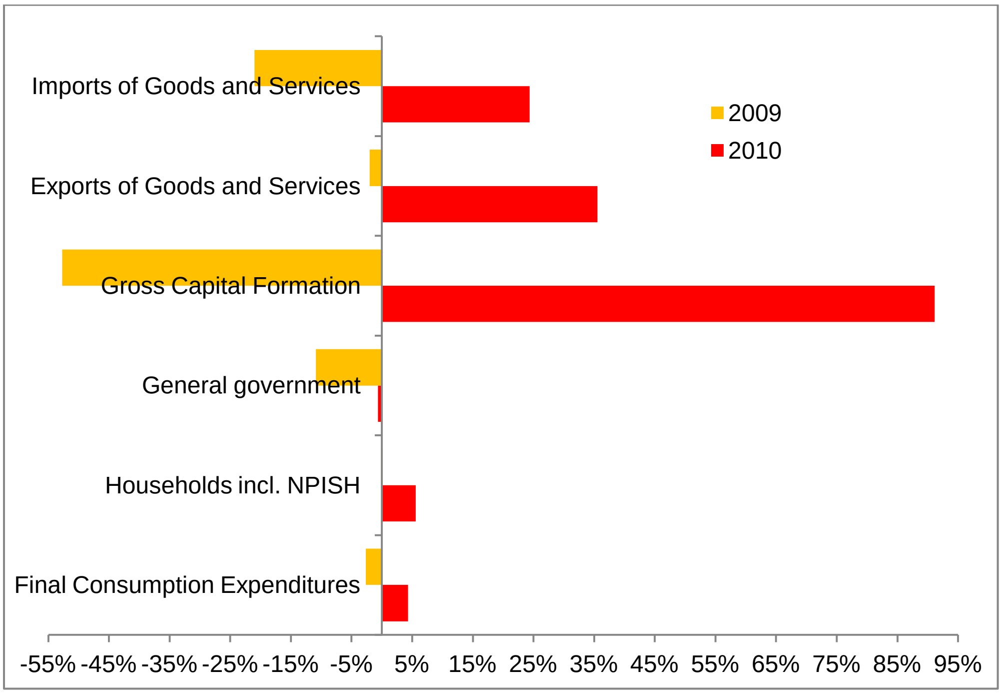
After a temporary setback in 2009, Georgia experienced an upturn in economic activity in the second half of 2009 that broadly continued into 2010 (Figure 3:1). Real GDP is estimated to have grown by 6.3 per cent in 2010, driven by a strong recovery in investment and exports (Figure 3:2).

Figure 3:1 Quarterly GDP at Constant 2003 Prices, 2008 to 2010



Source: Geostat

Figure 3:2 Year of Year Growth in Components of GDP, 2009 to 2010



Source: Geostat; Based on data in current prices. data on breakdown of GDP in constant prices is not yet available on Geostat

3.1.2 Gross Value Added by Sector

All of the main sectors of the economy, bar construction, expanded in year-on-year terms in the second quarter. The fastest growth rates were recorded in the manufacturing sector (20.31 per cent); sale of used cars (14.14 per cent); hotels and restaurants (11.6 per cent); hotels and restaurants (12.95 per cent); transport and communications (10.74 per cent); and the financial sector (29.1 per cent), reflecting the ongoing recovery in the banking system – Table 3:1.

Table 3:1 Growth in real GVA by Sector, 2005 to 2010

	2005	2006	2007	2008	2009	2010
GDP at basic prices	10.38%	9.59%	11.58%	2.64%	-4.06%	7.19%
Agriculture, hunting and forestry; fishing	12.03%	-11.70%	3.27%	-4.43%	-6.79%	-1.73%
Mining and quarrying	-7.83%	18.72%	19.93%	16.69%	9.38%	4.74%
Manufacturing	14.09%	22.28%	11.55%	-1.48%	-8.49%	20.31%
Electricity, gas and water supply	5.14%	13.42%	6.80%	3.67%	6.19%	2.10%
Construction	14.08%	8.53%	14.63%	-11.08%	-3.15%	7.60%
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	9.37%	19.71%	9.65%	11.78%	-16.29%	14.14%
Hotels and restaurants	16.62%	10.49%	11.36%	4.90%	-4.42%	12.95%
Transport and communications	10.88%	15.71%	10.88%	-1.54%	-0.92%	10.74%
Finance and business services	14.76%	16.02%	14.88%	3.23%	-0.25%	8.68%
Public services	4.61%	8.89%	11.61%	9.71%	5.24%	2.23%
Miscellaneous services	14.31%	4.81%	26.01%	-1.74%	-6.78%	2.34%

Source: Geostat; data excludes Financial Intermediation Services Indirectly Measured (FISIM)

There is some evidence of structural change in the Georgian economy over time, with a general trend of decline in agricultural value added. Agriculture continued to suffer in the crisis with its share of GVA falling to less than 12 per cent in 2010 (see Table 3:2) possibly, exacerbated by trade sanctions imposed on Georgia by Russia.

In contrast, manufacturing GVA grew strongly before the crisis. Manufacturing output fell during the crisis, particularly in 2009, when export demand fell, before recovering strongly in 2010, with growth of more than 20 per cent. Post-crisis, manufacturing is now the second largest industry in the Georgian economy, accounting for 11.5 per cent of GVA in 2010. The largest industry in GVA terms is now distribution, comprising principally wholesale and retail trade, representing Georgia's continued transition from an agrarian to a services and manufacturing-based economy.

In 2010, the service industries accounted for around 65 per cent of total value added in Georgia, up from around 60 per cent in 2005. Driven by the expansion of manufacturing, the share of the broader industrial sectors also increased, from around 14 per cent in 2005 to more than 16 per cent in 2010. While construction's share of GVA has fallen (from around 9 per cent in 2005 to 8 per cent in 2010), this is due to the relatively strong contractions in output in 2008 and 2009 during the crisis, owing to the sharp reductions in investment spending and funding from capital inflows. Financial services is one of the few market-sector industries to experience sustained annual growth over the period 2005 to 2010 (in contrast to the decline in finance and business services more broadly in 2009) and while its share in total GVA remains modest (around 3 per cent) it is expected to form an important part of Georgia's new economy.

Table 3:2 Breakdown of (real) GVA by Sector, 2005 to 2010

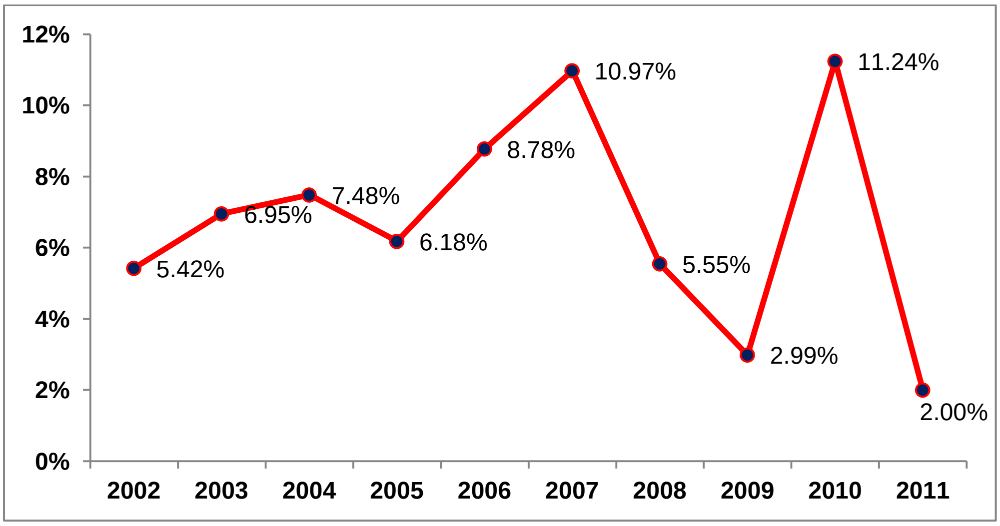
	2005	2006	2007	2008	2009	2010
Agriculture, hunting and forestry; fishing	18.20%	14.66%	13.57%	12.63%	12.27%	11.25%
Mining and quarrying	0.59%	0.64%	0.69%	0.78%	0.89%	0.87%
Manufacturing	10.13%	11.30%	11.30%	10.84%	10.34%	11.61%
Electricity, gas and water supply	3.49%	3.61%	3.45%	3.49%	3.86%	3.68%
Construction	9.05%	8.96%	9.21%	7.98%	8.05%	8.08%
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	14.35%	15.68%	15.41%	16.78%	14.64%	15.59%
Hotels and restaurants	3.15%	3.18%	3.17%	3.24%	3.23%	3.40%
Transport and communications	15.04%	15.88%	15.78%	15.14%	15.64%	16.16%
Finance and business services	8.81%	9.33%	9.61%	9.66%	10.05%	10.19%
Public services	10.95%	10.88%	10.88%	11.63%	12.76%	12.17%
Miscellaneous services	7.82%	7.48%	8.44%	8.08%	7.85%	7.50%

Source: Geostat; data excludes Financial Intermediation Services Indirectly Measured (FISIM)

3.1.3 Inflation

Headline inflation in Georgia is driven largely by the price of fuel and food - the weight attached to food in the Consumer Price Index (CPI) basket is 39 per cent. While the price level increased at a relatively constant rate of around 5 per cent per year during the first half of the decade, rising global food and energy prices led to sustained upward pressure on inflation between 2005 and 2007 (Figure 3:1). However, the rise was temporary and not due to structural factors, a fact affirmed by the sharp drop in average inflation to around 3 per cent in 2009 as a result of lower international prices for food, fuel and raw materials, as well as the domestic economic slowdown which resulted in reduced demand. In 2010, inflationary pressures were higher, due to global commodity prices, a bad agricultural harvest and renewed domestic demand growth, and for the year the average inflation rate rose over 11 percent. NBG's monetary policy seeks to control inflationary pressures by affecting interest rates[21], but the impact of the rate changes is diminished by the high degree of dollarisation of the economy. Nevertheless, NBG lowered the refinancing rate from 12 per cent in mid-2008 to 5 per cent by the end of 2009 in order to stimulate the economy. As the economy recovered, NBG raised refinancing rates to 7.5 per cent by end 2010, and then to 8.0 per cent in February 2011. The NBG maintained its refinancing rate at that level until July 2011 when it reduced it to 7.75 per cent as inflationary pressures eased due to weakening of demand. By the end of December 2011 the refinancing rate was lowered to 6.75 percent. The annual inflation in 2011 was comfortably below the Central Bank's inflation target.

Figure 3:3 Consumer Price Inflation, year-end, 2002 to 2011



Source: Geostat

3.1.4 Public Finances

Georgia has greatly improved fiscal management over the years, and in particular has achieved success in increasing and broadening the revenue base, while it has also rationalised expenditures via tools such as medium term expenditure planning frameworks. After a period of strong double-digit growth (averaging 30 per cent on an annual basis) over the period 2002 to 2008, total tax revenue fell by 8 per cent in 2009, but grew again in 2011 by 11 per cent – Table 3:3.

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[21] The Bank's inflation target for 2011 to 2013 is 6 per cent

Table 3:3 Consolidated Budget of the Government, 2002 to 2010

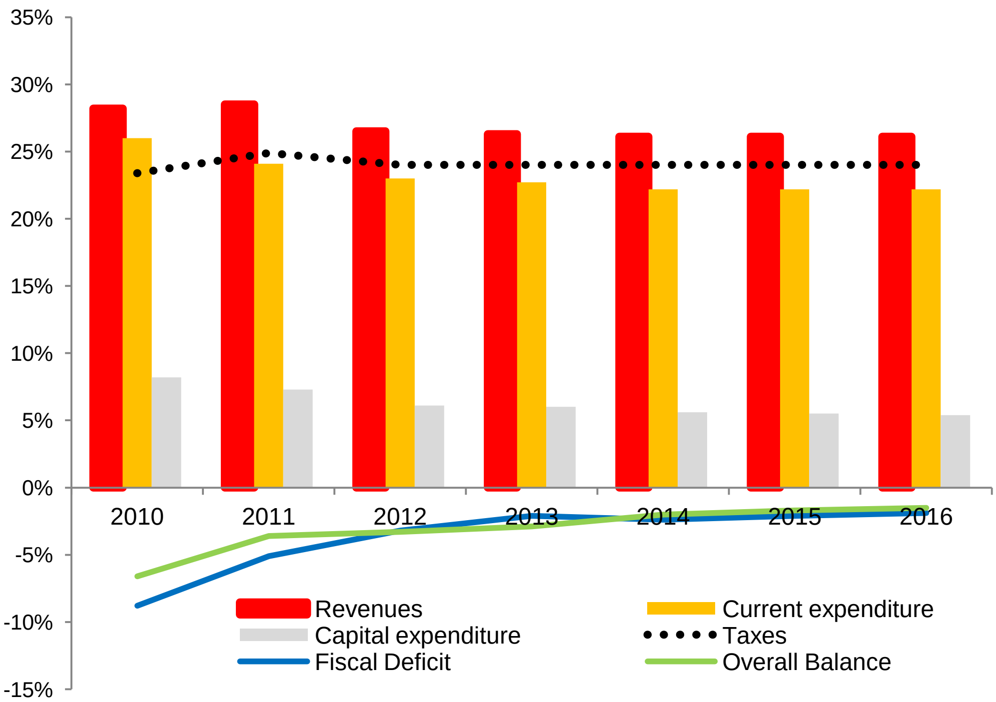
	2002	2003	2004	2005	2006	2007	2008	2009	2010
Revenue	**1,143.7**	**1,345.0**	**2,266.9**	**2,828.9**	**3,850.2**	**4,972.7**	**5,854.2**	**5,264.5**	**5,865.8**
Taxes	924.0	1,005.9	1,530.2	1,982.8	2,646.6	3,669.0	4,752.7	4,388.9	4,867.5
Social contributions	134.7	222.7	402.2	428.8	502.8	722.1	-	-	-
Grants	22.6	48.4	124.7	104.5	195.7	102.0	617.3	388.6	472.1
Other revenue	62.4	68.0	209.8	312.8	505.1	479.6	484.2	487.1	526.2
Expense	**1,114.1**	**1,261.4**	**1,835.8**	**2,425.9**	**2,978.7**	**4,379.0**	**5,410.9**	**5,397.1**	**5,480.3**
Compensation of employees	222.2	288.6	472.9	549.6	563.3	696.9	1,008.1	1,048.3	1,120.2
Use of goods and services	325.8	320.3	428.7	572.0	786.6	1,590.8	1,606.4	1,105.2	1,138.6
Consumption of fixed capital	-	-	-	-	-	-	-	-	-
Interest	146.7	168.5	153.0	121.9	105.2	98.6	120.5	171.2	206.1
Subsidies	104.6	105.3	217.4	436.3	419.0	267.3	362.5	613.5	380.0
Grants	0.0	0.0	0.0	4.7	6.8	18.7	12.2	8.8	10.5
Social benefits	314.8	378.7	547.6	558.1	661.4	933.7	1,347.4	1,505.9	1,623.6
Other expense	0.0	0.0	16.2	183.3	436.4	773.0	953.8	944.3	1,001.3
Net operating balance	**29.6**	**83.6**	**431.1**	**403.0**	**871.5**	**593.7**	**443.3**	**-132.5**	**385.5**
Net acquisition of nonfinancial assets	**185.6**	**158.9**	**352.8**	**240.8**	**505.1**	**541.0**	**826.7**	**1,041.3**	**1,320.9**
Net lending (+) / borrowing (-)	**-156.0**	**-75.3**	**78.3**	**162.2**	**366.4**	**52.7**	**-383.4**	**-1,173.8**	**-935.3**
Memorandum items									
Debt at the end of the period	4,843.3	4,608.0	4,306.6	4,076.1	**3,855.4**	**3,919.6**	**5,153.6**	**6,225.2**	**7,633.5**
of which:									
Domestic debt	1,520.3	1,567.9	1,575.8	1,535.3	1,510.9	1,489.9	1,458.9	1,693.2	1,818.3
Foreign debt	3,323.0	3,040.1	2,730.8	2,540.8	2,344.5	2,429.7	3,694.7	4,532.0	5,815.2

Source: Geostat

Prior to the dual shocks, the Government's budget was basically in balance, with only a tiny deficit in 2008. Following the shocks, the decline in economic activity which reduced revenue on the one hand, and the rise in counter-cyclical spending in order to cushion the impact of the economic downturn on the other hand, resulted in a fiscal deficit of 9.2 per cent of GDP in 2009.

In 2010, the Government pursued a policy of fiscal consolidation resulting in an improvement in fiscal deficit to 4.8 per cent of GDP for the year. The IMF projects additional fiscal consolidation in 2011 and beyond; and a subsequent decline in the fiscal deficit over time (Figure 3:4). Latest data shows that Georgia has carried out rapid and sizeable fiscal consolidation ahead of schedule. Fiscal deficit reduced from -9.2 per cent in 2009 to -3.6 per cent in 2011 and is expected to decline further below 3 per cent by 2013[22] in line with the Economic Liberty Act (adopted in July 2011)[23]. The Act caps budgetary expenditures at 30 percent of GDP, the fiscal deficit at 3 percent, and the public debt at 60 percent The Economic Liberty Act will enter into force in 2014.

Figure 3:4 Public Finances (General Government), 2010 to 2016



Source: IMF IXth Program Review p.13, June 2011; Projections 2011 onwards
Fiscal Balance = Government Revenue – Current Expenditure - Capital spending and net lending

Breakdown of Government expenditure by function is not available for recent years. However, on the basis of available data, it can be seen that the Government has maintained social welfare spending during and after the crisis due to a need to offset the negative impact of higher unemployment and poverty (Table 3:3). Although defence spending has been curtailed in recent years, it still represents the largest item of Government spending.

[22] Ministry of Finance (2012) Georgia – The Outlook, April 2012

[23] Revised 'Economic Liberty Act' Passed with Final Reading, Civil Georgia, Tbilisi / 1 Jul.'11 / 17:18. [online] Available at: http://www.civil.ge/eng/article.php?id=23691

Table 3:4 General Government Expenditure by Function, 2003 to 2009

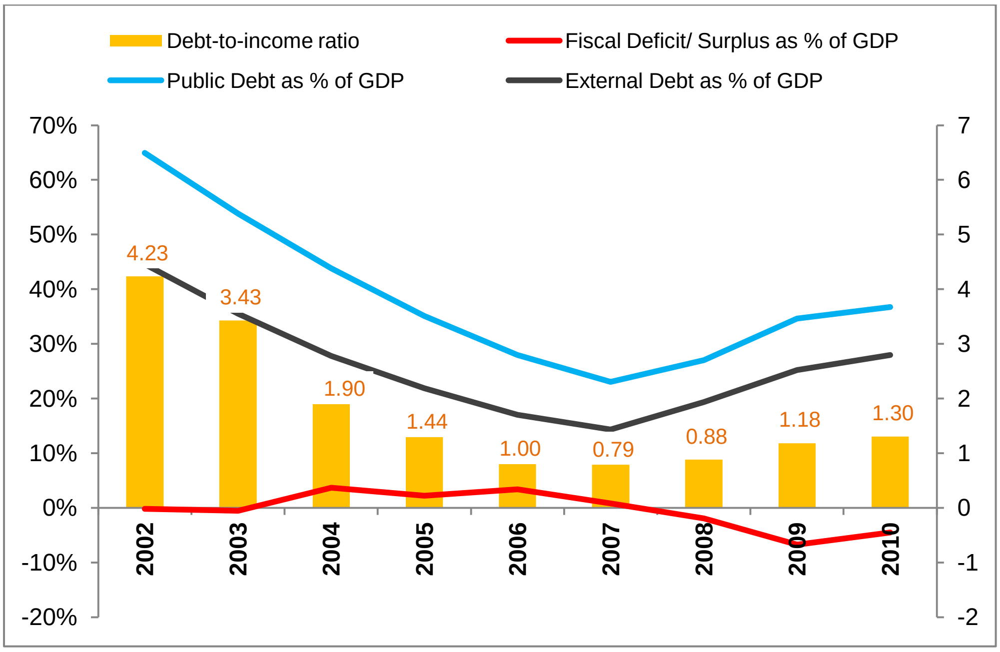
	2003	2004	2005	2006	2007	2008	2009
million GEL							
General Public Services	441.80	434.00	108.40	123.50	45.80	44.70	741.70
Defence	61.20	160.40	396.00	722.20	1498.20	1552.10	1047.10
Public Order and Safety	113.60	272.10	286.60	382.70	725.40	1010.60	882.60
Economic Affairs	92.10	120.30	385.00	468.80	353.80	768.70	1005.30
Environmental Protection	0.00	0.00	0.00	0.00	77.10	88.00	114.90
Housing and Community Amenities	62.40	140.60	262.70	448.60	498.70	534.90	349.70
Health	29.50	95.40	204.30	225.80	261.80	313.10	363.80
Recreation, Culture, and Religion	49.70	80.40	107.50	139.00	176.80	202.10	239.50
Education	164.10	286.30	288.70	413.90	458.30	553.80	579.60
Social Protection	405.90	599.10	627.50	690.00	824.10	1169.60	1312.30
Total Outlays	1420.30	2188.60	2666.70	3614.50	4920.00	6237.60	6636.50
as % of total							
General Public Services	31.1%	19.8%	4.1%	3.4%	0.9%	0.7%	11.2%
Defence	4.3%	7.3%	14.8%	20.0%	30.5%	24.9%	15.8%
Public Order and Safety	8.0%	12.4%	10.7%	10.6%	14.7%	16.2%	13.3%
Economic Affairs	6.5%	5.5%	14.4%	13.0%	7.2%	12.3%	15.1%
Environmental Protection	0.0%	0.0%	0.0%	0.0%	1.6%	1.4%	1.7%
Housing and Community Amenities	4.4%	6.4%	9.9%	12.4%	10.1%	8.6%	5.3%
Health	2.1%	4.4%	7.7%	6.2%	5.3%	5.0%	5.5%
Recreation, Culture, and Religion	3.5%	3.7%	4.0%	3.8%	3.6%	3.2%	3.6%
Education	11.6%	13.1%	10.8%	11.5%	9.3%	8.9%	8.7%
Social Protection	28.6%	27.4%	23.5%	19.1%	16.8%	18.8%	19.8%
Total Outlays	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: IMF Government Finance Statistics

3.1.5 Public Debt

In 2007, the ratio of total public debt to GDP was 23 per cent, while the ratio of external public debt to GDP was 14 per cent. The low levels of public indebtedness and the favourable maturity and interest rate structure of the public debt portfolio helped to provide necessary fiscal space for the Government to enact its countercyclical fiscal stimulus measures in late 2008. Consequently, stocks of public debt and external debt have been rising during 2008 to 2009 Georgia's debt-to-income ratio (stock of public debt as a multiple of Government revenue) has also been rising during this period, although it remains well below the unhealthy levels seen in 2002 and 2003.

Figure 3:5 Overview of Public Finances (as % of GDP), 2002 to 2010



Sources: Geostat, MoF

3.1.6 Money and Exchange Rates

In the aftermath of the 1998 Russian financial crisis, the lari was heavily devalued by nearly 50 per cent against the US dollar. Since then, it has proved remarkably stable and in the years up to 2008 had modestly but steadily appreciated against the US dollar. Later in 2008, there was a substantial depreciation of the currency after Georgia returned to a "managed float" exchange rate[24] regime to allow for a natural adjustment owing to declining capital inflows, deposits and international reserves from greater investment uncertainty in the financial crisis.

In March 2009, the authorities adopted a more flexible exchange-rate policy, with weekly NBG initiated foreign-exchange auctions in order to allow the exchange rate to be determined by the market. Downward pressure on the lari strengthened in the second quarter of 2010, causing the lari to depreciate to Lari1.89:US$1 by mid-June 2010.

A stronger US dollar, lower than expected FDI inflows and a widening trade deficit in the second quarter were the main pressures on the currency. To prevent a

[24] NBG implements a 'managed floating exchange rate' policy, but intervenes in markets at times in order to avoid the risk of sharp short term movements in the exchange rate, and to maintain external competitiveness.

further fall of the lari against the US dollar, the NBG increased the volume and frequency of auctions to support the currency, and raised the refinancing rate.

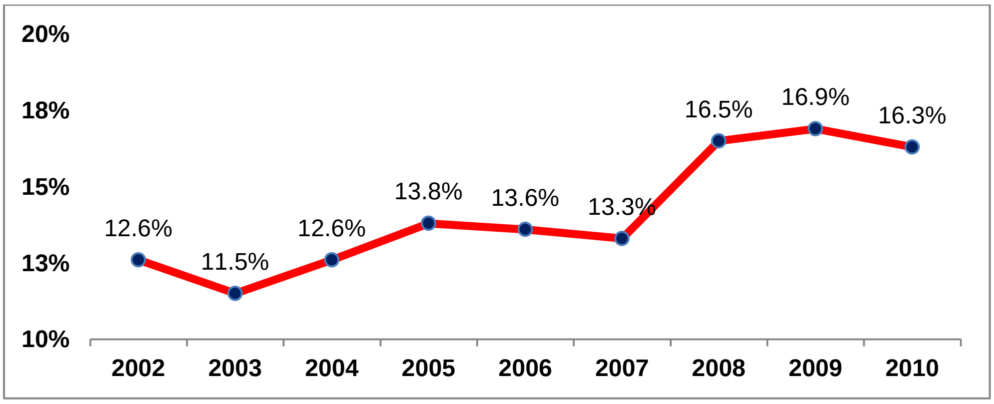
Dollarisation of the economy remains high, and this hinders the effectiveness of the implementation of monetary policy and reflects a relative lack of confidence in the lari. Prior to the dual crises, deposit dollarisation had fallen to around 60 per cent, a figure which rose in the aftermath of the crises to 76 per cent before receding to around 72 per cent at end 2010. Achieving greater de-dollarisation remains a key objective of Georgia's monetary authorities.

The financial crisis triggered a reduction in both the supply of broad money and credit to the private sector, although both variables rebounded in 2010. The IMF projects growth in broad money to decelerate from 2011 and, while growth in credit to the private sector is expected to stabilise, the monetary tightening is expected to result in a fall in the loan to deposit ratio. A significant reduction in the percentage of total loans classified as non-performing provides further evidence of an improvement in the financial soundness of banks in Georgia.

3.1.7 Labour Market

The labour market in Georgia has been characterised by high unemployment over the past decade. In 2005 the unemployment rate stood at 13.8 per cent and fell marginally, as national income rose, to around 13.3 per cent in 2007. The effects of the global financial crisis and in particular, the reduction in foreign investment flows were to increase the unemployment rate to 16.5 per cent in 2008. Despite a recovery in output and investment expenditure in 2010, the unemployment rate stood at 16.3 per cent.

Figure 3:6 Unemployment Rate, 2002 to 2010



Source: Geostat

3.2 Counterfactual Assessment

3.2.1 Specification of Potential Counterfactual Scenarios

To determine the net impact of the MFA, two types of counterfactual scenarios were developed:

- Scenario 1: no MFA i.e. the MFA grants in 2009 and 2010 are not disbursed;
- Scenario 2: no MFA and no SBA i.e. the MFA grants and IMF credit in 2009 and 2010 are not disbursed.

The MFA was delivered to the state budget to help finance the budget deficit created by the Government's countercyclical fiscal stance. In the absence of an MFA operation, the Georgian Authorities would have been faced with the following alternatives:

- Seek other forms of assistance from the EU so that it could honour its 'pledge' at the Donors Conference;
- Request a larger programme from the IMF;
- Seek more funding from the World Bank;
- Seek more funding from other bilateral donors;
- Higher borrowing (external/ domestic);
- Higher taxation to increase its revenue;
- Reduce its expenditure.

Table 3:5 below assesses the likelihood of occurrence of each of the above alternative courses of action. The assessment is subjective as it is predominantly informed by the opinions of key informants. In order to make the assessment as robust as possible, the different stakeholder accounts were checked against each other, and against the evidence drawn from the desk research.

Table 3:5 Potential Alternatives and their Likelihood of Occurrence

Potential Alternatives	Likelihood	Explanatory Remarks
Other forms of EU assistance	unlikely	EU funding from other (non-MFA) sources was not an option. The EU pledge was significant (EUR 484.1 million) and resources were not readily available within the EU budget to meet this commitment. The EU had already exhausted all alternative instruments at its disposal (such as ENPI, humanitarian aid, stability instrument etc.) and boosted these to the extent possible by transferring funds between budget lines and using the reserves.
A larger programme from IMF/ WB	unlikely	A larger programme from the IMF or the World Bank was also not a possibility. According to the IMF, the approved IMF programme already represented an unusually high percentage of the quota and the MFA financing (EUR 46 million) was needed to fill the residual financing gap. The World Bank had delivered upfront budget support and they claim that they would not have been in a position to offer further support in case the MFA had not materialised. Moreover, IMF and World Bank provide support in the form of loans which would have created a repayment burden and thus pressures on the BoP.
Larger assistance from other bilateral donors	unlikely	Donors had been quite generous in their pledges at the International Donors Conference. Georgian authorities believe that further assistance from bilateral donors (to substitute MFA grant of EUR 46 million) was highly unlikely.
Higher taxation	unlikely	It would not have been feasible for the Government to finance higher public expenditure by raising taxes in recessionary conditions. Raising taxes would have further reduced incomes and consumption; and, exacerbated the recession. Reduced output in turn would have led to lower tax collection - evidence suggests that tax revenues tend to fall more sharply than their respective tax bases during recessions (and recover more strongly than bases during booms) [25].
Reduced public spending	possible	The Government was pursuing a counter-cyclical fiscal policy. The size of its fiscal stimulus package was crucially based on financing expected to be made available by donors following the 2008 International Donors Conference. However, GoG could possibly have reduced the scale of the fiscal stimulus (and thus, run a lower fiscal deficit) in case donor pledges did not materialise.
Higher external borrowing	unlikely	The loss of private sector confidence meant that Georgia had limited access to international capital markets; external borrowing (for example, by issuing Eurobonds) would have been unsuccessful in such a context. The spread on Georgia's sovereign bonds over comparable U.S. Treasury bills increased from 550 to nearly 800 basis points during the conflict, declined to 700 basis points after the cease-fire, but rose to over 1100 basis points in the wake of the global financial crisis[26] - see Figure 3:7.

[25] Sancak, C., Velloso, R. and Xing, J. (2010) *Tax Revenue Response to the Business Cycle*. IMF Working Paper, WP/10/71, March 2010. Available at: http://www.imf.org/external/pubs/ft/wp/2010/wp1071.pdf

[26] IMF Country Report No. 09/1, January 2009

Potential Alternatives	Likelihood	Explanatory Remarks
Higher domestic borrowing[27]	possible	As part of the Government's fiscal stimulus package for 2009, the Government of Georgia successfully debuted GEL denominated T-Bills on August 5, 2009[28]. However, the Government decided to follow a conservative approach to T-Bills auction (as the market for T-Bills in Georgia was untested and there were concerns that a large issuance may not be well received by the market). It was also felt that the cost of financing from this source might be high. The Government's initial plan therefore, was to limit issuance of T-Bills in 2009 to around GEL 160 million and to rely on external balance of payments support to finance a portion of its budgetary needs[29]. However, later that year, NBG supported the development of a secondary market for T-bills by introducing an electronic trading platform. Consequently, the Government decided to increase issuance of T-bills in 2009 to around GEL 270 million. However, due to limits in the capacity of the banking sector to absorb additional T-Bills, it stated its continuing need to rely on external balance of payments support to finance a portion of its budgetary needs in 2010. Looking at the data, it is assumed that the Government could not have raised further money from T-bills in 2009 but, it had more flexibility in using this option in 2010.

[27] Ministry of Finance of Georgia issues two types of Government Securities: T-bills and T-notes. T-bills are issued with maturity of up to one year at a discount and are redeemed at nominal value; T-notes are issued with maturity of 2 years with semi-annual coupon payments. Government Securities are issued in domestic currency; the nominal value of one government security is GEL 1000. Government Securities are sold via auctions which are conducted through the Bloomberg electronic trading system. Only commercial banks are eligible to participate in the auctions. Source: http://www.treasury.gov.ge/~/m/u/f/file/PDF/axali%20logo%20prezen/certiliani%20logo/Government_%20Securities1.pdf

[28] http://www.government.gov.ge/files/34_29832_727148_T-BILLSHITRECORDLOWYIELDSINCEITSDEBUT.pdf

[29] LoI, 30 Jul 2009. Available at: http://www.imf.org/external/np/loi/2009/geo/073009.pdf

Figure 3:7 Georgian Bond Yields, basis points, April 2008 to August 2011

Source: NBG

The two likely alternatives that emerge from the above analysis are as follows:

Scenario 1: no MFA i.e. the MFA grants in 2009 and 2010 are not disbursed

Within this scenario, two alternative sub-scenarios were developed:

- Alternative A: reduced public spending by the Government of Georgia in 2009 and 2010. The Government faces a borrowing constraint and consequently, the non-availability of MFA grant to Georgia leads to a corresponding reduction in government revenue, and thus expenditure.
- Alternative B: reduced public spending in 2009, but no change in spending in 2010 i.e. the government is able to maintain its expenditure in 2010 without the MFA by incurring more domestic debt (in place of the lost grant revenue). Net borrowing is higher in 2010 compared to the baseline and domestic debt increases accordingly.

Scenario 2: no MFA and no SBA i.e. the MFA grants and IMF credit in 2009 and 2010 are not disbursed

Scenario 2 models the additional effect of the IMF-SBA provided to Georgia. The extent to which IMF financing was used for (a) reserve accumulation and (b) deficit financing was an important consideration in the modelling of scenario 2. Data shows that a majority of the SBA disbursed in 2009 was used to bolster Georgia's foreign exchange reserves (equivalent to SDR 131.5 million out of a total of SDR 220.8 million) and the loan funds disbursed in 2010 were entirely used to finance a higher deficit.

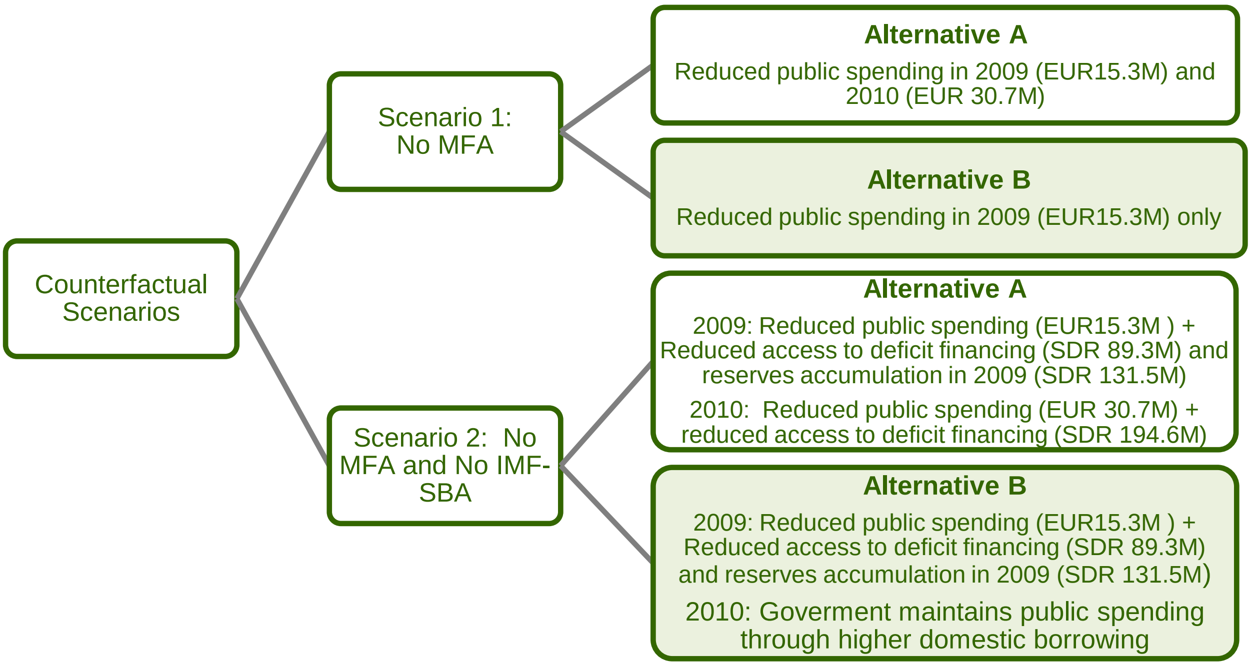
Within this scenario, the following alternative sub-scenarios were developed:

- Alternative A: in 2009, the absence of SBA leads to a reduction in the government's available deficit financing (i.e. net borrowing) and a marked reduction in reserve accumulation. In 2010, the government's access to deficit financing falls by the full amount of the SBA in that year.
- Alternative B: reduced public spending, and reserves accumulation in 2009 but, no change in spending in 2010 i.e. the government is able to maintain

its expenditure in 2010 without the MFA and SBA by incurring more domestic debt.

The above two sub-scenarios are illustrated in Figure 3:8.

Figure 3:8 Schematic Illustration of the Counterfactual Scenarios



Given the relatively linear nature of the model, the analysis focuses on the two extremes of financing options set out in Alternatives A and B; degrees of deficit financing within the bounds produce similar effects, only of different sizes. The two alternative projections, with and without additional domestic borrowing, differ only in the results for 2010.

3.2.2 Scenario 1: No MFA i.e. the MFA grants in 2009 and 2010 are not disbursed

The MFA to Georgia was provided as a grant and is thus counted as government revenue. The initial impact of 'removing' the MFA, assuming no further borrowing, is a reduction in government revenue by the value of the grant. Expenditure must also fall by the same amount in order to maintain the deficit level in the baseline (by the amounts shown in Table 3:6). The MFA grants in 2009 and 2010 were modest relative to the size of the Government expenditure: 0.7 per cent and 1.3 per cent, respectively.

Table 3:6 Value of EC MFA Funds in 2009 and 2010

	2009	2010
MFA (EUR million)	15.3	30.7
MFA (GEL million)	35.7	72.5
Exchange rate: GEL/EUR (annual average)*	2.33	2.36
Government Expenditure (GEL million)*	5,397	5,480
MFA as % of Government Expenditure	0.7%	1.3%

**Source: Geostat*

Because the transfer of funds comes from overseas, there is also an immediate deterioration in the Current Account. In the first instance, this is met by a reduction in accumulated reserve assets.

However, there are also indirect consequences of reduced Government expenditure. Lower Government expenditure leads to lower final demand (and thus, lower GDP), leading to lower production and income. This has implications for Government tax revenue; lower consumption/production yields lower revenues (a multiplier effect).

Figure 3:9 below illustrates the key transmission mechanisms of 'removing' the MFA, to generate the counterfactual results, leading to:

- Lower GDP and employment;
- An overall wider current account deficit (and lower reserve accumulation).

The sections that follow discuss these results in more detail, by scenario.

Figure 3:9 Transmission Channels of MFA with No Additional Deficit Financing

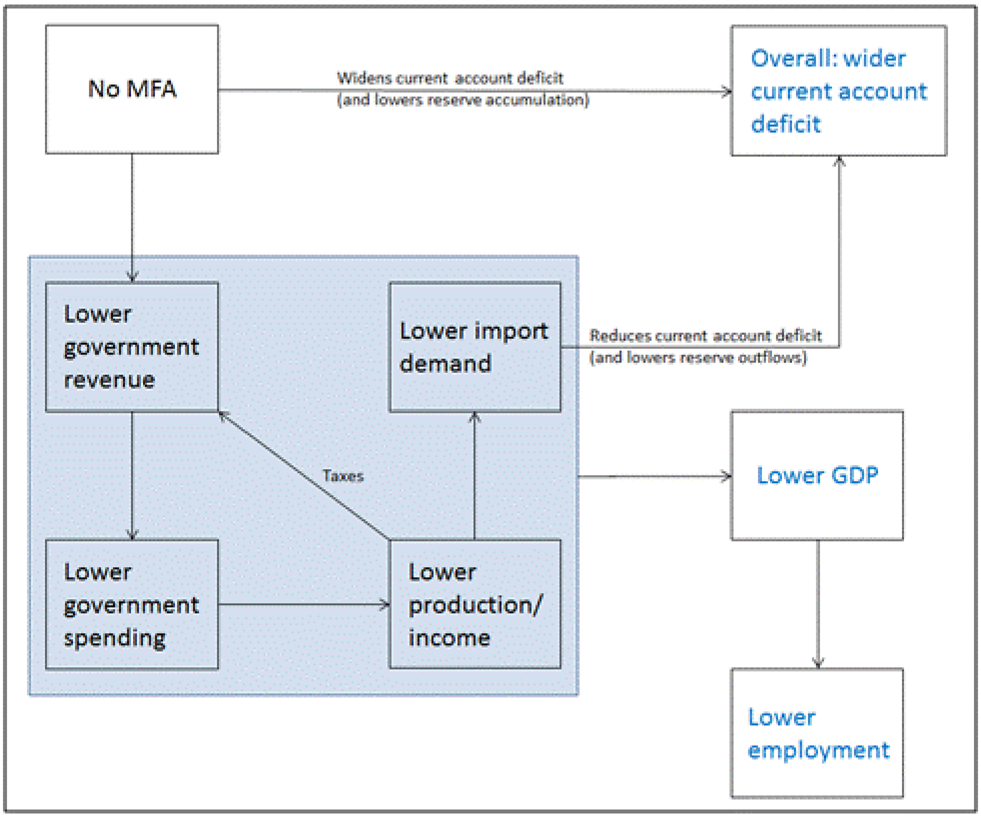


Table 3:7 presents the results from the Scenario 1 modelling, for the years 2008 to 2010. For all but employment, the table present the absolute difference in the results across scenarios i.e. differences in GEL million for levels and percentage-point differences for rates.

Scenario 1 – Alternative A (Reduced public spending by the Government of Georgia equivalent to EUR 46 million)

Under the assumptions of the scenarios, the Government faces a borrowing constraint which, under Alternative A, is equal to domestic borrowing with MFA in the baseline. Consequently, a GEL 35.7 million reduction in grants to Georgia in 2009 leads to a GEL 35.7 million reduction in revenue, and thus expenditure, as a first-round effect. The indirect impacts on output and income lower government tax revenue and, in order to maintain the same levels of deficit financing, it is necessary to reduce Government expenditure further to cover the lost tax revenue.

Overall government expenditure falls by around GEL 42 million: more than the initial GEL 35.7 million decrease in Government grant revenue.

Lower economic activity drives reductions in household expenditure and investment, but also reductions in import demand. Georgia is relatively import-intensive with an import-to-GDP ratio of around 50 per cent. Thus, lower import demand as a result of lower economic activity, from lower government spending, helps to counter around half of the widening of the current account deficit[30] in 2009 and 2010 in the A scenario when MFA is subtracted:

- The current account deficit widens by around GEL 16 million in 2009, compared to the initial widening of GEL 35.7 million from subtracting the MFA;
- The current account deficit widens by around GEL 34 million in 2010, compared to GEL 72 million of MFA.

Georgia accumulated relatively large quantities of reserves in 2009 and 2010 so the effect of MFA was to accelerate existing reserve accumulation, albeit by a negligible amount (contributing less than 0.5 per cent to reserves). The government maintains its levels of net borrowing in the A scenario so there are no changes in debt relative to the baseline.

In the Alternative A scenario, with no additional public borrowing, changes in reserve asset holdings are reflected entirely in equal changes in the supply of money[31]: MFA led to more rapid accumulation of reserves and thus an expansion of the domestic money supply. In the model, monetary expansion drives inflation although this is outpaced by nominal GDP growth. The results suggest MFA contributed to a slightly smaller decline in prices and real GDP in 2009 and slightly stronger growth in 2010:

- GDP fell by 3.8 per cent in 2009 and the counterfactual suggests the fall would have been slightly more severe, at 4.0 per cent, had there been no MFA;
- GDP grew by 6.3 per cent in 2010 and the counterfactual suggests that this growth would have been slightly lower without MFA, at 6.2 per cent.

The modelling results suggest that the economic impact of MFA was quite small (in the order of 0.2 per cent), with similarly small employment effects.

Scenario 1 – Alternative B (Reduced public spending in 2009; spending levels maintained in 2010 through domestic borrowing)

Under Alternative B, the Government is able to maintain its expenditure in 2010 (and thus maintain nominal GDP) without MFA by incurring more domestic debt in place of the lost grant revenue. Net borrowing is higher in 2010 compared to the baseline and domestic debt increases accordingly. In this situation, the absence of MFA in 2010 leads to a deterioration of the Current Account that is compounded by sustained higher economic activity, maintaining import demand at baseline levels. This is in contrast to the Alternative A projection where the wider Current Account deficit was mitigated somewhat by the reduction in imports from lower economic activity.

In terms of the real sector (GDP and employment), economic performance in the B scenario in 2010 is comparable with the baseline with MFA. However, in the B

[30] Exports and exchange rates are assumed to be exogenous in the model.

[31] This is an accounting identity which simply states that liabilities (money) are equal to the sum of foreign and domestic assets.

scenario, the government has a (modestly) greater debt burden from issuing bonds and lower holdings of reserve assets (equivalent to the value of the MFA in that year). The expansion of government debt in the B scenario drives some additional money growth over that in the A scenario, but the money supply does not recover to the levels seen in the baseline. Additional borrowing in the B scenario nullifies the real-economy impacts of subtracting MFA in 2010, but at the cost of higher debt and lower reserves.

Conclusions from Scenario 1 modelling

In conclusion, the modelling results suggest that the MFA achieved the following, although the size of these impacts is small (less than 1 per cent):

- An improvement in the current account, although by less than the value of the MFA, if the government would have reduced its spending without the grant revenue;
- Higher accumulation of foreign exchange reserves;
- An increase in government revenue, by more than the value of the grant, owing to multiplier effects;
- An expansion of the domestic money supply (and modest inflationary effects);
- A reduction in public debt, assuming that Georgia would have issued bonds had it not received the MFA (relates to Alternative B only);
- Higher GDP growth;
- Higher employment/lower unemployment.

Given the small size of the effects relative to Georgia's economy and its balance sheet items, it is difficult to argue convincingly, from the model results, that MFA contributed substantially to averting a crisis through improved external sustainability, although the modelling fails to capture confidence effects and conditionality that may well have longer-term implications for the country's economic trajectory.

Table 3:7 Modelling Results – Scenario 1

MACROECONOMIC VARIABLES

					Difference from Baseline		
		2008	2009	2010	2008	2009	2010
Employment ('000s)	Baseline	1602	1656	1628			(%)
	1A - No MFA	1602	1653	1622	0.0	-0.2	-0.4
	1B - No MFA (more borrowing in 2010)	1602	1653	1628	0.0	-0.2	0.0
Inflation (% pa)	Baseline	9.9	-2.1	8.5			(pp)
	1A - No MFA	9.9	-2.2	8.4	0.0	-0.1	-0.1
	1B - No MFA (more borrowing in 2010)	9.9	-2.2	8.5	0.0	-0.1	0.0
Real GDP growth (% pa)	Baseline	2.1	-3.8	6.3			(pp)
	1A - No MFA	2.1	-4.0	6.2	0.0	-0.2	-0.1
	1B - No MFA (more borrowing in 2010)	2.1	-4.0	6.5	0.0	-0.2	0.2
Unemployment rate (%)	Baseline	16.5	16.9	16.3			(pp)
	1A - No MFA	16.5	17.0	16.6	0.0	0.1	0.3
	1B - No MFA (more borrowing in 2010)	16.5	17.0	16.3	0.0	0.1	0.0

GOVERNMENT FINANCES (GEL MILLION)

		2008	2009	2010	Difference from Baseline 2008	Difference from Baseline 2009	Difference from Baseline 2010
Government expenses	Baseline	5411	5397	5480			
	1A - No MFA	5411	5355	5394	0	-42	-87
	1B - No MFA (more borrowing in 2010)	5411	5355	5479	0	-42	-2
Government revenue	Baseline	5854	5265	5866			
	1A - No MFA	5854	5223	5779	0	-42	-87
	1B - No MFA (more borrowing in 2010)	5854	5223	5792	0	-42	-74
Government net borrowing	Baseline	383	1174	935			
	1A - No MFA	383	1174	935	0	0	0
	1B - No MFA (more borrowing in 2010)	383	1174	1008	0	0	73

BALANCE OF PAYMENTS (GEL MILLION)

		2008	2009	2010	Difference from Baseline 2008	Difference from Baseline 2009	Difference from Baseline 2010
Current account (GEL million)	Baseline	-4345	-2022	-2378			
	1A - No MFA	-4345	-2038	-2412	0	-16	-34
	1B - No MFA (more borrowing in 2010)	-4345	-2038	-2450	0	-16	-72
Reserves (GEL million) Minus indicates accumulation of reserve assets	Baseline	-195	-1030	-371			
	1A - No MFA	-195	-1013	-336	0	16	34
	1B - No MFA (more borrowing in 2010)	-195	-1013	-299	0	16	72
Capital account (GEL million)	Baseline	4593	2967	2787			
	1A - No MFA	4593	2967	2787	0	0	0
	1B - No MFA (more borrowing in 2010)	4593	2967	2787	0	0	0

BALANCE SHEET ITEMS (GEL MILLION)

					Difference from Baseline		
		2008	2009	2010	2008	2009	2010
Domestic debt	Baseline	1459	1693	1818			
	1A - No MFA	1459	1693	1818	0	0	0
	1B - No MFA (more borrowing in 2010)	1459	1693	1891	0	0	73
Foreign debt	Baseline	3695	4532	5815			
	1A - No MFA	3695	4532	5815	0	0	0
	1B - No MFA (more borrowing in 2010)	3695	4532	5815	0	0	0
Money (M3)	Baseline	4305	4657	6276			
	1A - No MFA	4305	4640	6225	0	-16	-51
	1B - No MFA (more borrowing in 2010)	4305	4640	6260	0	-16	-16
Reserve assets	Baseline	2206	3525	4035			
	1A - No MFA	2206	3509	3985	0	-16	-51
	1B - No MFA (more borrowing in 2010)	2206	3509	3947	0	-16	-89

3.2.3 Scenario 2: No MFA and No SBA i.e. the MFA grants and IMF credit in 2009 and 2010 are not disbursed

The Alternatives A and B of Scenario 2 model the additional effect of the IMF SBA provided to Georgia in the crisis. The SBA is a loan facility that is to be repaid within 3¼ to 5 years of the disbursement and represents an increase in a country's external debt and can be used either as a source of deficit financing or to increase reserves.

IMF analysis[32] and NBG statistics on Gross International Reserves suggest that a substantial proportion of the SBA disbursed in 2009 was used to bolster Georgia's foreign exchange reserves (equivalent to 60 per cent of the disbursement[33]) and that all of the IMF funds disbursed in 2010 were intended to finance a higher deficit. This is reflected in the modelling assumptions (see Table 3.8). In 2009, the absence of SBA leads to a reduction in the government's available deficit financing (i.e. net borrowing) of GEL 230.4 million, with the remaining GEL 339.5 million held as reserves. In contrast, it is assumed that all the SBA in 2010 went to financing the deficit, and the government's access to deficit financing falls by the full amount of the SBA in that year. This set of counterfactuals models the effect of removing SBA in addition to the effect of removing MFA.

Net borrowing in Scenario 2 is lower than net borrowing in Scenario 1, owing to the smaller facility for foreign borrowing (which also reduces foreign debt). As in Scenario 1, the government faces a domestic deficit-financing constraint.

As a share of government expenditure in 2009, the amount of IMF credit used to finance Georgia's deficit is substantially more than the value of the MFA grant (4.3 per cent compared to less than 1 per cent for the MFA). IMF credit accounts for a substantially larger proportion of government expenditure in 2010 (almost 10 per cent).

Table 3:8 Value of IMF SBA credit in 2009 and 2010

	2009	2010
IMF SBA (SDR million)	220.8	194.6
IMF SBA (GEL million)	569.9	529.9
Of which: contribution to deficit financing	230.4	529.9
contribution to reserves	339.5	0.0
Exchange rate: GEL/SDR (annual mean)	2.58	2.72
Government Expenditure (GEL million)	5,397	5,480
SBA for deficit financing as % of Government Expenditure	4.3%	9.7%

Sources: EC, Geostat, IMF

Note: In the counterfactual, IMF SBA is modelled in addition to EC MFA

32 IMF (2010) Staff Guidance Note on the Use of Fund Resources for Budget Support. [online] Available at: http://www.imf.org/external/np/pp/eng/2010/032310.pdf. Page 20 of the report states that: *Part of the support provided by the Fund in 2009 and all the support for 2010 is to be used to finance directly a higher fiscal deficit stemming from a sharper-than-expected economic slowdown.*

33 The SBA disbursed in 2009 amounted to SDR 220.8 million (around US$ 340 million) and Georgia's holdings of SDRs increased by SDR 131.5 million (around US$ 200 million). Under the assumption that the entire increase in SDR holdings was due to the SBA, in Scenario 2 is based on an assumption of an initial 60 per cent reduction in reserves (SDR 131.5 million divided by SDR 220.8 million) and a corresponding 40per cent reduction in government expenditure.

Figure 3:10 Transmission Channels of SBA

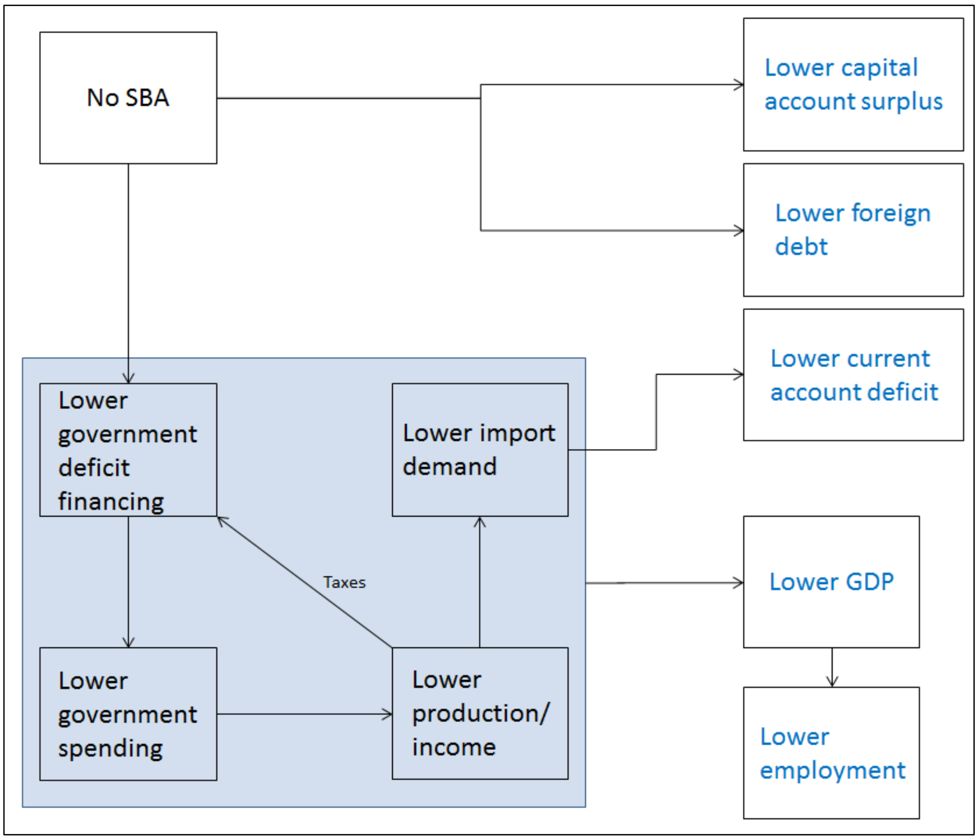


Figure 3:10 below outlines the key transmission channels with no SBA, leading to:

- Lower GDP and employment;
- A lower current account deficit (SBA entails some deterioration of the current account as it helps support import demand);
- A lower capital account surplus (lower inflows of foreign capital – the SBA);
- Overall lower reserve accumulation;
- Lower foreign debt.

Each of these is discussed in the context of the economic modelling below.

Table 3:9 presents the results from the Scenario 2 modelling, for the years 2008-10. As with the results for Scenario 1, for all but employment, we present the absolute difference in the results across scenarios i.e. differences in GEL million for levels and percentage-point differences for rates.

Scenario 2 – Results

As with the MFA on its own, reducing government expenditure leads to a series of indirect effects such that the reduction in government expenditure is greater than the value of the loan funds, owing to reduced tax revenues. The effect of removing the SBA in 2009 is similar to that of removing the MFA: there is a contraction in real GDP (more severe than the removal of MFA owing to the larger contribution to government expenditure):

- GDP declined by 3.8 per cent in the baseline;

- Without MFA, the GDP decline would have been stronger, at around 4 per cent;
- Without MFA and without the SBA credit, the contraction in GDP would have been stronger still, at around 5.1 per cent.

Thus, the SBA in 2009 contributed more to growth in the real economy compared to the MFA: about 1 percentage point. The employment results follow the GDP results with employment increasing more slowly in the absence of SBA.

A substantial proportion of the SBA in 2009 (about 60 per cent) was used to bolster Georgia's holdings of foreign exchange reserves and in the counterfactual, with no MFA or SBA, there is a marked reduction in reserve accumulation. The counterfactual suggests that Georgia would have continued to increase its reserves in 2009 without the SBA, but at a much slower rate. The lower economic activity - from reduced government spending - leads to lower import demand in this counterfactual scenario, cushioning the drop in reserves accumulation.

With the lower holdings of reserves (net foreign assets held within the Georgian banking system) come lower holdings of liabilities (money, by accounting identity). Thus, there is a contraction in the money supply (in contrast to slower growth in the money supply in Scenario 1), leading to a much sharper fall in prices in 2009. Prices fell by 3.7 per cent in the counterfactual in 2009, compared to a fall of 2.1 per cent in the baseline (the difference in the absence of MFA alone was negligible in Scenario 1).

In the baseline, Georgia sees strong economic growth in 2010, of some 6.3 per cent, with MFA contributing relatively little to this growth in the modelling (although the modelling has little to say about the market confidence and other 'soft' effects that the aid may have instilled). The model results for Scenario 2 suggest that the Georgian economy would have continued to grow strongly without MFA or SBA, but at a somewhat slower rate (by 1.0 to 1.3 per cent).

Government expenditure is substantially lower in 2010 in Scenario 2, compounded by the additional tax revenue effects. This leads to slower GDP growth: 5 per cent compared to 6.3 per cent in the baseline. Employment falls in the baseline and the slower economic growth in Scenario 2 leads to stronger falls in employment (and correspondingly higher unemployment).

Without the SBA, the surplus on Georgia's capital account is reduced by the value of the SBA. The current account improves without the SBA owing to lower net imports from reduced economic activity, which also serves to halt some of the outflows of reserves, although accumulation of reserves slows markedly: in contrast to the baseline, reserves increase little in Scenario 2 in 2010.

The reduction in foreign debt in the scenarios relative to the baseline implies lower (foreign) debt-servicing requirements, but this must be weighed up against the lost economic growth, that may impinge on Georgia's future economic performance, reducing its ability to service its debts and grow in the long term. The lower economic growth may have impeded Georgia's future economic growth if these funds were earmarked for infrastructure investment to rebuild after the conflict with Russia. There is the distinct possibility that the development of Georgia's capital stock and productive capacity would have been slowed without the SBA, limiting future growth and the country's ability to service its debts.

Similarly, it is observed that the absence of SBA leads to a stronger bout of deflation, which may have negative impacts on market confidence and the economy's ability to service debt. It is difficult to capture these effects fully in the macroeconomic modelling.

As such it is suggested that the figures in the SBA scenarios be treated with greater caution than the other model results; there are insufficient data to parameterise the model with estimates of capital stocks and productive capacity.

The effect of additional domestic borrowing in the B scenario mirrors the impacts from the MFA scenarios, although the impact is dwarfed by the SBA.

Conclusions from Scenario 2 modelling

Some of the effects of the SBA appear similar to those of the MFA, although the scale of the common effects is of course different:

- An increase in government financing and revenue (particularly in 2010), exceeding the size of the loan owing to multiplier effects and facilitating higher expenditure;
- An expansion of the money supply;
- Higher GDP growth;
- Higher employment/lower unemployment;
- A possible decrease in public debt, if the country would have issued bonds had it not received the MFA.

In contrast to MFA, the SBA led to:

- An increase in foreign debt, but this is arguably offset by improved short-term economic performance that may have helped to avert a crisis;
- A less severe fall in prices (deflation, which may have more severe repercussions than those implied in the modelling);
- A deterioration of the current account.

The model results present a somewhat clearer case for the SBA helping to avert a crisis, although assessing economic restructuring and reconstruction post-war, and market confidence, is beyond the scope of the macroeconomic model

Table 3:9 Modelling Results – Scenario 2

MACROECONOMIC VARIABLES

					Difference from Baseline		
		2008	2009	2010	2008	2009	2010
Employment ('000s)	Baseline	1602	1656	1628			(%)
	2A - No MFA or SBA	1602	1635	1583	0.0	-1.3	-2.7
	2B - No MFA or SBA (more borrowing in 2010)	1602	1635	1590	0.0	-1.3	-2.4
Inflation (% pa)	Baseline	9.9	-2.1	8.5			(pp)
	2A - No MFA or SBA	9.9	-3.7	8.1	0.0	-1.6	-0.4
	2B - No MFA or SBA (more borrowing in 2010)	9.9	-3.7	8.2	0.0	-1.6	-0.3
Real GDP growth (% pa)	Baseline	2.1	-3.8	6.3			(pp)
	2A - No MFA or SBA	2.1	-5.1	5.0	0.0	-1.3	-1.3
	2B - No MFA or SBA (more borrowing in 2010)	2.1	-5.1	5.3	0.0	-1.3	-1.0
Unemployment rate (%)	Baseline	16.5	16.9	16.3			(pp)
	2A - No MFA or SBA	16.5	17.9	18.6	0.0	1.0	2.3
	2B - No MFA or SBA (more borrowing in 2010)	16.5	17.9	18.3	0.0	1.0	2.0

GOVERNMENT FINANCES (GEL MILLION)

		2008	2009	2010	Difference from Baseline 2008	Difference from Baseline 2009	Difference from Baseline 2010
Government expenses	Baseline	5411	5397	5480			
	2A - No MFA or SBA	5411	5043	4733	0	-354	-748
	2B - No MFA or SBA (more borrowing in 2010)	5411	5043	4818	0	-354	-662
Government revenue	Baseline	5854	5265	5866			
	2A - No MFA or SBA	5854	5141	5648	0	-124	-218
	2B - No MFA or SBA (more borrowing in 2010)	5854	5141	5661	0	-124	-205
Government net borrowing	Baseline	383	1174	935			
	2A - No MFA or SBA	383	944	405	0	-230	-530
	2B - No MFA or SBA (more borrowing in 2010)	383	944	478	0	-230	-457

BALANCE OF PAYMENTS (GEL MILLION)

		2008	2009	2010	Difference from Baseline 2008	Difference from Baseline 2009	Difference from Baseline 2010
Current account (GEL million)	Baseline	-4345	-2022	-2378			
	2A - No MFA or SBA	-4345	-1867	-2124	0	155	253
	2B - No MFA or SBA (more borrowing in 2010)	-4345	-1867	-2162	0	155	215
Reserves (GEL million) Minus indicates accumulation of reserve assets	Baseline	-195	-1030	-371			
	2A - No MFA or SBA	-195	-615	-94	0	415	277
	2B - No MFA or SBA (more borrowing in 2010)	-195	-615	-56	0	415	315
Capital account (GEL million)	Baseline	4593	2967	2787			
	2A - No MFA or SBA	4593	2737	2257	0	-230	-530
	2B - No MFA or SBA (more borrowing in 2010)	4593	2737	2257	0	-230	-530

BALANCE SHEET ITEMS (GEL MILLION)

					Difference from Baseline		
		2008	2009	2010	2008	2009	2010
Domestic debt	Baseline	1459	1693	1818			
	2A - No MFA or SBA	1459	1693	1818	0	0	0
	2B - No MFA or SBA (more borrowing in 2010)	1459	1693	1891	0	0	73
Foreign debt	Baseline	3695	4532	5815			
	2A - No MFA or SBA	3695	3962	4715	0	-570	-1100
	2B - No MFA or SBA (more borrowing in 2010)	3695	3962	4715	0	-570	-1100
Money (M3)	Baseline	4305	4657	6276			
	2A - No MFA or SBA	4305	4242	5584	0	-415	-692
	2B - No MFA or SBA (more borrowing in 2010)	4305	4242	5618	0	-415	-657
Reserve assets	Baseline	2206	3525	4035			
	2A - No MFA or SBA	2206	3110	3344	0	-415	-692
	2B - No MFA or SBA (more borrowing in 2010)	2206	3110	3306	0	-415	-730

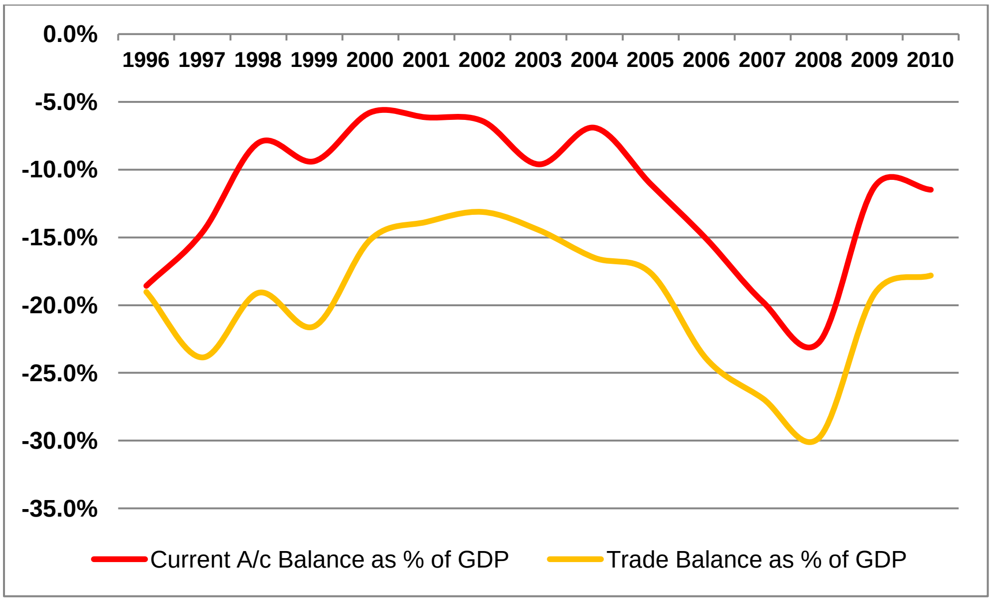
4 IMPACT ON EXTERNAL SUSTAINABILITY

This section assesses the impact of the MFA on the external financial situation of Georgia by examining the trends in key balance of payments and external debt statistics before and after the introduction of MFA.

4.1 Balance of Payments

Official statistics, available from 1996 onwards, show that Georgia has run a persistent current account deficit over the period 1996 to 2010 (Figure 4:1). In 1996, Georgia's current account deficit was at an unsustainably high level of 19 per cent of its GDP; however, it gradually fell to less than 6 per cent of GDP in 2000 before rising again in 2001. It has grown steadily since, reaching 20 percent of GDP in 2007 and peaking at 23 per percent in 2008. The main factors contributing to the deterioration in the current account deficit during this period were strong domestic demand, FDI-related imports, and rising commodity / energy prices.

Figure 4:1 Georgia's Current Account and Trade Balance relative to GDP, 1996 to 2010



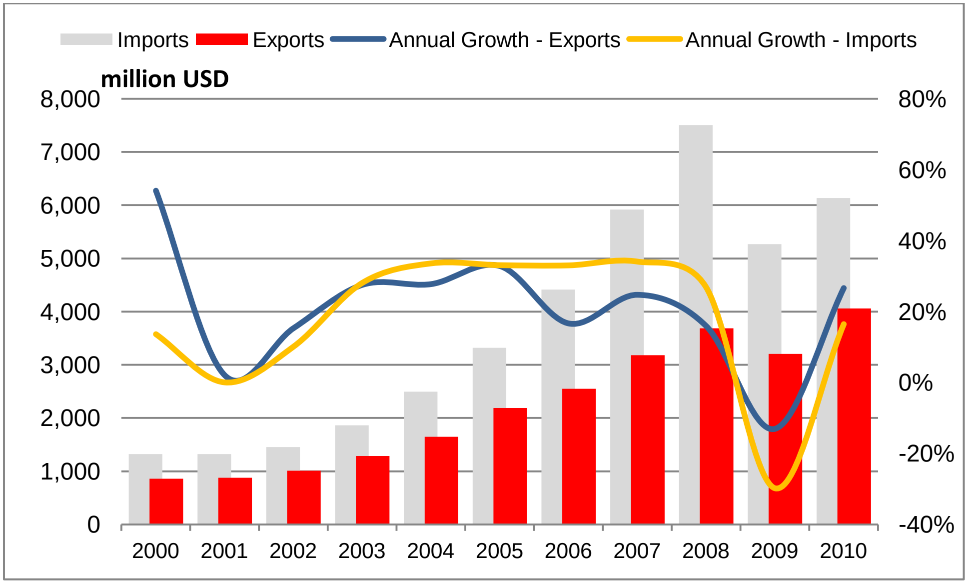
Source: National Bank of Georgia

In the last decade, Georgia's economy has become increasingly open to trade, with imports peaking at 58.62 per cent of GDP in 2008, compared to just under 40 per cent in 2000. It bears noting that in the boom years, import figures were inflated by high levels of imported equipment and intermediate goods for construction of energy lines from Azerbaijan, through Georgia and on to Turkey.

At the height of the financial crisis in 2009, Georgian imports fell by around 19.5 per cent. The current-price data for 2010 suggest a strong rebound in imports (an increase of 17.1 per cent relative to 2009), with oil and petroleum products representing the most important import item. Increases in the price of imported fuel and food may have, to some extent, attenuated a strong return to import growth in real terms, as indicated by the high inflation in 2010 (as measured by the consumer price index).

Exports accounted for 29 per cent to 34 per cent of GDP over the period 2002 to 2007 with stronger growth observed at the beginning of this period. The resulting trade gap has served to increase Georgia's current account deficit. There was a noticeable drop in the growth rate of exports in 2006 due in part to the loss of Russian markets[34]. However, export growth picked up in 2007 before declining at a similar rate in 2008. Exports for 2010 grew by 27 per cent relative to 2009, driven by increases in sales of ferrous metals, as demand for Georgian iron and steel increased significantly (as did the global prices for iron and steel). Other significant sources of revenues included re-export of motor cars and export of other minerals and metals.

Figure 4:2 Georgia's Exports and Imports, 2000 to 2010



Source: National Bank of Georgia

4.1.1 Foreign Direct Investment

The continually widening current account deficit has principally been financed by private capital flows, mainly FDI and external borrowing. As explained in section 2, Georgia has been a recipient of significant FDI. FDI grew continuously over the period 2002 to 2007 and more than doubled in 2006; net inflows of FDI, as a percentage of GDP, increased from 7 per cent in 2005 to over 16 per cent in 2007 (Table 4:1). In 2002 to 2005, FDI inflows were driven by pipeline construction. In 2006, while pipeline construction remained significant, more than half of the FDI went to banking, manufacturing and tourism sectors. In 2007, transport and communications sector was the biggest recipient of FDI (21 percent of total FDI) followed by mining and manufacturing (20 per cent) and energy (18 per cent).

Net FDI slumped in the third quarter of 2008 to 3 per cent of GDP as a result of the armed conflict with Russia; although it recovered slightly towards the end of the year (to 9 per cent of GDP in the final quarter). The global financial crisis further dampened investor confidence in the period that followed, leading to a fall in net FDI to 6 per cent in 2009 and to below 5 per cent of GDP in 2010. Preliminary figures from Geostat show that net FDI amounted to US$ 643 million during the first three quarters of 2011, slightly higher than the figure of US$ 600 million for the same period in 2010. Although these figures are encouraging, overall recovery in FDI remains weak and far below the pre-crisis levels.

[34] During 2006, Russia which had been Georgia's main trading partner until then, imposed a series of trade and transit barriers on Georgia.

As a result of falling net FDI, the current account deficit, which touched 23 per cent in 2008 (despite a significant increase in current transfers which partly offset the big increase in the trade deficit), appears to have been financed mainly by using Eurobond proceeds and donor support.

Table 4:1 Balance of Payments, US$ millions, 2000 to 2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
million USD											
GDP at current prices	3,059.05	3,221.03	3,397.81	3,990.82	5,124.72	6,410.98	7,761.72	10,171.92	12,800.54	10,767.05	11,636.52
Current account balance	-176.88	-198.06	-218.23	-383.74	-354.38	-709.66	-1,175.53	-2,009.44	-2,915.71	-1,210.46	-1,333.73
of which:											
Trade Balance	*-463.83*	*-446.64*	*-446.19*	*-577.07*	*-846.30*	*-1,130.31*	*-1,861.53*	*-2,734.64*	*-3,815.17*	*-2,060.13*	*-2,072.20*
Income	*37.15*	*20.04*	*11.53*	*13.33*	*78.05*	*61.62*	*162.06*	*36.74*	*-160.90*	*-117.84*	*-360.00*
Transfers	*249.80*	*228.54*	*216.43*	*180.00*	*413.88*	*359.04*	*523.94*	*688.45*	*1,060.35*	*967.50*	*1,098.47*
Capital and financial account	171.86	186.96	206.63	389.61	341.01	683.23	1,237.43	2,045.44	2,951.50	1,159.66	1,355.23
of which:											
Capital account	*12.37*	*13.53*	*18.62*	*19.87*	*40.68*	*58.64*	*171.16*	*127.95*	*112.28*	*182.50*	*206.09*
Financial account	*159.49*	*173.43*	*188.01*	*369.74*	*300.33*	*624.59*	*1,066.27*	*1,917.49*	*2,839.22*	*977.16*	*1,149.14*
of which:											
Net Foreign Direct investment	128.07	105.78	156.12	330.89	482.76	542.23	1,185.91	1,673.90	1,494.07	659.46	808.61
Portfolio investment*	14.50	119.02	63.62	20.35	-4.55	192.93	319.00	620.61	1,475.85	934.13	548.51
Reserve assets	16.93	-51.37	-31.73	18.50	-177.88	-110.57	-438.64	-377.03	-130.71	-616.43	-207.97
Net errors and omissions	5.02	11.11	11.61	-5.87	13.37	26.42	-61.9	-35.99	-35.79	50.79	-21.5
Total exceptional financing	143.41	177.06	137.79	21.21	43.34	67.09	7.79	80.03	783.84	-38.67	93.68
As % of GDP											
Current account balance	-5.78%	-6.15%	-6.42%	-9.62%	-6.92%	-11.07%	-15.15%	-19.75%	-22.78%	-11.24%	-11.46%
Trade Balance	-15.16%	-13.87%	-13.13%	-14.46%	-16.51%	-17.63%	-23.98%	-26.88%	-29.80%	-19.13%	-17.81%
Income	1.21%	0.62%	0.34%	0.33%	1.52%	0.96%	2.09%	0.36%	-1.26%	-1.09%	-3.09%
Transfers	8.17%	7.10%	6.37%	4.51%	8.08%	5.60%	6.75%	6.77%	8.28%	8.99%	9.44%
Net Foreign Direct investment	4.19%	3.28%	4.59%	8.29%	9.42%	8.46%	15.28%	16.46%	11.67%	6.12%	6.95%
Portfolio investment*	0.47%	3.70%	1.87%	0.51%	-0.09%	3.01%	4.11%	6.10%	11.53%	8.68%	4.71%

** Includes financial derivatives and other investment*
Source: National Bank of Georgia

The outlook for net FDI remains weak for the foreseeable future (< 6 per cent of the GDP) due to weak global recovery, uncertainty in Europe and limited scope for further privatisation. The current account deficit is expected to narrow steadily but, remains a source of vulnerability (Table 4:2).

Table 4:2 Balance of Payments – IMF Projections, US$ millions, 2011 to 2016

	2011	2012	2013	2014	2015	2016
million USD						
Nominal GDP	13,754	14,840	15,236	15,874	16,792	17,890
Current account balance	-1,481	-1,439	-1,228	-1,085	-970	-1,039
of which:						
Trade Balance	*-3,129*	*-3,158*	*-3,045*	*-3,019*	*-3,044*	*-3,225*
Income	*-300*	*-347*	*-372*	*-358*	*-336*	*-306*
Transfers	*1,176*	*1,149*	*1,165*	*1,214*	*1,262*	*1,309*
Capital and financial account	2,072	1,463	1,420	1,390	1,342	1,147
of which:						
Capital account	*137*	*91*	*83*	*74*	*75*	*74*
Financial account	*1,935*	*1,372*	*1,337*	*1,316*	*1,267*	*1,073*
of which:						
Net Foreign Direct investment	712	806	865	877	928	989
Portfolio investment*	1223	566	472	439	339	84
Net errors and omissions	0	0	0	0	0	0
Financing	-591	-124	-392	-306	-371	-108
Gross International Reserves	-531	126	0	-46	-290	-93
IMF Funds: Purchases (+)/ Repayments (-)	-60	-250	-392	-260	-81	-15
As % of GDP						
Current account balance	-10.77%	-9.70%	-8.06%	-6.84%	-5.78%	-5.81%
Trade Balance	-22.75%	-21.28%	-19.99%	-19.02%	-18.13%	-18.03%
Income	-2.18%	-2.34%	-2.44%	-2.26%	-2.00%	-1.71%
Transfers	8.55%	7.74%	7.65%	7.65%	7.52%	7.32%
Net Foreign Direct investment	5.18%	5.43%	5.68%	5.52%	5.53%	5.53%
Portfolio investment*	8.89%	3.81%	3.10%	2.77%	2.02%	0.47%

Source: IMF Country Report No. 11/146, June 2011

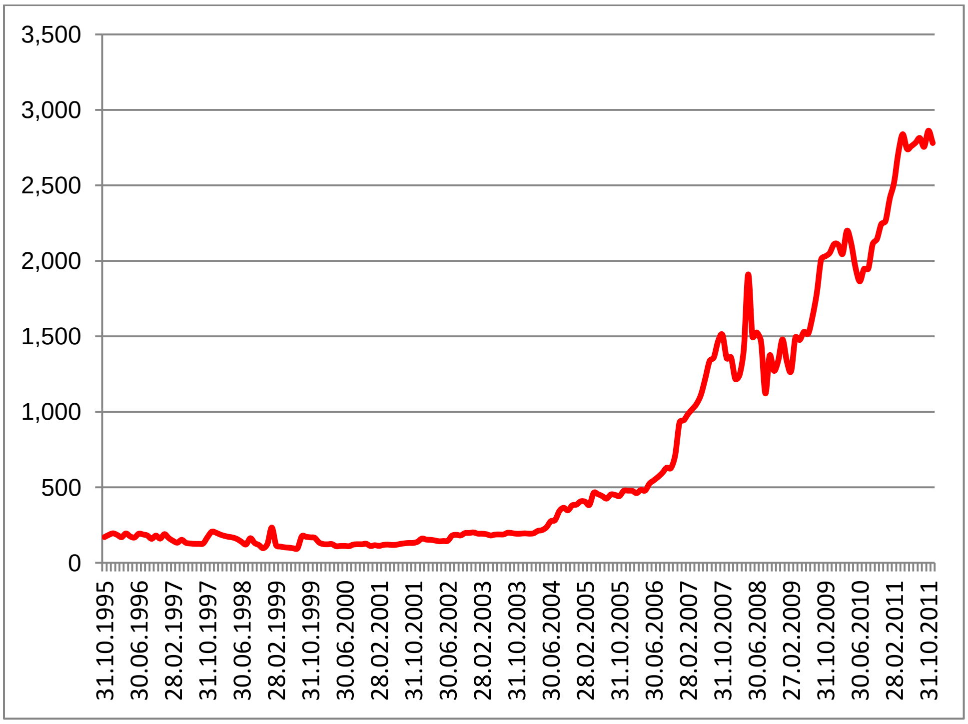
4.2 Reserves

As shown in Figure 4:3, Georgia's official reserves position steadily improved over the period 1995 to 2005. However, there was a rapid accumulation of reserves between 2006 and 2007- during this period Georgia's reserves almost trebled from US$ 479 million at the start of 2006 to almost US$ 1.4 billion at the end of 2007. Official reserves continue to rise until April 2008, but subsequently fell sharply due to the unfavourable global economic events and the conflict with Russia. Georgia implemented a temporary exchange rate peg during the 2008 conflict with Russia but, the declining capital inflows and depletion of reserves led to the return to a "managed float" exchange rate regime and the lari was allowed to depreciate.

The rebuilding of international reserves was among the aims of the IMF intervention that followed the conflict and funds were released to Georgia in September 2008. The IMF has set a floor on net international reserves (NIR) for the National Bank of Georgia, and these targets have generally been exceeded.

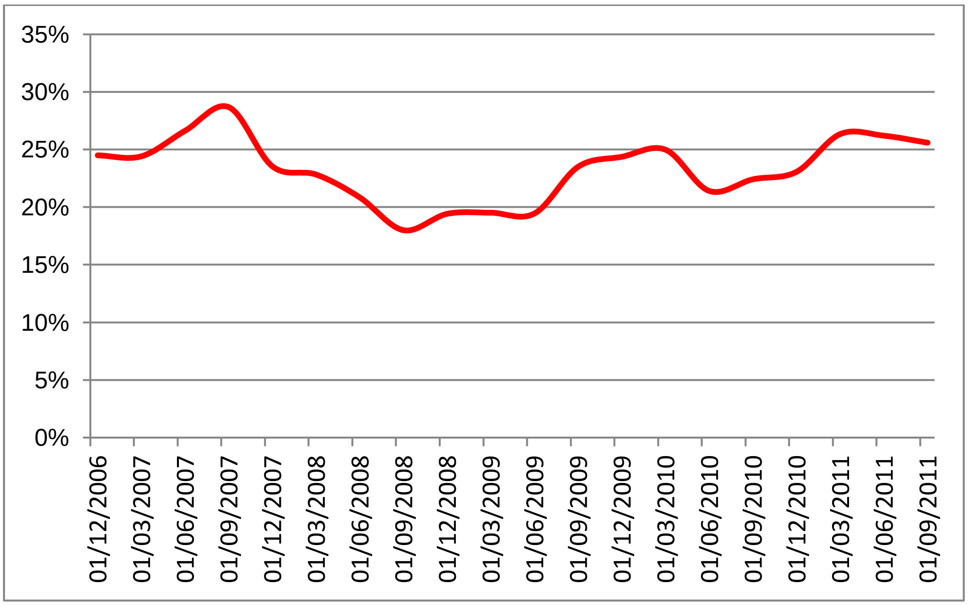
A slight appreciation of the lari against the dollar in 2011 facilitated the net purchase of US$ 20 million on the foreign exchange market by the Central Bank, restoring foreign exchange reserves to their pre-crisis levels. This is an important development given the rise in Georgia's repayment obligations for external debt which is expected from 2012 onwards.

Figure 4:3 Gross Reserve Assets, US$ millions, 1995 to 2011



Source: National Bank of Georgia

Figure 4:4 Reserves to External Debt Ratio, 2006 to 2011



Source: National Bank of Georgia

4.3 External Debt

Georgia's public external debt-to-GDP ratio fell significantly from 50 percent of GDP in 2000 to 17.5 percent in mid-2008, reflecting strong economic growth and real lari appreciation. However, following the 2008 conflict and as a result of the 2009 recession, public external debt-to-GDP has more recently risen to 36 per cent (Table 4:3); while overall external debt to GDP ratio has risen to 84 per cent. This is a key source of vulnerability in the balance of payments

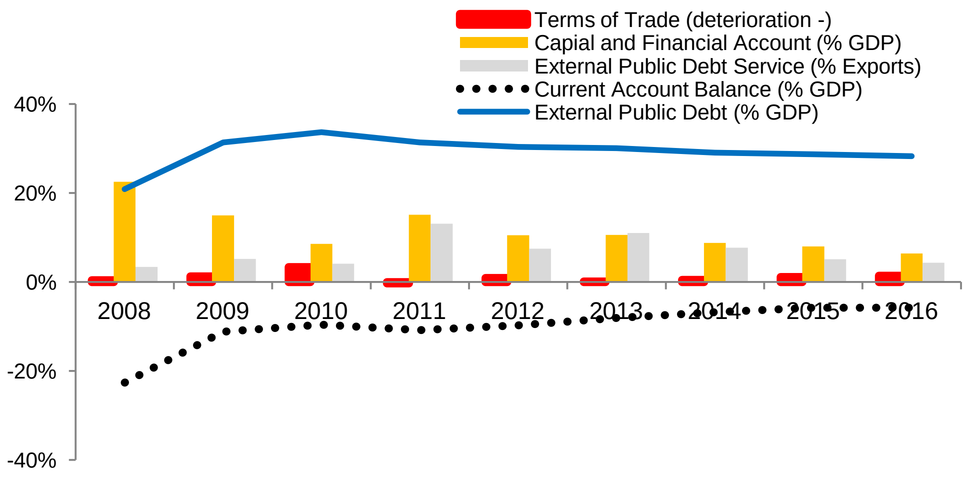
Table 4:3 Georgia's External Debt Position, 2006 to 2010

	2006	2007	2008	2009	2010
Nominal GDP (US$ million)	7,761.72	10,171.92	12,800.54	10,767.05	11,636.52
External debt (US$ million)	3800.535	5783.821	7624.405	8661.37	9817.145
of which public debt	*1697*	*1839.043*	*2548.526*	*3581.864*	*4219.213*
External debt to GDP ratio	49%	57%	60%	80%	84%
External public debt to GDP ratio	22%	18%	20%	33%	36%

Source: National Bank of Georgia

While much of Georgia's external debt is on affordable terms (83 per cent of its external public debt is on concessional IDA terms and 68 per cent is on a fixed interest rate, with average weighted interest rate being 2.04 per cent), substantial debt repayments are due over 2013 to 2015. In 2013 alone, repayment obligations were expected to reach US$ 750 million reflecting the repayment of the US$ 500 Eurobond issued in 2008[35]. To improve its amortisation profile, the government issued a US$ 500-million Eurobond at very favourable terms (10-year maturity and 7.125 percent yield) in April 2011. The issue was used to redeem, through a voluntary exchange, US$ 435 million of the US$ 500-million Eurobond maturing in 2013, reducing significantly the external debt rollover hump of 2013. Georgia's external debt ratio is expected to remain on a downward path and its external debt service profile looks manageable (Figure 4:5).

Figure 4:5 External Vulnerability Indicators, 2008 to 2016



Sources: IMF IXth Program Review, June 2011; Projections 2010 onwards

[35] DG ECFIN Country Mission Report, May 2011

4.4 Conclusions

Prior to the armed conflict and the global financial crisis, Georgia had been successful in cutting its public external debt burden from 50 percent of GDP in 2000 to 17.5 percent in 2008, despite worsening trade and current account deficits. However, the 2008 armed conflict and the global financial crisis created a significant external financing need (estimated to be US$ 1.4 billion by the IMF) over 2008 to 2010. These financing needs were largely met through IMF credits and donor support (including MFA). However, the crisis also led to a significant worsening of the external debt to GDP ratio. Although Georgia's public debt and external public debt remain below prudential level and the successful Eurobond issue in April 2011 has flattened Georgia's external repayments profile; the high current account deficit remains a key source of vulnerability for Georgia's balance of payment, in an environment of uncertain and volatile private capital flows.

It In recognition of Georgia's vulnerabilities in an 'unsettled external environment', on 28 March 2012, the IMF Board approved a 24-month Stand-By Arrangement (SBA) and Standby Credit Facility (SCF). Georgia would be able to access IMF credit of up to SDR 250 million (about US$387 million), evenly divided between the SBA and the concessional SCF. Access to IMF resources would become available in the event of a significant worsening of external economic and financial condition. The Georgian authorities are also currently negotiating a new MFA operation to meet a potential external financing gap in 2011/12.

5 IMPACT OF MFA ON STRUCTURAL REFORMS

This section of the report examines the role of the MFA in supporting structural reform in Georgia. To this end, the following issues have been explored:

- Relevance: to what extent was the design of the MFA conditions relevant to the PFM situation and/or the wider context?
- Fulfilment and durability of reforms: to what extent were the MFA conditions fulfilled? What has been done since?
- The specific role of MFA in promoting the reforms: how far can the MFA conditions be said to have influenced their fulfilment? Would these reforms have taken place anyway? And at the same speed?
- Impact: what difference did these conditions make?

5.1 Relevance of MFA Conditionality

The MFA operation comprised a narrow set of conditions with exclusive focus on PFM reform. This represented an area where there was strong domestic ownership of reform, as illustrated by the Public Finance Management Reform Policy Vision 2009-2013, a follow up to the 2005 Strategic Vision.

Furthermore, a primary (and pragmatic) consideration in the design of the MFA conditions was a concern for simplicity and the avoidance of conditions which might be difficult to fulfil, in order to facilitate quick disbursement. An evaluation of the previous MFA published in January 2010 highlighted the need to streamline conditionality, and the present MFA conditions were indeed few in number and the disbursement in two fixed instalments was straightforward and not complex.[36] The structural changes were feasible to meet in a relatively short time span. Three conditions and one sub-condition required the preparation and approval of action plans: (i) PFM Reform Action Plan for 2010; (ii) Internal Audit Action Plan for 2010; (iii) Chamber of Control (CCG) capacity development plan for 2010-2011; and (iv) State Procurement Agency (SPA) Action Plan for 2010 on the implementation of e-procurement. The other sub-conditions required SPA to implement e-procurement following a particular sequence prescribed in the existing amended Public Procurement Law; and to provide training on the amended Public Procurement Law. Additionally, the MFA included two conditions relating to programme based budgeting. Overall, MFA conditions represented continuity over previous EU support and consistency with parallel Sector Support Programme (Table 2:8).

MFA conditions were also relevant to the overall PFM situation as they were focused on areas that were scored relatively low in the 2008 PEFA Assessment as may be seen from Table 5:1 below which provides a summary of the PEFA performance indicators. The indicators related to Internal Audit (PI-21); Chamber of Control (PI-26); and State Procurement Agency (PI-19) all scored D+ in the 2008 PEFA. The PEFA indicators related to programme budgeting areas scored more highly than those for Internal Audit, CCG and SPA. The Classification of the budget (PI-5) scored B, and the Comprehensiveness of information included in budget documentation (PI-6) scored A, in the 2008 PEFA. However, the MFA conditions on programme based budgeting were in line with the priorities of other major donors (IMF, World Bank, and US Treasury).

[36] Ecorys, Ex-post evaluation of MFA operations in Georgia (2006-2008), Framework contact ECFIN-160-2005, Final Report January 2010.

Moreover, the Operational Assessment carried out at the end of 2010 reiterates that internal audit is the key persistent weakness of Georgia's public finance management framework – this theme ranked as high priority by the assessors.

The MFA could potentially have focused on other, more pressing, weaknesses in Georgia's PFM system. For example, if the intention was to correct sources of potential fiscal imbalances, a focus on internal and external audit and procurement practices would not have been appropriate. Rather there would have been some attention to the weaknesses in either budgeting processes or in accounting and reporting, which most probably are the root causes of the poor scores in the PEFA indicators relating to the aggregate expenditure out-turn (PI-1: D) and the composition of expenditure out-turn (PI-2: C). Similarly, one would expect a focus on improving oversight of aggregate fiscal risks from other public sector entities (PI – 9 : C+). Georgia continues to have a large public sector, which is a major source of contingent liabilities, and closer control of such liabilities would normally be considered a higher priority than the areas chosen for attention in the MFA conditions.

But there is an obvious trade-off between the depth of the structural reform and the need for quick disbursement. The identification and specification of alternative PFM conditions (more focused on the most urgent weaknesses) would have taken time. In this context, the focus of conditionality on simpler reforms was perfectly valid and relevant.

Table 5:1 Mapping of MFA Conditions against the weaknesses identified in the 2008 PEFA and 2011 Operational Assessment

PEFA Indicator and Score (data collection: May -July 07)			MFA Conditions	PwC Operational assessment (data collection: Nov - Dec 2010)
A. PFM-OUT-TURNS: Credibility of the budget				
1	Aggregate expenditure outturn compared to original approved budget	D		
2	Composition of expenditure outturn compared to original approved budget	C		
3	Aggregate revenue outturn compared to original approved budget	A		
4	Stock and monitoring of expenditure payment arrears	B+		
B. KEY CROSS-CUTTING ISSUES: Transparency and Comprehensiveness			Action Plan for 2010 for PFM reforms	
5	Classification of the budget	B	Adoption of the Budget Code with provisions on programme-based budgeting Preparation of a timetable for the implementation of programme based budgeting	Introduction of programme budgeting at all levels: LOW
6	Comprehensiveness of information included in budget documentation	A		
7	Extent of unreported government operations	B+		
8	Transparency of inter-governmental fiscal relations	B		
9	Oversight of aggregate fiscal risk from other public sector entities	C+		
10	Public access to key fiscal information	B		
C. BUDGET CYCLE				
Policy-Based Budgeting				

PEFA Indicator and Score (data collection: May -July 07)			MFA Conditions	PwC Operational assessment (data collection: Nov - Dec 2010)
11	Orderliness and participation in the annual budget process	A	Adoption of the Budget Code with provisions on programme-based budgeting Preparation of a timetable for the implementation of programme based budgeting	
12	Multi-year perspective in fiscal planning, expenditure policy and budgeting	C+		Budget planning based on Budget Data and Directions: MEDIUM Introduction of programme budgeting at all levels: LOW
Predictability and Control of Budget Execution				Complete the development of and implement PFMIS: MEDIUM Establish internal control function for the Treasury purpose, until internal control is properly handled at ministry level: HIGH
13	Transparency of taxpayer obligations and liabilities	C+		
14	Effectiveness of measures for taxpayer registration and tax assessment	B		
15	Effectiveness in collection of tax payments	D+		
16	Predictability in the availability of funds for the commitment of expenditure	B+		Developing a commitment management system and establish internal control function in place: HIGH

PEFA Indicator and Score (data collection: May -July 07)			MFA Conditions	PwC Operational assessment (data collection: Nov - Dec 2010)
17	Recording and management of cash balances, debt and guarantees	A		Prepare a debt management strategy: MEDIUM Establishment of a department integrating foreign and domestic debt management: MEDIUM Develop a dedicated module on debt management within the Financial Management Information System:LOW
18	Effectiveness of payroll controls	Could not score		
19	Competition, value for money and controls in procurement	D+	Action Plan for the implementation of the e-procurement system. Implementation of the e-procurement system Trainingto the personnel of the Agency and to the personnel of the selected line Ministries	Consider incorporating in legislation EU Directive 17 and 18 of 2004: MEDIUM Elaborate the format of the performance guarantee and include the form of the performance guarantee in the tender documentation: LOW Developing non-financial criteria: MEDIUM Establishment of an Internal Audit function in the SPA: HIGH
20	Effectiveness of internal controls for non-salary expenditure	C+		
21	Effectiveness of internal audit	D+	Adoption of the Law on Internal Audit and Inspection. Action Plan on internal audit for 2010.	Revision of the Law in line with PIFC principle: HIGH Segregate in separate structures the financial management and control from internal audit: HIGH Establish a professional certification scheme: HIGH Recreate the CHU or replace with identical structure: HIGH Q2/2011 Adopt the Internal Audit methodology in line with INTOSAI and IPSAS. Carry out pilot audits: HIGH Drawing up the relevant anti corruption legislation: MEDIUM Technical assistance: MEDIUM

PEFA Indicator and Score (data collection: May -July 07)			MFA Conditions	PwC Operational assessment (data collection: Nov - Dec 2010)
Accounting, Recording and Reporting				
22	Timeliness and regularity of accounts reconciliation	A		
23	Availability of information on resources received by service delivery units	D		
24	Quality and timeliness of in-year budget reports	B+		
25	Quality and timeliness of annual financial statements	D+		Accelerated transition to IPSAS and capacity building on IPSAS: MEDIUM
External Scrutiny and Audit				
26	Scope, nature and follow-up of external audit	D+	Capacity development plan for 2010-11	Recruitment of more auditors with employment at equal legislative basis (labour contracts or civil service): MEDIUM Review and amendment of the legal basis for equal treatment and independent status of CoC employees: HIGH Design and certify relevant national professional qualification (ACCA): MEDIUM
27	Legislative scrutiny of the annual budget law	B+		
28	Legislative scrutiny of external audit reports	C+		
D. Donor Practices				
D-1	Predictability of direct budget support	C+		
D-2	Financial information provided by donors for budgeting and reporting on project and programme aid	C		
D-3	Proportion of aid that is management by use of national procedures	D		

5.2 Fulfilment and Durability of Reforms

The ex-post evaluation and independent review of the evidence available from the Government of Georgia, European Commission, and other donor and public sources shows that all MFA conditions (which focused on PFM reforms) were implemented in full and within a relatively short timeframe. By the end of May 2010, the GoG had complied with all the specific conditions. Over the following months of 2010 and during the first nine months of in 2011, further significant structural reforms were implemented in these PFM reforms areas. Constraints on the institutional capacity of the GoG and the EU Delegation, in terms of language translation services and website development may however, have limited the publication and wider availability of information about GoG and donor activities during 2010-2011. Wider access to monitoring and annual reports on the overall PFM reform efforts would encourage more awareness of the reforms, set the stage for deeper analysis of the PFM reform efforts and effectiveness as well as facilitate policy dialogue with a broader range of stakeholders.

A summary of the main actions over the 21 month period between January 2010 and September 2011 is set out for each of the MFA conditions 1-6.

5.2.1 Condition 1 Overall PFM Reforms

In the framework of the Reform Policy Vision 2009-2013, the Ministry of Finance prepares and makes available to the wider public the Action Plan for 2010 that provides a clear roadmap for monitoring of the PFM reforms, including consultations with all relevant stakeholders

The rationale behind the inclusion of this condition was to provide a timetable for the implementation of the PFM Reform Policy Vision 2009-2013. It entailed three main components: publication of action plans, consultation, and monitoring.

Action taken by Georgian Authorities

Action Plans: The overall PFM annual Action Plan for 2010 was prepared and made available to the wider public on the website of Ministry of Finance in both Georgian and English (as it was the case in 2009).

The 2010 Action Plan provides a timetable and lists the responsible entities of the MOF in charge of implementing PFM reforms for 2010 in the field of: 1. Budgeting; 2. Resource Management; 3. Accounting and Reporting; 4. Internal Audit; 5. E-Technologies. One of the Pillars (Section IV) of the Action Plan 2010 refers to the monitoring process of PFM Reform.

Consultation with all relevant stakeholders via the PFM Coordination Council: A PFM reform Coordination Council was established in March 2010 by the Ministerial Decree No. 241 defining the charter and composition of the members. One of the main objectives of the PFM Coordination Council is the monitoring of the implementation of the 2009-2013 PFM Reform Strategy and annual action plans. The PFM Coordination Council is to meet quarterly to receive quarterly progress reports, referring to milestones and activities of the PFM Annual Action Plan. It is chaired by the Minister of Finance, and includes representatives from the MoF, Members of Parliament, international donor organisations, NGOs, private sector and media representatives. Other members of the Council may include representatives from the Chamber of Control, State Procurement Agency, legal entities at public law, and line ministries. The heads of all MoF Departments are members of the Coordination Council, which does not have its own secretariat.

The first meeting of the PFM Coordination Council was held on 1st April 2010, where the MoF of Georgia presented a draft “Public Finance Management Reform

2010 Action Plan" under the framework of the Reform Policy Vision 2009-2013. A total of four meetings were held up to September 2011. An unofficial translation of all Minutes was available from GoG. The minutes show that these meetings are well attended by many relevant stakeholders.

Monitoring of PFM reforms via the annual reports: The PFM Reform Annual Progress Report for 2010[37] details the work done to implement the actions set out in the Action Plan. According to the Progress Report, all planned reforms, as well as additional ones, have been implemented.

European Commission's Assessment of Compliance

When reviewing the fulfilment of the conditions, the European Commission had noted certain areas for improvement (including provision of more background information for activities listed in the Action Plan which are not self-explanatory; timely review of the PFM reforms and a timely preparation of the Action Plan, with publication of both documents in January; and improvement of the functioning of the Coordination Council). The evaluators also examined the whether the European Commission's observations have been taken on board by the Georgian authorities. Progress in this respect is less than satisfactory:

- Provision of more background information for activities listed in the Action Plan which are not self-explanatory: the 2011 Action Plan still does not provide sufficient background information on the actions which are not self-explanatory.
- Publication of both documents in January: the 2011 Action Plan was published on 1 April 2011. The 2012 Action Plan had not been published at the time of writing this Report. The Georgian authorities appear not to have taken on board the Commission's feedback regarding timely publication of action plans and progress reports.
- Improvement of the functioning of the Coordination Council: while the CCG, SPA as well as Transparency International Georgia do participate in the Coordination Council meetings, the line ministries still do not attend, and the focus group with PFM experts suggests that these meetings do not add much value as 'real decisions are made outside this forum'.

Durability of the Reforms (progress beyond MFA)

- The authorities have continued to prepare action plans: the 2011 PFM Action Plan, which foresees reforms in the same five areas as in 2010 is publicly available[38].
- In addition, the MoF reporting and transparency efforts have reduced in that, although not a requirement *stricto sensu*, the documentation is not made readily available in English for the donor community, which does not facilitate policy dialogue.

[37] Official version is only available in Georgian. An unofficial translation ws used for the purpose of this evaluation.

[38] Date of publication of 2011 Action Plan: 2011 April 1st, Decree of the Minister of Finance #192

5.2.2 Condition 2- Internal Control and Internal Audit

Effective internal controls and audits are essential for the integrity of the overall PFM system. The MFA contained two conditions in this area:

A. The Parliament of Georgia adopts the Law on Internal Audit and Inspection.

B. In the framework of the Public Internal Financial Control (PIFC) Policy Paper and the Law on Internal Audit and Inspection, the Government endorses and the Ministry of Finance makes available to the wider public an Action Plan on internal audit for 2010

The first condition represented the next step in taking forward a condition previously included in the EU Sector Policy Support Programme (2007 to 2009) relating to preparation and submission of a draft law to the Parliament on internal audit and internal control.

Action taken by Georgian Authorities

A. In March 2010, the Law on State Internal Audit and Inspection was adopted by the Parliament of Georgia.

B. On 5 May 2010, an Action Plan on internal audit for 2010 was discussed and endorsed by Cabinet**.** The Action Plan for 2010 on Internal Audit was developed within the framework of the Public Internal Financial Control (PIFC) Policy Paper.

European Commission's Assessment of Compliance

When reviewing the fulfilment of the conditions, the Commission noted that the Action Plan could have more explicit links between the PIFC Policy Paper, the general objectives of the Action Plan, and the specific Action Plan activities to make it easier for the line ministries as well as for the wider public to understand the policy reforms of the internal financial audit and control. The Commission also regarded the 2010 Action Plan to be highly ambitious. The 2011-2012 Action Plan of the Secretariat of the Internal Audit Council was made available to the study team in English and it is still not self-explanatory for a wide audience.

Durability of the Reforms (progress beyond MFA)

In June-July 2010, in line with the Law, Internal Audit Units (IAUs) were established in 12 out of 16 Ministries, and in the Autonomous Republics of Adzharia and Abkhazia. An IAU was formed in the Chancellery of the Government and Administration of Ossetia. Four Ministries have a waiver until 2013: the Ministry of Defence, the Ministry of Interior, the Ministry of Justice, and the Ministry of Corrections and Legal Assistance. Focus group participants explained that the ministries without IAU are mainly law enforcement ministries where inspection units are particularly strong.

The Law on State Internal Audit calls for the formation of a "Central Harmonisation Unit" (CHU). The National Centre of Internal State Control was initially set up in May 2010 to fill such a function. In September 2010 however, a major step back was taken when the Centre was shut down and the staff dismissed following an order of the Minister of Finance. It was quickly replaced with the Internal Audit Council established in November 2010, but such a case of institutional instability undermines confidence in the reform process (as such actions are perceived as 'backtracking') and concerns were expressed that Council members, who are ministries' officials, might have other priorities.

Box 5:1 Importance of a Central Harmonised Unit

One of the recommendations of the PIFC gap Analysis conducted by the EU was that Georgia should establish a Central Harmonisation Unit reporting to a body defined within the government and with oversight over internal audit and financial management and control. One of the Central Harmonisation Unit's long term objectives would be the establishment of a certification programme for internal auditors. The Central Harmonisation Unit would also prepare a standard internal audit manual.

EU best practice

According to EU best practice, all government departments and government owned and controlled entities should be audited by internal audit. The new EU countries have an authoritative oversight unit for internal audit and financial management and control reporting directly to the Minister of Finance called a Central Harmonisation Unit (CHU) which is described in more detail below.

A separate function of financial investigation/inspection, with a focus on anti-fraud and corruption, complements the internal and external audit. The EU system tends to organise the inspectorates-general into one centralised financial investigation/inspection department. This structure bolsters the independence of financial investigators/inspectors when top level management or the ministers have to be investigated.

Oversight of the Standards of Internal Audit and Financial Management and Control

The Central Harmonisation Unit oversight and co-ordination responsibilities include:

- Introduction of the PIFC concept for both financial management and control and internal audit throughout all ministries and all other budget and local spending units;
- Co-ordinating PIFC with the EU and other countries;
- Development of financial management and control and internal audit methodologies and guidelines for ministries and all other budget and local spending units;
- Providing relevant training and raising PIFC awareness;
- Establishment and management of the internal audit certification programme;
- Preparation of PIFC legislation;
- Annual assessment of and reporting on financial management and control and internal audit throughout all ministries and all other budget and local spending units

Planning and Coverage

The standards of international organisations, including INTOSAI, the Institute of Internal Auditors, IFAC's International Standards of Auditing and most national auditing bodies' standards call for annual and strategic planning, based on the auditor's risk analysis, as well as planning for individual audits. A multiyear plan is prepared that ensures that all departments, divisions or entities, cycles or operations are audited over, at least, a three or five year cycle.

Duties, Procedures and Documentation

Internal audit departments avoid a 'policeman role'. Disciplinary actions are not taken by internal audit departments.

Detailed audit procedures are included in an audit manual which is based on a standardised model and has been approved by the chief internal auditor. These procedures are reviewed and adapted to any changes in the auditee's procedures or other issues.

Qualifications

All internal auditors are required to be certified or to be training for recognised auditing certifications from the national accounting and auditing association(s), internationally recognised programmes such as the Institute of Internal Auditors' Certified Internal Auditor qualification, or an internal certification programme for government internal auditors which would be established and managed by the Central Harmonisation Unit.

The Internal Audit Council contains 12 members, including the Heads of the IAUs of the largest Ministries in the public sector, the Ministry of Justice and Deputy Minister of Finance. Since June 2010, the Council has been co-chaired by the Minister of Finance and the Chairman of the Chamber of Control of Georgia.

The Secretariat of the Internal Audit Council carries out the duties of the Internal Audit Council, and has been working on the improvement of existing laws so that they are aligned with international standards. It is understood that the Law on State Internal Audit and Inspection, which was approved in March 2010 required major improvements and that amendments to the law were being drafted in 2011 with a view of making it compliant with PIFC by clearly drawing out the distinction between internal audit (which is a pro-active approach to control based on risk assessment) and inspection (which is a reactive approach based on disciplinary and punitive measures).

Besides, the Secretariat has also developed and adopted a Code of Ethics; Internal Audit Manual; Methodology and Standards for Internal Audit Units. For example, manuals have been prepared in line with examples from various countries and international standards, and training has been provided. In addition, on 14 September 2011, the Government of Georgia introduced an amendment to the Decree dated July 30, 2010 on “Approval of Internal Audit standards” which endorsed the standards of the Internal Audit Council Secretariat.

In terms of next steps, Joint Pilot Audits will be conducted in six ministries in 2012.

Officials from MoF Internal Audit Department and the Secretariat of the Internal Audit Council reported that Government has focused more attention on Internal Audit since the arrival in mid-June 2011 of Minister of Finance Mr Dimitri Gvindadze (this was reiterated by PFM experts at the focus group discussion).

5.2.3 Condition 3: External Audit

Supreme Audit Institutions (SAI) have a vital role in holding government to account and ensuring transparency in government operations. Although, there are differing models for external audit, all models are guided by the fundamental objectives set out in the Lima declaration, and the international standards of auditing developed by the International Organisation of Supreme Audit Institutions (INTOSAI). The EU Sector Policy Support Programme (2007 to 2009) contained a condition relating to the submission of draft law to the Parliament on the transformation of Chamber of Control into a supreme external audit institution in line with international standards. The previous MFA (2006 to 2008) contained a condition relating to amendment of draft law on CCG to elevate its mandate and responsibilities to a supreme audit institution in line with INTOSAI standards. The approval of the law on CCG, was achieved in the last week of December 2008. Based on the delayed fulfilment of this conditionality, the disbursement of the third grant instalment of the previous MFA was withheld and eventually cancelled. The MFA conditionality in 2009/10 focussed on capacity building in CCG.

The Chamber of Control adopts and makes available to the wider public a capacity development plan that elaborates on organisational s and resource needs and resources of the Chamber of Control for 2010-11 (human resources, training, and equipment needs).

Action taken by Georgian Authorities

On 16 April, 2010, the Chairman of the Chamber of Control adopted the Capacity Development Plan of the Chamber of Control of Georgia for 2010-2011, by the Decree Number 55/42. The issue of the Capacity Development Plan was planned in the Chamber of Control Strategic Development Plan for 2010-2012. The purpose of the Plan was to define and ensure the essential resources required for upgrading public sector audit. The Capacity Development Plan sets out requirements for improving the necessary professional capabilities (financial, audit, performance audit, and IT audit) and institutional capabilities (human resources management, training strategy, IT support).

The Strategic Development Plan 2010-12 and the Capacity Development Plan 2010-2011, together with the Action Plans for 2010 and 2011, are all published in both Georgian and English, and are available to the wider public on the website of the Chamber of Control of Georgia.

European Commission's Assessment of Compliance

When reviewing the fulfilment of the conditions, the European Commission noted certain areas for improvement, such as the need to assess priority needs and to include cost estimates as part of future capacity development plan. This would be useful but should however be phased in gradually given the human resource constraints at the CCG, and the competing claims on scarce resources for audit operations and legal reporting responsibilities.

Durability of the Reforms (progress beyond MFA)

The Chamber of Control 2010 Annual Report spells out the results of the evolving manpower situation, and training provided. The achievements under the capacity development plan in 2010-2011 for financial audit, performance audit, and organisation capacity included the recruitment of 54 new auditors, internships and training for new recruits in audit practices, and recruitment of senior auditors from major accounting firms to provide guidance on the conduct of pilot financial audits. The performance audit methodology has been prepared with technical support from GIZ and Swedish National Audit Office, and tested in pilot audits.

However, according to PFM experts present at the focus group discussion, the CCG still crucially lacks auditors, especially auditors who can carry out non-financial audits (e.g. performance audits). It was reported it would not even have 20 qualified auditors. The CCG tends to recruit highly educated young staff sometimes lacking experience, and suffers from a very high staff turnover. To illustrate this, out of the 300 CCG staff receiving ACCA training – only 30 remained with the organisation in summer 2011. According to PFM experts representing donor organisations, there are significant human resource constraints in general in the auditing sector in Georgia. There are very few certified auditors – only a fraction of operating auditors (~1/10) is certified. The scarcity falls disproportionally on the public sector, as careers in the private sector are more attractive.

Beyond capacity development, another major recent development includes revisions to the law on the CCG. The law was enacted in 2009 and amendments were tabled in November 2011 (expected to be adopted by the Parliament in January 2012). It is expected that the independence of the CCG will increase.

5.2.4 Condition 4: Public Procurement

Public procurement is a major activity of governments that generates important financial flows and makes the State one of the largest economic actors in many countries. Public procurement is an essential strategic government function that is critical in implementing a country's development agenda. It has a direct impact on many economic and social outcomes such as the quality and efficiency of public expenditures; the level of competition in the economy; and, the quality and efficiency of goods and services delivered to the public. Good procurement practices can generate significant cost savings for the government and also reduce the cost of doing business with the government.

The MFA operation included three conditions relating to the implementation of an e-procurement system and associated training. This was an area where there was strong domestic ownership of reform.

A. The State Procurement Agency (SPA) prepares an Action Plan for the implementation of the e-procurement system.

B. The SPA implements the e-procurement system in the sequence prescribed by the amended Public Procurement Law.

C. The SPA provides training on the amended Public Procurement Law to the personnel of the Agency and to the personnel of the selected line Ministries on the basis of the training strategy

Action taken by Georgian Authorities

A. Action Plan. In the first quarter of 2010, the SPA, in cooperation with SIGMA (OECD/EC) prepared an "Action Plan for the Successful Implementation of E-Procurement" which was approved by the supervisory board of SPA in March 2010. The Action Plan anticipated the implementation of new electronic procurement system by September 2010, as envisaged under the amended Public Procurement Law. The Action Plan provided a road map with timetable and clear description of activities for ensuring the gradual phasing out of the paper-based tendering system and establishing a tendering system entirely based on electronic means before end December 2010.

B. Implementation. The SPA has proceeded quickly with the implementation of the Government led e-procurement reforms, although the actual implementation path between March and December 2010 did not always strictly follow the timetable and sequencing as envisaged under the amended Public Procurement Law. The Law was flexible and allowed the electronic and paper-based procurement systems to run in parallel during the transitional period between March and December 2010. Since December 2010 only the electronic system has been in operation.

C. Training. Training on the amended Public Procurement Law for the personnel of the SPA and of the selected line ministries, is one of the main activities (Section 4.10) of the SPA Action Plan. The Training strategy prescribed in the SPA Action Plan deals with (i) Content Development (ii) Training for Contracting Authorities (iii) Training for Economic Operators; (iv) Methodology; (v) Timescale and Scheduling; (vi) Training Evaluation. The SPA has provided training on the amended Public Procurement Law to all major contracting authorities (line ministries and their subordinated bodies), Ministry of Internal Affairs and its subordinated bodies, and all major contracting authorities of the Autonomous Republic of Adjara. The training of trainers has been undertaken, and the e-procurement system has been explained to business centres and training centres.

European Commission's Assessment of Compliance

The condition was deemed to be fulfilled; no further comments or observations were made by the Commission.

Durability of the Reforms (progress beyond MFA)

The achievements of the Georgian e-procurement system reforms undertaken since March 2010 are recognised by the international community. For example, in the EBRD 2011 Public Procurement Assessment of the public sectors across 29 countries, Georgia scored well above average in the EBRD region, both overall (4th position) and in the individual components of the EBRD Public Procurement Legal Frameworks Assessment (Legal Framework, Regulatory institutions, Scope of

Regulation, Eligibility Rules, Procurement Procedure, Review and Remedies, and Public contract management)[39].

The SPA reported that more reforms were undertaken in the 18 month period up until the end of October 2011, and at a faster speed, than set out in the SPA Action Plan. Pending issues however, include the inclusion of non-financial criteria in the evaluation of technical bids, and the establishment of an internal audit function in the SPA.

5.2.5 Conditions 5 & 6 Budget Process

Programme-based budgeting (PBB) reforms involve the introduction of a programme dimension to the budget classification system, usually in addition to existing administrative and economic or line item classification. This allows for the budget to be allocated to programmatic objectives and/or for stakeholders to view budget allocations against governments' overarching or sector- and institution-specific objectives. The benefits of PBB are well documented in literature[40]:

- Permitting a budget focused on clear objectives;
- Developing a coherent strategy for longer term strategic planning as well as short term performance;
- Ensuring program managers are responsible for resources under their control and increasing their margin of manoeuvre in how those resources are spend to improve efficacy and performance;
- Using performance information to improve programme delivery and reallocating resources to high-performing programs and emerging priorities;
- Simplifying the budget structure and making it more transparent and accessible to all, notably parliamentarians.

The MFA contained two conditions relating to PBB:

Condition 5: The Parliament of Georgia adopts the Budget Code with provisions on programme-based budgeting

Condition 6: The Ministry of Finance prepares and makes available a timetable for the implementation of programme-based budgeting

Action taken by Georgian Authorities

Condition 5. On 18 December 2009, the Parliament of Georgia adopted the Budget Code incorporating provisions on programme-based budgeting. The actual transfer to programme budgeting required a number of changes to the Budget Code of Georgia. On 1st July 2011, the Parliament, Committee on Budget and Finance, passed two decrees of the Ministry of Finance, namely "Change to the Decree No 672 of August 25, 2010 of MOF on Ratification of the Budgetary Classification of Georgia" as well as "Ratification of Methodology of Program Budgeting".

Condition 6. In accordance with the Budget Code of Georgia, the Ministry of Finance prepared a timetable for the implementation of programme-based budgeting which was approved by Government Decree Number 282 "On adoption of the plan of establishing the Program Budgeting", dated 10 March 2010. The

[39] EBRD (2011) Public Procurement Assessment: Review of laws and practice in the EBRD region. [online] Available at: www.ebrd.com/downloads/legal/procurement/ppreport.pdf

[40] http://blog-pfm.imf.org/pfmblog/2009/06/seminar-on-program-budgeting-in-mali-may-2009.html

decree is published and available to the public on the website of the Ministry of Finance of Georgia.

European Commission's Assessment of Compliance

The condition was deemed to be fulfilled; no further comments or observations were made by the Commission.

Durability of the Reforms (progress beyond MFA)

PBB was first introduced in Georgia in 2010 in three pilot ministries and rolled out to three more ministries in 2011 (education, health, environment, agriculture, justice, corrections and legal assistance). Programme budgeting will be fully implemented across all 16 Ministries with the 2012 budget law, due to be approved by Parliament before the end December 2011. It will include Performance Indicators presented in a separate Annex. Programme budgeting gives more freedom to spending units (which at the same time puts more pressure on the CCG to carry out checks).

5.3 Role of MFA in Promoting Structural Reform

The government's strong ownership of the PFM reforms and concurrent donor support limits the role of MFA...

Over 2010-2011, the Government of Georgia demonstrated an eagerness to implement the agreed PFM reforms. The 2010 PFM reform annual progress report indicated that the number of reform measures effectively undertaken was greater than the list of reforms indicated in the 2010 PFM Action Plan, as was also the case in 2009. The impression gained is therefore, that the GoG appears to be leading or in the "driving seat", and that there is a strong sense of domestic ownership of the PFM reform process, and a focus on achieving results – quickly, with technical support from local and foreign expertise.

This is best illustrated in the pace at which the Georgian authorities conducted the public procurement reform and in the way the SPA promotes its model abroad[41].

The choice of MFA conditions facilitated quick disbursement and does not appear to have been primarily defined with the objective of obtaining additional policy leverage. The MFA conditions were implicitly contained in the Government's broad PFM Reform Policy Vision published in 2009, before the EU approved the MFA and the MoU was agreed. Similarly, the timetable for the MFA conditions was broadly in line with the GoG timetable for PFM reform. The specific MFA conditions were all implemented before the end of May 2010, whereas the second and final instalment were disbursed two to three months later in August 2010. Moreover, the entire MFA programme was implemented and disbursed within nine months, which is effectively only a 'snapshot of time' within the lifetime of the related PFM reforms, which were conceived prior to MFA and the implementation of which has continued after its completion.

Domestic ownership is a key success factor for the implementation of any reform. In the case of Georgia, domestic ownership in certain PFM reform areas such as e-procurement is particularly high. It is all the more true that a number of other donors are supporting PFM reforms in Georgia:

- The IMF-SBA signed in 2008, and the World Bank-DFID-SIDA-the Netherlands Public Sector Financial Management Reform Support initiated in 2006, both included conditions or prior-conditions on the

[41] http://procurement.gov.ge/index.php?lang_id=ENG&sec_id=10&info_id=535

adoption of the Budget Code with provisions for programme-based budgeting.

- In the field of public procurement, the flagship donor is GIZ with others including Sigma and the World Bank.
- In terms of support to the CCG in Georgia, the following donors are active: the World Bank, the joint group of development partners (SIDA, DFID, Koninkrijk der Nederlanden), the German Technical Cooperation Group (GIZ) and the Sigma project.
- The EU is considered as the lead donor in internal audit. In its SBA however, the IMF did include a benchmark on submission to Parliament of the Law on Internal Audit by September 2009. It is also understood that the GIZ plans to delivers technical assistance for the training of internal auditors.

It could be argued that the MFA had a reinforcing effect on the reforms championed by Georgian authorities and other donors. However, the evaluation found no concrete evidence for or against this theory.

... except in the field of Internal Audit

However, there is evidence to suggest that the Commission had a political and operational reinforcing effect on reforms in the area of internal audit. The European Court of Auditors observed that the Georgian authorities had resisted the concept of internal audit when the ENPI sector budget support for PFM reform (EUR 15 million) was launched, but a change in the wider context, related, among other things, to an increased need for donor support, made the authorities more receptive:

"To summarise, the PFM programme progressed very little during its first 12 months. However, the beginning of 2009 saw an encouraging change of attitude from the Georgian side. For example, having shown hostility in 2008 towards the concept of internal audit, the government adopted an Internal Audit Strategy in 2009. The increased receptiveness towards PFM reform might be explained by changed basic conditions. After the twin shock of the August 2008 conflict with Russia and the global recession, the Georgian economy depended on outside aid, leading the government to pay more attention to inflows of EU budget support."[42]

As the MFA has more financial leverage to push for reforms than ENPI, this argument would be valid for MFA as well.

Along the same lines, a consistent message emerging from the interviews conducted with the IMF, World Bank and focus group discussion with PFM experts is that the EU has played a visible and defining role in promoting reforms in the area of internal audit. Indeed, the specific nature of the reforms undertaken in Internal Audit were influenced by the EU framework and standards as outlined in PIFC Policy Paper and the pace of Internal Audit reform has been assisted by EU technical assistance over several years.

It can be concluded that the EU had a clear political and operational reinforcing effect in promoting reforms in the area of Internal Audit. The cross-conditionality between MFA and budget support gave the EU greater leverage in promoting reforms in this area.

[42] European Court of Auditors, "Is the new European Neighbourhood and Partnership Instrument successfully launched and achieving results in the Southern Caucus (Armenia, Azerbaijan and Georgia)?", Special Report No 13/2010, page 29 (2010).

5.4 Impact of the Reforms

Capacity building remains a challenge, but Georgia is performing well in implementing structural reforms in the specific areas of MFA conditions.

It is still too early to attribute any tangible benefits to these reforms. However, even though Transparency International warns against comparing index scores over time (as the sources for the index change each year and the list of countries has altered over the years), an encouraging sign is that on the broader measures of governance, Georgia scores well in terms of the Transparency International Corruption Perception Index for 2010 and the country's position has improved in terms of both global and regional ratings since 2003 and the Rose Revolution.

There is indeed a link between the broader measures of governance and PFM over the long term. The literature[43] suggests that PFM is one of the core dimensions of governance, and that some aspects of governance benefit from PFM reforms. The following four effects of PFM reforms on governance are cited as among the most important:

- Accountability: A functioning system of PFM makes actors more accountable to parliament, the national audit office, and the public and other stakeholders;
- Separation of Powers: Established PFM structures encourage the separation of powers by seeking to build institutions that are based on division of labour and equipped with control mechanisms;
- Participation and decentralisation: PFM reforms can help to improve transparency by generating information, by networking sources of information, and by making them accessible. This also is a prerequisite for governance reforms, such as decentralisation processes;
- Effective government action: PFM processes improve the effectiveness and efficiency of government action and so increase the State's legitimacy, which is often marred by corruption and inefficiency.

The implementation of comprehensive reforms to Georgia's PFM system can only be achieved incrementally and gradually over many years, and the full impact of this PFM reform package on governance will be observable over the long term.

There is however, evidence to demonstrate that the MFA- PFM conditions are having a positive impact in promoting good economic governance in Georgia in the short term:

- The State Procurement Agency has reported benefits such as reduced corruption, cost savings, greater transparency, value for money, and efficiency[44]. For example, tendering fee has decreased four times – GEL 50 (instead of GEL 200) as a result of the introduction of e-procurement[45].
- In terms of budget processes, change in expenditure composition has not yet materialised, but there is more transparency. For example the 2012

[43] For a discussion of evaluating the impact of donor support on PFM reforms see: Paulo de Renzio, Matt Andrews, and Zac Mills, "Evaluation of donor support to public financial management (PFM) reform in developing countries: analytical study of quantitative cross-country evidence", Overseas Development Institute, (November 2010, p4).

[44] EBRD (2011) Public Procurement Assessment: Review of laws and practice in the EBRD region. [online] Available at: www.ebrd.com/downloads/legal/procurement/ppreport.pdf

[45] SPA (2010) Introduction of e-procurement in Georgia: goals, results, further activities. [Online] Available at: http://www.e-government.ge/uploads/library/4.%20SPA_%20Presentation_GITI_2010_Eng%20(fin).pdf

budget contains more explanatory notes on what the government is financing and the open budget index is improving[46]. Another good indicator that budget processes have improved over time is the level of revenue collection, which has dramatically increased over time in real terms.

- Focus group participants reported that the reputation and credibility of the CCG has improved in recent years. CCG's annual report shows that it has enhanced its efficiency through more sophisticated planning of audits based on risk assessments. Between 2009 and 2010, the number of audit assignments has declined (from 243 to 119) while the financial impacts of the audits has increased (from GEL 13 million to GEL 44 million)[47].
- In the field of internal audit, tangible impacts are yet to materialise as the Internal Audit Units are only starting to become operationally functional. A change in mentality/ culture needs to takes place which is not a purely technical issue, but one that takes time.

5.5 Indirect and/ or Unexpected Effects

The use of conditionality relating to the adoption of laws was criticised by other donors. According to them, it puts pressure on the recipient Government to rush through the process in order to tick-off the conditionality associated with disbursement of funds. As a result, laws are often passed which are not fit for purpose and do not take into account potential constraints and implementation issues. In Georgia, amendments to laws are frequent, confirming a tendency to rush through reforms in order to satisfy donors. For example, the MFA included a condition relating to the adoption of the Law on State Internal Audit and Inspection by the Parliament of Georgia. The law, which was adopted by the Parliament only recently (in March 2010) was being reviewed at the time of writing this report.

5.6 Conclusions

Table 5:2 overleaf summarises the conclusions with respect to the structural reforms promoted by the MFA.

[46] http://internationalbudget.org/wp-content/uploads/2011/04/OBI2010-Georgia.pdf . New survey will be launched in 2012

[47] CCG Annual Report 2010. http://www.control.ge/files/upload-file/pdf/annual-report-2010-en.pdf

Table 5:2 Overview of Conclusions relating to Structural Reforms Promoted by the MFA

MFA Conditionality	Action taken by Georgian Authorities	Relevance	Durability - beyond the formal fulfilment of conditionalites, what has been done by the Georgian authorities?	Additionality - did MFA conditions have a political reinforcing effect? Did MFA have an operational reinforcing effect ?	Impact - what difference have the reforms made?
1.Overall PFM reforms - the Ministry of Finance prepares and makes available to the wider public the Action Plan for 2010 that provides a clear roadmap for monitoring of the PFM reforms, including consultations with all relevant stakeholders	*Preparation of Action Plans:* The overall PFM annual Action Plan for 2010 was prepared and made available to the wider public *Consultation with all relevant stakeholders via the PFM Coordination Council:* A PFM reform Coordination Council was established in March 2010 to monitor the implementation of the 2009-2013 PFM Reform Strategy and annual action plans *Monitoring of PFM reforms via the annual reports*: The PFM Reform Annual Progress Report for 2010 details the work done by Georgian authorities	Strong domestic ownership as illustrated in the Public Finance Management Reform Policy Vision 2009-2013.	Georgian authorities demonstrate continued commitment to PFM reforms. The PFM Reform Annual Progress Report for 2010 shows that all planned reforms, as well as additional ones have been implemented. Annual action plan for 2011 has been adopted. The PFM Coordination Council has been set up and is meeting at regular intervals but has not acquired a prominent role in terms of taking the reforms forward. However, Commission feedback has not been taken on board in its entirety by the Georgia authorities	Strong domestic ownership was demonstrated by PFM reform vision 2009-2013 prepared after November 2008 donor conference, and published in 2009 before MFA design. It is quite possible that the EU-MFA reinforced domestic reform efforts and the efforts of other donors by providing a useful second voice. Moreover, the EU had no additional leverage to promote PFM reforms in Georgia during the implementation period of MFA– the EU SPSP for PFM reforms (2007-2009) had ended in December 2009 and there was no SPSP in place in 2010 . The MFA conditions certainly triggered the availability of relevant documentation (action plan, progress report) in English (which is useful to track reforms and facilitate policy dialogue among a wide	It is still too early to attribute any tangible benefits to these reforms. The literature however suggests that there is a link between the broader measures of governance and PFM over the long term

				range of stakeholders). These documents are now readily available in Georgian only.	
2. Internal Control and Internal Audit - adoption of the Law on Internal Audit and Inspection and Publication of Action Plan on internal audit	In March 2010, the Law on State Internal Audit and Inspection was adopted by the Parliament of Georgia. On 5 May 2010, an Action Plan on internal audit for 2010 was discussed and endorsed by Cabinet. The Action Plan for 2010 on Internal Audit was developed within the framework of the Public Internal Financial Control (PIFC) Policy Paper	PEFA PI-21 D+ In line with priorities identified in PIFC policy paper.	After an initial step back when the National Centre of Internal State Control was closed, the reform efforts are seemingly back on track . The Secretariat of the Internal Audit Council is working on the improvement of existing law and has produced a number of outputs (codes, manuals, standards). The 2011-2012 Action Plan of the Secretariat of the Internal Audit Council was made available to the study team in English and it is still not self-explanatory for a wide audience	Political reinforcing effect - as there are cultural issues (difficult to move away from an inspection style control), explicit support by international communtity helps the reformers within Georgia authorities to push this issue higher on the agenda. MFA and EU technical assistance have helped shape the scope of the reform in line with the PIFC concept. Operational reinforcing effect - Timetable would have been slower without MFA conditions. Relatively weak domestic ownership to the appointment of the current Finance Minister.	The Internal Audit function is not yet fully operational. Beyond technical matters, a change in mentalities needs to happen, it is a long term process but at least the issue is on the table. There are still a number of high priority issues to address - as revealed in the 2011 operational assessment.
3.External Audit - publication of a capacity development plan	On 16 April, 2010, the Chairman of the Chamber of Control adopted the Capacity Development Plan of the Chamber of Control of Georgia for 2010-2011, by the Decree Number 55/42. The Capacity Development Plan sets out requirements for improving the necessary	PEFA PI-26 D+	Training, hirings and development of methodological have taken place. However, staff retention at the CCG remains an issue. Moreover, there are significant human resource constraints in the auditing sector in Georgia more generally. Beyond capacity development,	Strong support from other donors in this area. However, it is possible that the EU-MFA had a political and operational reinforcing effect. The last instalment of the previous MFA was cancelled due to delayed fulfilment of conditionality in this area. It is possible that this was a key consideration in the timely fulfilment of	Increased credibility of CCG Its efficiency is improving through a better planning of audits based on risk assignments: between 2009 and 2010, the number of audit assignments has

	professional capabilities (financial, audit, performance audit, and IT audit) and institutional capabilities (human resources management, training strategy, IT support).		another major recent development for the CCG includes revisions to the law on the CCG. The law had been enacted in 2009 and amendments have been tabled in November 2011. The law seeks to increase the independence of the CCG.	conditionality in the case of the present MFA.	declined (from 243 to 119) while the financial impacts of the audits has increased (from GEL 13 m to GEL 44 m).
4.Public Procurement - preparation of Action Plan for the implementation of the e-procurement system; implementation of e-procurement system ; provision of training on the amended Public Procurement Law	In the first quarter of 2010, the SPA in cooperation with SIGMA (OECD/EC) prepared an “Action Plan for the Successful Implementation of E-Procurement” which was approved by the supervisory board of SPA in March 2010. e-procurement system implemented although the actual implementation path between March -December 2010 did not always strictly follow the timetable and sequencing as envisaged under the amended Public Procurement Law Training activities undertaken	PEFA PI-19 D+ Strong eagerness from the Georgians to champion this reform.	As from Dec 2010, procurement only via the e-system which as of Sep 11 counted 10,000 registered users.	Strong domestic ownership was demonstrated by SPA, which places a high emphasis on quick implementation of reforms. The EU-MFA might have reinforced domestic ownership, but this cannot be definitively concluded.	The Georgian model has become a success story (e.g. EBRD report, conferences abroad) Reduction in corruption reported; and costs savings; transparency, efficiency and more equality/increased competition (paper based procurement engenders very high transaction costs). Introducing internal audit within SPA should remain a priority. Also pending is the introduction of non-financial criteria
5 & 6. Programme-based budgeting -	On 18 December 2009, the Parliament of Georgia adopted the Budget Code incorporating provisions on	PEFA PI from C+ to A Reinforcing effect with World Bank- DFID-SIDA-the	Programme budgeting was piloted in 2010-11. Should be rolled out across all 16 Ministries in 2012.	Reforms promoted by IMF and World Bank conditionality, and US Treasury technical assistance project in MoF.	There is more transparency. There are more explanatory notes on what the government

adoption of Budget Code with provisions on programme-based budgeting; preparation of timetable for the implementation of programme based budgeting	programme-based budgeting. In accordance with the Budget Code of Georgia, the Ministry of Finance of Georgia prepared a timetable for the implementation of programme based budgeting which was approved by Government Decree Number 282	Netherlands Public Sector Financial Management Reform Support programme.		By putting consistent pressure, the MFA might have helped accelerate reforms, but this cannot be definitively concluded.	is financing and the open budget index is improving. With time, change in expenditure composition should materialise

6 DESIGN, IMPLEMENTATION AND ADDED VALUE OF THE MFA

6.1 Design and Implementation Constraints

The evidence contained in previous sections demonstrates that the MFA was relevant and effective. However, the following issues have emerged from the research as potential constraints:

- Several stakeholders (Georgian authorities and IMF representatives) have highlighted that the MFA approval process is resource intensive, lengthy, and creates uncertainty. On that matter, the Commission Proposal for a regulation laying down general provisions for Macro-Financial Assistance to third countries[48], if adopted, would certainly constitute a step forward.
- Although the focus, scope and flexibility of MFA support was adapted to achieve quick disbursement, and to have a positive impact in terms of supporting the Commission's international commitments and diplomatic standing, the timing of the actual disbursements under MFA was later than initially anticipated by the Georgian and IMF authorities for reasons described earlier on in the report.
- The public and businesses are, in the main, aware of the support provided by the EU to Georgia; but the MFA instrument is not visible to them,unlike, for instance, assistance provided by USAID. Greater visibility of MFA support and its achievements can contribute towards relationship-building between the EU and the recipient country and have a stronger confidence boosting effect.
- The use of conditionality relating to adoption of laws was criticised by other donors. Such conditionality is intrusive by nature as donors should not be dictating what the Parliament does: it creates uncertainty as the adoption of a law by Parliament cannot be guaranteed, and it has the potential to have a perverse effect by exerting pressure on Government to rush through ill conceived laws (particularly in countries with weak opposition).
- The Commission's expectations as regards conditionality relating to publication of Action Plans and Capacity Building Plans do not appear to have been fully communicated to the Georgian authorities. As a result, although the conditionaliies have been fulfilled, they have been found to be lacking in detail. This points to a need for better formulation of conditionality.

6.2 Added Value

6.2.1 Financial added value

The main added value of the MFA from the Georgian authorities' perspective was the availability of assistance in grant form which did not burden the country with repayment. Moreover, the size of the MFA, although small in financial terms, was not insignificant.

[48] COM(2011) 396 final

6.2.2 Non financial added value

Georgian authorities pointed to a confidence boosting effect of the MFA. However, this was not detected in the focus group discussions held with wider stakeholders (businesses, NGOs) who, as previously mentioned, were generally aware of the EU support at the Donors' Conference but not specifically aware of the MFA instrument.

Some stakeholders also mentioned a political aspect in that the EU had honoured its pledge by granting the MFA.

7 CONCLUSIONS AND RECOMMENDATIONS

This section sets out the main conclusions and recommendations emerging from the evaluation.

7.1 How would the economy of Georgia have evolved in the absence of MFA assistance?

In the absence of the MFA, it is highly likely that one of the following scenarios would have occurred:

- Scenario A: reduced public spending by the Georgian government in 2009 and 2010 (lower expenditure matches the lower revenue);
- Scenario B: reduced public spending in 2009 but no change in spending in 2010 (the revenue gap in 2010 in the absence of MFA is replaced with additional deficit financing).

In both cases, Georgia would have experienced a greater fall in GDP in 2009 as compared to what actually happened (i.e. a 4 per cent reduction in GDP instead of 3.8 per cent). Moreover, under Scenario A, real GDP would have grown by a smaller amount in 2010 (6.2 per cent instead of the actual observed growth of 6.3 per cent). On the other hand, under Scenario B, real GDP would have grown at a slightly higher rate in 2010 (6.5 per cent) – as the economy would have grown from a much smaller base in 2009 when compared to the baseline scenario.

The unemployment rate would have been slightly higher in 2009 (+0.1 per cent) under both counterfactual scenarios. Under scenario A, a slightly higher unemployment rate (+0.3 per cent) would also have been observed in 2010.

7.2 To what extent has the MFA assistance been effective in terms of the short-term macroeconomic stabilisation of Georgia?

The modelling results suggest that the MFA had the following impact on Georgia's economy, although the size of these impacts is small (less than 0.5 per cent):

- An improvement in the current account, although by less than the value of the MFA, had the government reduced its spending without the grant revenue;
- A higher accumulation of foreign exchange reserves;
- An increase in government revenue, by more than the value of the grant, owing to multiplier effects;
- An expansion of the domestic money supply (and modest inflationary effects);
- A reduction in public debt, assuming that Georgia would have issued bonds had it not received the MFA (relates to Alternative B only);
- A higher GDP growth;
- A higher level of employment/lower unemployment.

Overall, the results of the modelling exercise show that the net effect of MFA on Georgia's economy was marginal: the impact on real GDP ranging from -0.2 per cent to +0.2 per cent. The MFA had a bigger impact in conjunction with the IMF-SBA: the impact on real GDP ranging from -1.0 per cent to -1.3 per cent.

7.3 To what extent has the MFA contributed to returning the external financial situation of Georgia to a sustainable path over the medium to longer-term?

The MFA, which was provided in grant form, has contributed to improving Georgia's external financial situation in the short term. However, given the small size of the effects described above, relative to Georgia's economy and its balance sheet items, it is difficult to argue convincingly from the model results that MFA contributed substantially to averting a crisis through improved external sustainability. However, the modelling fails to capture confidence effects and conditionality that may well have longer-term implications for the country's economic trajectory.

7.4 To what extent has the MFA assistance been effective in terms of supporting structural reform in Georgia?

Overall, the MFA has made a positive but marginal difference in promoting PFM reforms in Georgia. The scope and impact of the MFA conditions was limited. The MFA conditions were heavily concentrated on the simpler reform activities or 'softer and low lying fruit' such as action plans, capacity development plans, manuals, and training. This narrow focus of conditionality on simpler reforms was relevant and appropriate, given the need for quick disbursement of support and the scale of the assistance.

All conditions were fully met technically, as Georgian authorities implemented the necessary actions. However, the Commission, in its assessment of compliance, noted that there was some scope for improvement, for example the clarity and quality of the action plans and capacity development plans that were produced by the Georgia authorities could be improved.

The added value and reinforcing effect of EU support was most clearly evident in the case of internal audit reforms. In other areas, the added value of EU support was less obvious due to existence of strong domestic ownership and/or other donor support. For example, there was strong domestic commitment to the implementation of an e-procurement system. As regards the conditions on programme-based budgeting (that represented harder and more basic reforms), these were reinforced by both the IMF and the World Bank conditionality. Moreover, reform in the area of budget execution has been supported by a US Treasury Resident Adviser and technical assistance project to Ministry of Finance over many years. In these areas, it is quite possible that the EU-MFA supported and accelerated domestic reform efforts and the efforts of other donors by providing a useful second voice and a clear timetable for implementation (linked to disbursement the second instalment of the MFA grant); however, the evaluation did not find any concrete evidence to confirm or refute this theory.

It is too early to assess the full impact of PFM reforms supported by the MFA operation. However, some benefits can be observed, such as costs savings through the implementation of e-procurement system, greater transparency in government expenditure (2012 budget); and the enhanced efficiency, reputation and credibility of the Chamber of Control.

7.5 What have been the indirect and/ or unexpected effects of the MFA assistance?

There is a possibility that the conditionality relating to the adoption of the Law on Internal Audit and Control by the Parliament put pressure on the Georgian Government to rush through poorly conceived laws in order to meet the conditionality relating to disbursement of funds. However, this cannot be categorically confirmed.

> Lesson Learned 1: generally speaking, conditionality relating to adoption of laws should be avoided in MFA operations given their quick disbursing nature.

7.6 How has the way in which the MFA operation was designed and implemented conditioned its effectiveness and efficiency?

The size of the MFA was based on the IMF's assessment of Georgia's external financing needs. The MFA was expected to cover approximately 13 per cent of Georgia's estimated cumulative residual financing gap for the period 2009 to 2010. The decision to provide the assistance in grant form was justified on both, political and economic grounds. It was based on a consideration of Georgia's geo-political significance for the EU. Moreover, the EU did not want to add to Georgia's debt burden by providing assistance in loan form.

Lengthy and uncertain approval procedure, lack of visibility of the instrument, formulation of conditionality relating to legislative enactments and lack of clarity regarding some of the softer conditionality are some issues potentially constraining the effectiveness of the instrument.

> Lesson Learned 2: The Commission should be more specific in formulating conditionality and be clear about its expectations, especially in the case of softer actions such as development of action plans.

7.7 To what extent has EU added value been maximised?

The availability of assistance in grant form which did not burden the country with repayment was the main added value of the operation. The evaluation did not detect any discernible confidence boosting effect of the MFA.

> Lesson Learned 3: The Commission should take steps to improve the visibility of the MFA instrument in the recipient country through, for example, local press releases.