May 17, 2001
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 00/43

9:30 a.m., April 21, 2000

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Fischer, Acting Chairman
S. Sugisaki, Acting Chairman
E. Aninat, Deputy Managing Director

Executive Directors	**Alternate Executive Directors**
	A.S. Alosaimi
	M.F. Melhem, Temporary
	S. Thiam, Temporary
	P. Charleton
	J.A. Chelsky, Temporary
	H. Oyarzábal
R.F. Cippà	W. Szczuka
	W.-D. Donecker
	D.H. Kranen, Temporary
	J.A. Costa, Temporary
	H. Vittas
	G. De Blasio, Temporary
	C. Harinowo
	S.N. Kioa, Temporary
	S.K. Keshava, Temporary
	J. Prader
	Å. Törnqvist
	J. Sigurgeirsson, Temporary
	P.A. Brukoff, Temporary
	G. Bauche
	S. Le Gal, Temporary
A. Mirakhor	M. Daïri
	Y. Patel, Temporary
A.V. Mozhin	A. Lushin
S. Pickford	
M. Portugal	
	A.F. Al-Faris
	O. Himani, Temporary
G.F. Taylor	
Wei Benhua	Jin Qi
	Xu J., Temporary
J. de Beaufort Wijnholds	Y.G. Yakusha
	H. Toyama
	K. Gobe, Temporary

A.S. Linde, Acting Secretary
A. Mountford, Acting Secretary
G. Nkhata, Assistant
M. Schulte, Assistant

Staff Compensation—2000 Review
Staff representatives: Kelly, HRD; Baumgartner, HRD; Jones, LEG

Georgia—1999 Article IV Consultation
Staff representatives: van der Mensbrugghe, EU2; Brachet, PDR

Also Present
IBRD: A.W. D'Hoore, Europe and Central Asia Regional Office; Office of Executive Director: M. Gogiashvili. Staff Association Committee: P. Alonso-Gamo, Chairperson; B.J. Clements, G.C. Tsibouris. European II Department: J. Odling-Smee, Director; J.R. Márquez-Ruarte, Deputy Director; S.R. Bassett, J. Hartley, G.C. Pastor, G.C. Tsibouris, E. van der Mensbrugghe, R.P.A. van Rooden, T.A. Wolf. External Relations Department: C.N. Lotze. Fiscal Affairs Department: T. Baunsgaard. Human Resources Department: M.R. Kelly, Director; U. Baumgartner, Deputy Director; S.J. Adams, Y. Jiang, J.P. Kennedy, C.C. Loureiro, B.R. Shannon. Legal Department: J.A. Jones. Policy Development and Review Department: C. Brachet, K. Srinivasan. Secretary's Department: P. Cirillo, P. Gotur, A. Mountford, B.A. Sarr. Office of the Managing Director: M. Cross, Personal Assistant; J.A.P. Clément, D.A. Citrin, E.-A. Conrad, P.J. McClellan. Advisors to Executive Directors: J.C. Estrella, E.J.P. Houtman, M.E. Kandil, A.R. Palmason, M.R. Shojaeddini, I.M. Woolford. Assistants to Executive Directors: R. Burgess, N. Burnashev, V. Dhanpaul, M.R. Hajian, S. Hinata, I.C. Ioannou, A. Jacoby, B. Kelmanson, E. Kornitch, K. Kpetigo, K. Ongley, A.A. Rojas, A.W. Scoffier, C.A.E. Sdralevich, R.J. Singh, S. Vtyurina.

1. STAFF COMPENSATION—2000 REVIEW

The Executive Directors, meeting in restricted session, considered the staff paper on the 2000 review of staff compensation (EBAP/00/32, 3/29/00). They also had before them a paper on staff recruitment and retention experience in 1999 (EBAP/00/40, 4/11/00).

Decision adopted, with two objections and two abstentions, to become effective upon adoption of Administrative Budget for FY 2001. See Secretary's Understanding of decision (EBAP/00/32, Sup. 1, 4/25/00).

Adopted April 21, 2000

2. GEORGIA—1999 ARTICLE IV CONSULTATION

The Executive Directors considered a staff report for the 1999 Article IV consultation with Georgia (SM/00/53, 3/14/00; Cor. 1, 4/15/00; and Sup. 1, 4/18/00). They also had before them a background paper on recent economic developments and selected issues in Georgia (SM/00/74, 4/7/00).

The staff representative from the European II Department informed Directors that the Georgian parliament had ratified the treaty on Georgia's accession to the WTO with an overwhelming majority and that the Minister of Finance had communicated to the staff during the morning of the current day that all interest due to Georgia's bilateral creditors had been paid. Therefore, Georgia was current with regard to all interest obligations, including on rescheduled bilateral debt.

Mr. Yakusha submitted the following statement:

> Georgia has been through a tough economic period since the conclusion of its last Article IV consultation. Having been severely affected by the Russian crisis in 1998, the authorities are still struggling to set the economy on a path of sustainable growth. In this regard, the authorities appreciate the staff's cooperation and useful advice.
>
> Economic developments in Georgia up until the first half of 1998 had been more or less in line with the ESAF supported program. This made possible the approval of the Third Annual Arrangement under the ESAF in July, 1998. Beginning in August of 1998, however, the Russian crisis, together with a severe drought, began to exert its toll on the economy. Exports to Russia, which accounted for around 30 percent of total exports prior to the crisis, declined significantly, while the exchange rate came increasingly under pressure. Following substantial losses in foreign exchange reserves, which fell to dangerously low levels, the central bank followed Fund advice and decided to stop intervention in the foreign exchange market and let the lari float. As a result, prices rose by 10 percent in the month of December 1998, after several years of declining inflation. Growth for the year as a whole was restrained to

2.9 percent, significantly lower than the double-digit rates exhibited in the past two years.

The reaction to the crisis was to tighten fiscal and monetary policy in support of the floating exchange rate. The National Bank of Georgia also took swift action to ensure that the crisis did not seriously impact the banking system. While a tight monetary policy was instrumental in containing inflation around 10.9 percent in 1999, as opposed to the programmed target of 12.9 percent, fiscal weaknesses, in particular in the area of tax collection, prevented the fiscal deficit (on a commitment basis) from declining as provided under the program. For the year as a whole, growth accelerated slightly to 3 percent exceeding the program target of 2 percent.

The impact of the Russian crisis on Georgia exposed to a greater extent the underlying institutional weaknesses in the areas of fiscal policy and governance. My Georgian authorities are committed to trying to address these issues and President Shevardnadze has repeatedly underscored the importance of addressing this issue in a resolute manner. Nevertheless, vested interests make reform efforts difficult and progress slow. We are hopeful that the strong mandate given to the authorities in recent parliamentary and presidential elections will provide the necessary impetus to pursuing with more vigor the necessary reforms.

The main challenge facing the authorities in 2000 and beyond is to ensure a sustainable path for public finances. Tax revenue as a percent of GDP is one of the lowest in the region, thus limiting the ability of the authorities to address the country's many developmental needs. To put things in perspective, however, tax revenue as a percent of GDP has been on a steady increase in the past few years [Text Table 3], albeit not as fast as it would be desirable.

It must also be understood that the authorities have taken difficult measures (described in Box 1 of the staff report) to address the problem of the meager performance of tax revenue. The authorities have, for example, hired a British company to engage in pre-shipment inspection, in an effort to boost customs proceeds. Results however, have not been very encouraging so far, further underscoring the magnitude of the challenges that lie ahead. Regarding the disappointing collection of indirect taxation by the Customs Department, it must also be remembered that in addition to governance weaknesses, border control is undermined by the inability of the authorities to administer two breakaway regions. The authorities have also established a large taxpayers unit to step up collection by large taxpayers (albeit with mixed results) and they have discontinued the recourse to tax offsets. They have also established a new Revenue Ministry to increase accountability in the Customs and Tax Departments. They have also increased taxes and did that months before the elections, something that few governments would be willing to do. The effect of increased tax rates has not been only positive, however.

Beyond these measures, the authorities have also engaged in extensive judicial reforms in an effort to reduce corruption. In this regard we consider the staff's conclusion that the absence of sufficient revenue enhancement is due to insufficient political will a bit exaggerated. This is not to say that governance weaknesses do not exist or that they do not constitute a significant problem. Rather, it is to underscore the difficulty of altering deep rooted problems in a short time span in a difficult political and external environment, and to draw attention to the fact that changes in this regard are not directly under the control of the authorities, nor can they happen overnight, no matter how swift an action is taken to improve tax administration. The failure of some foreign investors to immediately improve payment discipline in their respective sectors underscores the difficulties and the seriousness of the problem.

To ensure fiscal sustainability, the 2000 budget passed by Parliament envisages a reduction in the fiscal deficit on a commitment basis to 4.0 percent of GDP. On the revenue side, the authorities are planning additional tax and administrative measures (some of them are outlined in Box 2). The effectiveness, however, of new taxes and amendments in the tax code may be limited, if not enough attention is given to improving administration. Such increases may in fact lead to an increase in tax evasion. It is therefore imperative that additional technical assistance be provided in this regard, with concrete recommendations of changes that need to be implemented to enhance tax collection.

On the expenditure side, an adjustment of one percent of GDP is envisaged from last year's estimated level. As the staff notes, given that one-third of total revenues for the central government is absorbed by interest payments, cuts across the board are inevitable. Nevertheless, special attention is given to protecting social spending, including health and education where an increase in nominal terms is envisaged. An important element of the 2000 budget is the envisaged reduction in the stock of arrears. Priority will be given to the clearance of wages, pensions and social allowances arrears which are essential elements of the fight against poverty. Under these circumstances, although a larger fiscal adjustment as advocated by the staff would have been desirable on theoretical grounds, a more gradual and realistic approach, especially taking into account past experience, may make more sense.

In the area of monetary policy, my authorities will continue to steer it in support of price and exchange rate stability. Inflation is targeted to fall by almost 4 percentage units by the end of 2000, while gross international reserves will continue their upward trend rising to 1.9 months of imports. The authorities are committed to intervening in the foreign exchange market only for the purpose of replenishing reserves.

The current account deficit is also expected to show some improvement in 2000, declining to 12 percent of GDP from 14 percent in 1999, reflecting a recovery in both export and import volumes following the slump in 1999. Taking into account transfers, the current account balance in 2000 is expected to be 6.7 percent of GDP. It must be noted in this regard that Georgia has maintained, even amidst the difficult conditions following the Russian crisis, a liberal trade and payments system. Thanks to its commitment to trade liberalization, Georgia has become the second country in the CIS to become a member of WTO (pending ratification by the Georgian Parliament).

In the area of structural reforms, the authorities acknowledge the existence of considerable weaknesses in the areas of governance and corruption. They are planning however further steps to tackle these problems, including prosecuting public officials suspected of fraud, broadening financial disclosures laws and establishing an independent agency to monitor these initiatives. In dealing with such issues, all governments strive to strike some balance between breaking the power of entrenched interest groups and maintaining political stability necessary for the government to stay in power. In addition to addressing the problem of governance, the authorities are also embarking in a rather ambitious privatization program which will involve energy and telephone companies as well as seaports. They are committed to implement the privatization program in a transparent manner, building upon progress already achieved in the areas of fiscal and monetary transparency.

Clearly, fiscal sustainability and improved social conditions cannot be attained without a significant consolidation of external debt, including debt service. The staff ascribes (in paragraphs 20 and 42) Georgia's limited capacity to service its debt to lack of a sufficiently strong adjustment effort. Nevertheless, as the staff's analysis in appendix V indicates, even under a strong policy adjustment scenario and assuming a further round of rescheduling, the balance of payments position remains difficult over the medium term and a potential source of vulnerability. Clearly, without such rescheduling, a strong adjustment effort by the authorities will not suffice. The problem is especially acute for 2000-02 due to the bunching of debt service obligations reflecting the expiration of the grace period on principal obligations under the previous round of debt rescheduling. My authorities are in the process of preparing the groundwork for a further rescheduling on a multilateral basis. The success of this effort, however, hinges largely on the willingness of Turkmenistan, Georgia's largest external creditor, to participate in such a multilateral rescheduling. Georgia has repeatedly exhibited its willingness to reach a cooperative understanding with the Turkmenistan authorities on this issue, as evidenced by its repayment of principal of US$22 and US$25 million in 1998 and 1999, respectively (the latter constituting 19 percent of the central banks' gross international reserves at end-1999). However, so far the Turkmenistan authorities have not demonstrated in good faith their willingness to participate in a multilateral framework of debt rescheduling. In fact, as the staff notes in paragraph 44, the Turkmenistan authorities have rescinded on earlier assurances they had provided the staff regarding their participation in a multilateral framework of debt rescheduling.

In conclusion, the Georgian authorities are committed to putting their economy back on track and they are working closely with staff to conclude negotiations on a PRGF-supported program. The key to attaining a sustainable growth path over the future is strong governance efforts in conjunction with another round of debt rescheduling. Following the reelection of President Shevardnadze, the outlook for an improvement in the situation has increased substantially. The authorities are prepared to work closely with the Fund staff to bring this about.

Extending his remarks, Mr. Yakusha emphasized three issues regarding Georgia's recent economic performance: the difficult external position, the problems in domestic politics, and the overall security environment. The staff report was appropriately critical in some respects, but it inappropriately tended to understate the difficulties that the authorities were facing with regard to revenue collection. Georgia was a small country of 5 million people in the Caucasus region, troubled by various conflicts and currently undergoing a difficult phase after the civil war. It faced a refugee problem involving 300,000 people, and political tensions arising from two breakaway regions and one autonomous border region. It should not be forgotten that civil unrest was continuing outside Georgia's borders in Chechnya. Those factors had contributed to the failure of both the authorities, their advisors, and foreign investors to appropriately and consistently enforce payment discipline. The election cycle was another factor contributing to those problems, given that governments would not normally engage in unpopular measures ahead of elections.

With regard to financing, there had not been many options open to the authorities, Mr. Yakusha continued. International financial assistance had recently been limited, privatization would not yield large receipts because of arrears accumulated by the companies involved, and, at the same time, major creditors appeared to be unwilling to discuss debt rescheduling despite the authorities' enormous efforts. The main issue in that context was the improvement of domestic revenue collection. While in theory that was the correct starting point for improvements, the question remained as to what would happen to the significant poverty in Georgia, should it prove impossible to increase domestic revenue collection sufficiently rapidly despite the efforts by the authorities to improve governance and to curb corruption and fraud? Also, what would be the consequence for poverty in Georgia, if the increased fiscal adjustment would hamper growth?

While acknowledging that those concerns were partly hypothetical, Mr. Yakusha considered that there was a ceiling of revenue collection below which growth would not be hampered and that Georgia had probably not yet reached that point. However, more thought should be given to appropriate expenditure policies, to the avoidance of domestic arrears, and to finding ways for providing exceptional foreign financing, which could be conditional upon the implementation of specific measures by the authorities.

There was also new information on the authorities' intentions for the coming months, Mr. Yakusha noted. The newly reelected president had announced that he would focus on the elimination of poverty, the creation of jobs, and the eradication of corruption. The return of refugees to their homes and the restoration of Georgia's territorial integrity had also been mentioned among those priorities. With respect to the budget, Georgia's president had stated earlier during the current day that it was impossible to continue previous practices. He had called on the entire administration to direct all their efforts toward the proper implementation of the budget. There was thus reason for the hope that the next Article IV consultation with Georgia would entail more good news than the one for 1999.

Mr. Törnqvist and Mrs. Steinbuka submitted the following statement:

> It is unfortunate that, after some positive economic achievements supported by the recently expired arrangement under the ESAF, Georgia's economy has suffered serious setbacks. Since the end of 1997, Georgia's macroeconomic imbalances have reached a clearly unsustainable level. Looking at the large current account deficit, the low level of gross international reserves, the large public expenditure arrears, and the difficulties in servicing debt, it is hard to find any light at the end of the tunnel.
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> Some positive signals on the authorities' recent efforts to accelerate reforms were conveyed by Mr. Yakusha's very helpful preliminary statement. We particularly welcome the authorities' efforts regarding monetary policy and their steps in strengthening banking supervision. We concur with Mr. Yakusha that, following the reelection of President Shevarnadze, the outlook for putting the economy back on track has improved. We support the Georgian authorities' close cooperation with the staff to conclude negotiations on a PRGF-supported program. The need for a comprehensive adjustment program cannot be overstated. Growth prospects and poverty elimination depend on full and consistent implementation of a number of much-needed reforms, particularly with regard to fiscal tightening and tackling corruption.
>
> The tightening of fiscal policy is crucial, given the chronic inability to collect adequate tax revenues, the increasing budgetary burden of external debt, the large fiscal deficit, and budgetary arrears. Since 1995, revenues have consistently fallen far short of the target. Corruption and tax evasion remain major difficulties in promoting economic activity and establishing a healthier fiscal environment. The size of the shadow economy in Georgia in 1994-1995 was more than 60 percent of GDP. General government tax revenues remained the lowest in the world at about 13-14 percent of GDP.
>
> It is highly regrettable that, despite the staff's recommendations, the revenues within the approved 2000 budget are not backed by either administrative or fiscal measures. The experience of many transition countries suggests that, in order to gradually transfer businesses from the "shadow" to the legal economy, the tax burden should be re-balanced toward indirect taxes, which are more easily collectable. Contrary to this principle, Georgia's

parliament endorsed an essential reduction in indirect taxes–specifically, in tax rates on petroleum products. We are very much concerned that this measure reverses the increases in fuel excises introduced last year as part of the program supported under ESAF. Moreover, according to recent information, proposals to reduce taxes on tobacco products, automobiles, and lubricants remain under consideration by Georgia's authorities.

Like the staff, we encourage the government to strengthen fiscal policy in order to place the economy on a sustainable path. The macroeconomic implications of fiscal adjustment over the medium-term are well presented in the staff's analysis, which indicates that only significant fiscal tightening and decisive measures against corruption would allow growth to rise and poverty to be eliminated. Unfortunately, the budget adopted for 2000 maintains a high risk of revenue shortfall, overspending, and a larger deficit. It may turn out that there will again be a large discrepancy between the fiscal target and actual income. In order to reduce this risk, we urge the authorities to mobilize revenues and implement an expenditure control mechanism as advised by the staff.

Recovery will also depend on addressing a number of structural issues. First, attracting more foreign direct investment is the key component of economic growth. Investors' confidence depends on government efforts to strengthen revenues, improve governance and eliminate corruption. Second, prudential regulations for the banking sector need to be tightened, particularly as regards minimum capital requirements. The merger or timely liquidation of insolvent banks should be enforced. Third, the large-scale infrastructure privatization needs to be accelerated. Fourth, the long-term reforms in the social sphere, which include measures to reduce the scale of poverty, to minimize differences in living standards between different strata of the population, and to address massive unemployment, should be accelerated. However, in practice, all of the above measures remain highly dependent on the fiscal policy and the budget.

The external policies should be viewed in the light of the large current account deficit and high external debt. Even with optimistic assumptions, the external outlook remains unsustainable. We would support Georgia's request to bilateral creditors for exceptional financing in the form of a multilateral rescheduling. In the course of Article IV consultations with Turkmenistan, the Board welcomed the authorities' initiative toward settling Turkmenistan's claims on Georgia. Against this background, we encourage Turkmenistan to consider participating in a multilateral rescheduling of Georgia's debt, which could hopefully lead to a mutually acceptable solution for both countries.

Mr. Junguito and Mr. Dhanpaul submitted the following statement:

It is clear from the staff report that Georgia must meet and overcome some critical challenges. The key areas of reform continue to be centered on fiscal, financial, structural, and governance issues. The benefits attained during the first half of the ESAF-supported program have not been consolidated and strengthened. Despite actions taken by the Georgian authorities to contain macroeconomic instability, major internal and external imbalances are still evident. After recording double-digit real growth in 1996-97, increased economic activity slumped to 3 percent in 1998-99. The deficit (commitment basis) on the government's fiscal account is expected to reach 6.7 percent of GDP, while the deficit (excluding transfers) on the external current account is targeted at 14 percent of GDP. In addition, Georgia is faced with the burden of a growing public debt and rising unemployment and poverty levels. It is, therefore, important for the authorities to accelerate the pace of reform in Georgia to facilitate the mitigation of poverty and the provision of an improved level of social services, which could in turn strengthen the process of social stabilization.

The authorities will need to strengthen the fiscal position with solid emphasis on expenditure control, especially the wage bill and tax administration, and on the structural aspects of the budget. We agree with staff that the strong fiscal stance must be maintained in 2000 and the medium term. The fiscal consolidation process should be enhanced by focusing on revenue raising measures including improvements in tax administration and collections, as well as expenditure reduction. In this context, we need further clarification on the staff's statement that "the envisaged revenue improvement in 1999 continued to be hampered by a lack of political will to collect taxes." We find it difficult to imagine that a country with such a low tax-to-GDP ratio would adopt or even tolerate such a stance. It seems to us that the problem may be much more deep-rooted. We, therefore, urge the authorities to accelerate the implementation of measures aimed at eliminating tax evasion and rampant corruption in the collection of taxes. It is obvious from the staff report that Georgia's revenue potential is being hampered more by a lack of administration than by appropriate tax rates. An enhanced revenue performance is even more critical given the fact that as the authorities implement strategies to improve domestic production and export performance; external assistance will be required to support both the budget and the external account well into the medium term, thereby further aggravating an already heavy debt burden.

Both the staff report and Mr.Yakusha's preliminary statement coincide in establishing sustainability of public finances as the main challenge facing the Georgian authorities in 2000 and beyond. It is especially disappointing to find out in the staff's Supplementary Information that the approved 2000 budget fell well short of the budget required to bring about the needed fiscal adjustment. It is also disappointing to know that while revenue projections do not seem to be backed by a comprehensive package of measures in tax administration, the parliament proceeded to enact reductions in tax rates on petroleum products. We share the view of the staff that this situation is not sustainable.

We support the authorities' introduction of a market-based monetary policy, including a more market-determined exchange rate. However, recent fiscal pressures have led to a relaxation of monetary policy. This could have an adverse effect on the control of inflation, which has displayed signs of improvement in the first quarter. It could also undermine the relative stability of the exchange rate. The authorities' implementation of financial sector reform measures to improve the efficiency and competitiveness of the financial system and strengthen bank supervision and prudential regulations, should also improve the role of banks in providing credit to the private sector. However, until the financial system becomes sufficiently stronger, there will remain some potential risks, which could have implications for the budget.

To avoid a further build-up of arrears, we agree with staff that the Georgian authorities should put measures in place to speed up further debt rescheduling, and accelerate the divestment of public sector assets. The authorities will have to negotiate the restructuring of the country's official bilateral debts to reduce the level of external arrears and by extension, the burden on the fiscal account. Finally, the authorities urgently need to regain credibility by proceeding to undertake the policy reforms suggested in the appraisal of the staff report. We wish the authorities well in their endeavors.

Mr. Chelsky made the following statement:

Let me begin with an expression of appreciation to staff for a very frank, focused and fair discussion of the state of the economy and economic management in Georgia. The profile given to issues of corruption, governance and the absence of the rule of law is fully appropriate and—in the context of our recent discussions on the scope for IMF surveillance—it is consistent with the Board's desire to consider all issues that are of macroeconomic importance.

The good news pertains to the authorities' continued maintenance of a flexible exchange rate policy, without which they would have been in even more serious trouble. Recent steps to strengthen banking supervision and prudential regulations are also welcome as are efforts to obtain WTO membership. Regrettably, the quality of economic management deteriorates substantially from that point.

The report is clear on Georgia's chief macroeconomic challenges, the most important of which include increasing the revenue-to-GDP ratio and achieving better expenditure management. That being said, a discussion of these issues that does not dwell on the governance roots of policy challenges would be misleading, at best.

At the outset, it should be noted that the current government has had an outright Parliamentary majority since 1995—not merely since October 1999. This suggests that the failure of economic management is not the result of absent political capacity but—as staff clearly illustrate—of political will. I appreciate Mr. Yakusha's comments on the challenges for the authorities in the face of vested interests, but I am not comfortable with his defense of the lack of progress. What experience has shown us is that a gradual and ad hoc effort to fight widespread corruption is rarely effective. Rather, what is needed is a bold, comprehensive and front-loaded strategy, including—in the very near future—a comprehensive public expenditure review. President Shevardnadze's repeated calls to address governance shortcomings are certainly welcome, but repeated failure to follow through with decisive action has only served to undermine the credibility of the Government's commitment.

The staff is fully justified in its conclusion that it would be "unrealistic to expect the international financial community to continue to provide substantial financial budgetary support to make up for the loss of foregone revenue as wealthy individuals and companies succeed in avoiding paying taxes". The implication of this for Georgia's PRGF prospects are clear—no such program should be put in place until significant progress has been achieved in addressing the governance concerns that underpin weak revenue performance and expenditure management.

It would be irresponsible were the Fund to extend credit to the authorities under present conditions. Given the accumulation of arrears on wages, pensions and social expenditures, the failure of efforts to raise revenue from large tax payers, and the potential for abuse in the extension of tax exemptions to encourage FDI, the burden of repayment on Fund credit would eventually—and predominantly—fall on the average citizen. Interest payments already account for one-third of central government revenue. Any additional burden would further exacerbate the already-troubling income distribution perpetuated by other highly-regressive fiscal policies and practices. This is certainly a development to which the Fund should in no way contribute. Here, I am in complete agreement with staff's assertion that "failure to pay adequate attention to the equity issues raised by the tax and spending polices of the Government has implications for the sustainability of economic reforms and social stability".

I appreciate that the 2000 budget contains a reduction in expenditure arrears and attempts to protect social spending. However, given that revenue projections remain unrealistic, I have little confidence that these worthwhile goals will be achieved. It is therefore up to the authorities to prove themselves by fulfilling these commitments while, at the same time, realizing the significant potential for revenue collection which has been pointed out by the staff. Only then should the Fund be in a position to undertake serious negotiations on a PRGF program. We therefore need to guard against raising inappropriate expectations. It would be a shame if the year 2000 were to witness the same sort of expenditure priority setting that has resulted in significant spending on items such as luxury cars for senior officials while at the same time there has been a systematic failure on the part of the government to pay civil service wages and respect World Bank conditionality on payments to pensioners.

While the Russian crises obviously had a negative impact on economic developments in Georgia, we also need to be clear that the depth and persistence of the impact is largely due to problems with internal economic management. Again, it would be a shame if the perpetrators of rampant corruption were to hide the damage they have done to Georgia's economic prospects behind a mask of exogenous shocks.

Finally, and in light of the above considerations, I hope that the summing up from this Article IV consultation is clear and up front in describing the extent to which corruption and weak governance have led to a deterioration in economic conditions. Discussion of this issue should not be buried toward the end of the summing up, but—in keeping with its importance to Georgia's macroeconomic prospects—find itself front and center. The summing up should also make clear that Fund financial involvement in Georgia would not be appropriate–least of all through the PRGF–in the absence of a bold, comprehensive and front-loaded strategy to improve governance and fight corruption.

Mr. Mozhin made the following statement:

Georgia had achieved considerable progress in macroeconomic stabilization and structural reforms implementation during the first half of the period under the ESAF-supported program. Therefore, it is regrettable to see the deterioration of macroeconomic conditions in Georgia. Certainly, the external environment over recent years has not been very favorable. However, policy slippages, especially in the fiscal area, have played a crucial role. It is clear that without strong fiscal adjustment measures, the macroeconomic stabilization process will be compromised. Moreover, these fiscal adjustment measures need to be supplemented by strong and decisive structural reform measures.

Now let me turn to the areas of major concern.

The main obstacle to financial stability is a persistent weakness in the fiscal position. Revenue collection in Georgia remains extremely weak with, apparently, the lowest revenue-to-GDP ratio among all the BRO countries.

Here my question is, to what extent are various territories not fully under control of the central authorities taken into account in the GDP and revenue-to-GDP calculations? Regardless of the answer to this question, my impression is that all tax policy and tax administration measures implemented so far have been insufficient to address weak revenue performance. At the same time, the expenditure performance has also been unsatisfactory, characterized by instances of unbudgeted ad hoc spending steps and accumulation of budgetary expenditure arrears. In 1999, overall fiscal deficit on a commitment basis reached 6.7 percent of GDP instead of 2.8 percent, as anticipated under the program.

Under these circumstances, decisive fiscal adjustment measures are urgently needed. As I support the staff recommendations, I regret that these recommendations were largely ignored in the budget for 2000. Therefore, along with the staff, I would urge the authorities to proceed with the implementation of comprehensive tax administration measures. Concurrently, the expenditure control mechanism should be strengthened in order to streamline government spending and to achieve more efficiency and better targeting. Social spending should be protected, and budgetary arrears related to wages, pensions, and other social spending items should be cleared as quickly as possible. However, the decision to allow the clearance of pension arrears through in-kind payments instead of cash payments is highly regrettable, as it was, clearly, a step in a direction further weakening of financial discipline.

The authorities are planning to finance the budget deficit mainly through external borrowing and privatization proceeds. Given the external debt situation, it is critical that the authorities refrain from any nonconcessional borrowing, as well as from providing government guarantees on nonconcessional loans. At the same time, I share the view that a significant part of privatization proceeds should be used for the purpose of debt repayments and not for financing current expenditures.

Georgia's external position remains extremely difficult, as total external debt has already reached more than 60 percent of GDP. Georgia has already accumulated considerable external arrears, including arrears on principal repayments to Russia, which is highly regrettable. I urge the Georgian authorities to clear these arrears as soon as possible. However, under the current circumstances, it is clear that Georgia's capacity to service its external obligations is very limited. The staff may be right that another round of negotiations with bilateral creditors on debt rescheduling is unavoidable. However, such negotiations will only become possible after Georgia is able to reach an agreement with the Fund on a new arrangement. Until such new arrangement is in place, there will simply be no basis for such negotiations.

Let me now briefly turn to the structural reform agenda.

I welcome the authorities' efforts in the area of banking sector restructuring. My sense is that banking supervision and prudential regulations have been strengthened. However, much still needs to be done to improve the soundness and credibility of the banking system. All banks that do not meet prudential regulations should be dealt with through restructuring or liquidation.

Although the progress in enterprise privatization has been rather moderate and majority ownership of many large enterprises still remains in state hands, some commendable steps have been taken, including improvements in the legal framework facilitating the sale of medium and large enterprises. I would urge the authorities to remain committed to their privatization agenda.

The situation in the energy sector remains a matter of great concern. The degree to which energy consumption is subsidezed seems to be very high. It is clear that domestic energy prices should be gradually but forcefully increased and brought to a more adequate level, customer discount system needs to be reconsidered, and strong administrative measures should be undertaken to increase payment collection rate.

With these remarks I wish the authorities every success.

Ms. Brukoff made the following statement:

First, I would like to take a moment to address the issue of surveillance and timeliness with regard to Georgia. It is our opinion that almost two years between Article IV reviews is much too long for a country such as Georgia. Similarly, we believe the four-month lag between consultations and production of the staff paper is lamentable. While we appreciate the difficulties of working with a country like Georgia, greater efforts to improve timeliness of reporting would be useful and appreciated.

The situation in Georgia is clearly dire. Since the last Article IV review, there are few accomplishments to point to, and many troubling developments. The basic story to explain the recent economic path is one of excuses and broken promises—an election around the corner which precludes reforms; a promised increase in revenue which somehow fails to be realized. And the Supplement paints an increasingly grim and alarming picture as revenues continue to under-perform, expenditure arrears increase, arrears on external principle payments rise, and foreign interest payment arrears begin to emerge.

Moving forward, Georgia desperately needs to focus on two issues: revenues and growth. Addressing these matters will help with a third crucial element of improving economic conditions, namely restructuring external obligations to restore a semblance of balance to the currently-untenable external position. But external creditors will be reluctant to help Georgia if Georgia is not willing to help itself, and the Paris Club will not be accommodating without the Fund's seal of approval. As far as debt relations with Turkmenistan, we encourage both parties to work in good faith toward a mutually beneficial resolution.

With regard to revenues, the authorities know broadly what they need to do, though thus far they have been either unwilling or unable to implement appropriate measures. While the large taxpayer unit and the Revenue Ministry are good ideas in theory, implementation is critical. Indeed, improved tax administration is essential to addressing abysmal tax compliance and to raising the very low ratio of revenue-to-GDP.

Otherwise, continued weak fiscal performance will exacerbate already widespread expenditure arrears, especially in the social sector. And, as the Issues Paper notes, this increasingly threatens to significantly raise poverty levels, while undermining the credibility of the state. Now that President Shevardnadze has been re-elected and the ruling party has secured nearly two-thirds of the seats in Parliament, there exists no further excuses for not doing what is necessary to improve the fiscal situation.

With regard to growth, the only viable options are implementing structural reforms, accelerating privatization with the help of FDI, and fostering financial deepening and remonetization. But the government must realize that these measures are all critically dependent on overall confidence, where confidence hinges on such things as macroeconomic stability, absence of corruption, and strength of the rule of law. Put differently, structural reforms may create the opportunities to redeploy assets and exploit new economic opportunities, but economic actors must be confident that they will be allowed to reap the profits from their activities if they are to take on risks.

Corruption is an enormous obstacle to improving economic prospects in Georgia, and is made worse by the web of expenditure, tax, and inter-enterprise arrears. Additionally, corruption exists at the highest levels of government which, as staff note on page 24, has gone unprosecuted, thus allowing a "culture of impunity" to flourish, and completely undermining the government's reforms efforts. We welcome the authorities' intentions to adopt a handful of anti-corruption measures, but would encourage the development of a comprehensive anti-corruption program, including assurances that the rule of law is enforced first and foremost among the highest ranks. Perhaps participation in the World Bank's corruption diagnostic exercise would be in order.

We urge the authorities to work closely with staff in coming months and to capitalize on the new electoral mandate and enhanced Parliamentary majority to implement reforms needed to boost Georgia out of the current trap of low growth and macroeconomic instability, and to allow it to begin to achieve a portion of its substantial economic potential.

Mr. Xu made the following statement:

At the outset, I would like to thank the staff for a thorough and well-prepared report and Mr. Yakusha for his comprehensive preliminary statement. I welcome the authorities' recent efforts to accelerate structural reforms, their continued efforts on fiscal consolidation, and their renewed efforts on monetary policy and banking supervision. I concur with Mr. Yakusha that the outlook for the Georgian economy has improved. I believe that there is a need for Georgia to establish a track record on revenue collection, and expenditure management. Since I am in broad agreement with the thrust of the staff report and the preliminary statement, I would like to make several brief remarks.

On the fiscal front, I share the staff's view that a significant strengthening of fiscal policy is crucial for placing the economy on a sustainable track. It seems to me that after years of fiscal difficulties, fiscal consolidation becomes a prerequisite for sustainable economic recovery. However, much remains to be done in revenue collection and expenditure management. Therefore, the authorities are encouraged to design and implement effective measures in order to strengthen the fiscal account.

On monetary policy, the authorities are encouraged to continue to pursue a prudent stance to support price and exchange rate stability. I concur with staff that the floating exchange rate regime has served Georgia well and remains appropriate. To maintain exchange rate stability it is important for Georgia to increase its exports.

On banking supervision, I am impressed by the authorities' efforts in strengthening banking supervision and prudential regulations, specifically, the recent increase in the minimum capital requirement. Thus, it is necessary for the National Bank of Georgia to continue to reinforce these regulations.

Poverty alleviation remains a daunting challenge facing the authorities. Against this background, a PRGF-supported program is needed. I am hopeful that the authorities can work out a comprehensive program in consultation with the Fund, which can be supported by the Fund.

With these remarks, I wish the authorities every success.

Mr. Le Gal made the following statement:

I will be brief since unfortunately I agree with the staff's appraisal; I say unfortunately because the situation the report describes is rather sad. Unfortunately also, the comments this chair made last summer are still valid since the problems of Georgia have not been addressed and therefore have actually worsened.

I'd like to comment about economic management and external debt.

First, on economic management, the staff rightly emphasizes the need to improve the fiscal situation. The level of revenue is too low by any standards and I will not go into the details since this is well described in the report. Under the same heading, I would reiterate that the recourse to expenditures arrears is not only bad fiscal management in the sense that it leads to a hidden deficit, but also because it is very disruptive and initiates a vicious cycle of weak financial discipline. The problem of corruption is certainly related to this bad fiscal management and it needs to be forcefully addressed and not only in words but in action.

Second, Mr. Yakusha rightly underlines in his statement the difficult situation of the external debt and that, beyond a determined adjustment policy, there is a case for rescheduling the external debt, since, although it is sustainable, it puts a heavy burden on the economy. I would nevertheless put it the other way round: a rescheduling would make sense only if there is a strong program addressing the source of the Georgian vulnerability, i.e., the fiscal situation. Therefore we urge the Georgian authorities to take the necessary measures to address the home-grown imbalances and reach an agreement with the Fund. In that case, we would support a rescheduling within the framework of the Paris Club.

Turning to Turkmenistan which is not a Paris Club member, my authorities consider that in the case of a rescheduling, the principle of comparability of treatment should apply and therefore they favor a multilateral rescheduling. In this sense, we welcome the effort from Staff to convince bilateral creditors to envisage such a multilateral rescheduling and regret that in spite of a good faith payment from Georgia, there was not enough progress toward this solution. We reiterate that the Paris Club is the adequate framework to settle this problem. The Paris Club has the expertise and the experience to deal with such issues in a way which ensures a fair treatment for the country and its creditors.

Mr. Alosaimi made the following statement:

Georgia continued to experience a drop in growth and rise in inflation last year, with only a marginal improvement set for this year. This in part reflects factors beyond the authorities' control, including effects of the drought at home and the crisis in Russia. However, the economy poses major challenges even in the absence of these exogenous developments. Here, I am encouraged by reassurances in Mr. Yakusha's helpful preliminary statement that the authorities are cognizant of the challenges and committed to speed up the necessary adjustment and reform.

As the staff emphasizes, the key to sustained economic revival is in a sizable strengthening of the fiscal position. Here, the challenge is one of ensuring institutional discipline rather than taking further discretionary action in additional tax or spending steps. On the revenue side, the report makes the remarkable assertion that improved tax administration alone could nearly double the revenue outcome. Here, while I appreciate the difficulties that the authorities are facing, I endorse the staff's view that it is unrealistic to expect the international community to continue to help offset the large foregone revenue from tax avoidance by wealthy individuals and companies. On the expenditure side, better spending priorities are critical for reduction of core arrears, including those on wages and pensions that add to the high incidence of poverty.

Closely linked to the fiscal situation, the external debt problem requires the authorities' urgent attention. The fiscal drag of a debt payment already bordering on one-third of budgetary outlays is a serious matter. I agree that an easing of these difficulties presupposes a measure of creditor concurrence to an appropriate rescheduling of the debt obligations. Here, I urge the authorities to regularize relations with all creditors, especially Turkmenistan.

Turning to structural policies, I am encouraged by the good start in reform and restructuring of the banking sector. Effective merger or liquidation of banks that fail to meet the set minimum criteria is critical and should be continued. I also welcome the progress of the crucial land privatization program that should be intensified. The challenge now is to build on this progress and extend the proactive stance to other areas where the structural reform has lagged substantially.

On privatization, while I welcome the effort to accelerate the pace, it is important to be alert to risks inherent in the law now under consideration to auction medium and large enterprises without a price floor. Here, and also in the energy sector, the inefficient functioning of enterprises is primarily a matter of lax management and financial irregularities. Efficiency gains can only come from a removal of these failings irrespective of whether the ownership is private or public.

I fully agree that the Fund should stand ready to support the authorities in implementing an appropriate adjustment and reform effort. However, resumption of Fund support should be based on prior establishment of a track record on fiscal management, structural reform, and improved relations with creditors.

With these comments, I wish the authorities success.

Mr. Gobe made the following statement:

I regret that the macro economy has deteriorated since mid-1999. It seems that fiscal discipline had been lost before the election. However, such a pattern should not be repeated. In this regard, improving the quality of public sector activity is most important. "Improving the quality" means not only tackling governance problems, but also improving efficiency and downsizing. In particular, improving the quality of activities related to fiscal transactions should be an urgent task. The external sector is also a main concern; however, the authorities should first focus on fiscal problems. Related to this, it is good news that political stability has been strengthened following the enlargement of the ruling party's share in parliament. I hope that the authorities will be able to achieve appropriate macroeconomic management and to address difficult reforms, by taking advantage of the political stability. I generally share staff's view, but would like to comment on the fiscal side.

First, I urge the authorities to eliminate expenditure arrears as scheduled. Needless to say, they should prevent further accumulation of arrears. Although it is a welcome development that the expenditure control framework has been introduced based on FAD's proposal, our attention should be focused on how the authorities will use this system. I must stress that all efforts will become meaningless if the new framework is not used appropriately. Arrears problem can and should be resolved shortly, however the task of balancing the budget—revenue increases and expenditure cuts are substantial areas that will require medium-term efforts. In particular, I hope they will address with strong determination the issue of increasing revenue, which is lowest in the BRO countries. In this regard, it is disappointing that the tax rates on petroleum products were reduced. In addition, our concern on the fiscal side is whether each policy can be implement as expected. Therefore, strengthening the tax administration is paramount in securing the effectiveness of some measures to increase tax rates and to expand coverage. Furthermore, for success in fiscal consolidation, the governance problem needs to be addressed seriously. In this regard, I welcome that the authorities have recognized the importance of addressing this issue, as described in Mr. Yakusha's statement. Once again, I must stress the importance of continuing their efforts in implementing policy measures as expected. If some targets seem to be difficult to attain, contingency measures should be prepared.

With these remarks, I wish the authorities every success.

Mr. Kranen made the following statement:

Since I am in broad agreement with the staff appraisal, I can confine my remarks to a few points.

On fiscal policy. Like the staff, we encourage the authorities to implement decisive measures on both sides of the budget, i.e., tax administration as well as expenditure control. We have some doubts about the forecast of a fiscal deficit of 4.4 percent of GDP in 2000. We should take into account that the revenue-to-GDP ratio is among the lowest in all transition countries, and that budgetary arrears have increased further. In the context of safeguarding a sustainable revenue basis I would like to stress the need for realistic domestic energy-prices.

Concerning external debt, the significant consolidation of external debt is a precondition for fiscal stability and viability of the balance of payments position. In this context, we also emphasize the need for a rescheduling on a multilateral basis. Since this effort depends largely on the willingness of Turkmenistan to participate in this process, we welcome Georgia's attempts to improve its relationships with its largest bilateral creditor. Like other speakers, we are concerned that after encouraging signs in this direction at the end of last year, Turkmenistan seems to become more and more reluctant to reconsider a future rescheduling of Georgia's debt.

To conclude my statement, I would like to wish Georgia's government much success in its efforts. Since the outlook of the World economy has improved significantly, Georgia should use this window of opportunity to restructure its economy, improve governance, and fight corruption. We stand ready to support a new program when the authorities have proven their commitment to reform Georgia's economy, to stabilize public finances, and to tackle governance issues.

Mr. Kioa made the following statement:

I do not have new elements to add to the discussion at this stage. Therefore, I will submit my statement for the record.

The economic situation in Georgia is mixed and the ESAF-supported program is way off track. Compared to double-digit growth in 1996 and 1997, economic growth has leveled off at 3 percent per annum, inflation is above 10 percent while unemployment is around 20 percent. Exports still lag behind 1997 levels and the improvement in the current account balance is attributed to the falling import demand; all in all, the level of foreign exchange reserves remains at a very low level. Slacked revenue collection and the substantial overrun in expenditures have contributed to accumulated expenditure arrears and an unsustainable fiscal position. In spite of these, however, the continuing efforts of the authorities to move ahead with certain structural reforms such as the banking sector reforms and privatization are commendable. The staff report is comprehensive, and we agree with the thrust of the staff appraisal.

Despite the protracted effects of the Russian crisis, the lacking of fiscal consolidation is the principal source of economic difficulties in Georgia. The worsening fiscal stance is unsustainable, and the authorities' way out is through a forceful consolidation and tightening of fiscal policy, as its effects on the monetary sector. On the revenue side there is ample room for improved tax revenues, as its tax revenue to GDP ratio is lowest among the BRO. Broadening the tax base and eliminating certain VAT exemptions and preferential rates would be but a few of the available options. However, the effective implementation of these tax reforms must be accompanied–compellingly–with thorough improvement in tax administration. Serious efforts toward better governance via prosecuting the public officers suspected of fraud and corrupt practices is appropriate, and introduction of code of ethics for civil servants and broadening of financial disclosure laws are indeed needed.

On the expenditure side, there seems to be a multitude of factors that contributed to the overrun in expenditure. Unrealistic budgeting and inability to prioritize public spending are manifest, and the lack of an expenditure control framework where authorities instead resorted to ad hoc procedures and sequestration of expenditure has contributed to the hysterical overspending. We encourage the authorities to consolidate the budgetary process, and to use an expenditure-control framework to monitor and prioritize expenditure. Avoiding unbudgeted expenditure would contribute to the credibility of the budgetary process. These measures would minimize the accumulation of arrears to pension, wages, and the other components of the social safety nets in Georgia, and most importantly, they would tone down the current trend in fiscal performance to a more sustainable level.

On the monetary side, we agree that authorities should continue to adopt the restrained monetary policy stance. Under the existing exchange rate regime, the tightening of credit lending to government would be appropriate in order to support price and exchange rate stability. Moreover, the continued effort in reforming the banking sector is most welcomed, particularly in strengthening of banking supervision and prudential regulation.

Finally, on the debt level, we agree that a significant consolidation of external debt and debt servicing is a necessary condition to fiscal sustainability and improved social conditions. While the current and near future loads of debt servicing is increasingly unmanageable, we agree that a strong fiscal adjustment effort by the authorities will not be sufficient to relieve the heavy burden. Given the current economic difficulty facing Georgia, we support the authorities' appeal for debt rescheduling, and therefore seek consideration and willingness from Georgia's external creditor to participate.

With the above remarks, we wish the Georgian authorities success in its fight to put the program back on track.

Mr. Szczuka made the following statement:

Given the importance of the debtor-creditor relation for both Georgia and Turkmenistan I would like to make a few points on this issue.

Turkmenistan's position cannot be directly compared to the situation of other, more developed creditors of Georgia. The value of scheduled repayments of Georgia's debt (about $80 million annually) exceeds 10 percent of Turkmenistan's fiscal and export revenues, while the value of total claims on Georgia amounts to between 5 and 15 percent of Turkmenistan's GDP (depending on the choice of the exchange rate). Turkmenistan itself has a significant external debt, but makes very strong efforts to remain current in servicing its foreign obligations, even though some indicators of Turkmenistan's debt servicing burden are less favorable than in Georgia.

In early February my Turkmen authorities sent letters to most Paris Club members explaining Turkmenistan's situation and stating that Turkmenistan would not agree with including its claims on Georgia under the Paris Club framework. In these letters Turkmenistan also asked for support and guidance how to deal with this difficult issue. Last year Turkmenistan welcomed the Fund's involvement in looking for a solution of this problem with the assumption that a proposed solution would take into account the economic conditions in both countries. Given the normally very strong position of the traditional Paris Club creditors, discussions in this forum focus predominantly on the debt servicing capacity of the debtor country. This is why, this framework may not be fully adequate for protecting the interests of Turkmenistan.

The issue of debtor-creditor relation between Georgia and Turkmenistan invokes many analogies to our recent discussion on non-Paris Club creditors of the HIPC countries. Even though this is not a case of a debt reduction, the proposed third debt rescheduling of Georgia's debt to Turkmenistan would lead to such a large loss of Turkmenistan's revenues that it clearly deserves to be considered on a special, case-by-case basis.

Staff indicate in the report that Georgia's limited debt servicing capacity reflects in part lack of a sufficiently strong adjustment effort, that lack of political will may explain poor revenue performance, and that little by way of concrete action have been taken so far in dealing with serious governance problems. Such statements can hardly be interpreted as an encouragement for a creditor country to provide renewed debt relief.

Finally, could the staff explain what kind of sequence they have in mind when expressing their willingness to support Georgia's request for exceptional financing? Would an agreement on a new program with the Fund be considered a precondition for supporting such request and how would it correspond to the Board's position taken in July 1999 that appropriate financing assurances from Georgia's creditors would be necessary prior to presenting a request for a new arrangement?

On other issues, I broadly share the assessment presented in the staff report.

The staff representative from the European II Department, responding to questions on Georgia's autonomous regions and their treatment in the national statistics, acknowledged that Georgia's tax authorities were operating in a difficult environment, given that in certain areas of the country taxes could not be collected. Georgia did not receive tax revenues from either of the two autonomous regions, Abkhazia and South Ossetia. While there was an attempt by the Department of Statistics to include those regions in the GDP data, they were not included in the revenue statistics.

Another problem concerned a change in revenue sharing arrangements made under the 2000 budget, the staff representative noted. According to those changes the autonomous region of Adjara and other regions would receive less, while the central government would receive more of total tax revenue. However, it appeared that Adjara was not remitting its revenues to the central government, thereby exacerbating the overall fiscal difficulties. The former Managing Director had addressed that issue once in a conversation with President Shevarnadze. On that occasion, the Managing Director had stressed that such political problems had to be solved by the authorities and that the Fund could not address such matters directly. There had been efforts on the part of the central government to overcome the tensions with Adjara, and it would be important to resolve that problem in order to improve the prospects for more central government revenue.

Mr. Mozhin wondered whether all autonomous regions were included in the national accounts statistics and, given that they were not contributing to central government revenue, what the impact was on the revenue-to-GDP ratio mentioned in the staff report.

The staff representative from the European II Department noted that the actual impact of the discrepancy between revenue and national account statistics on the revenue-to-GDP ratio was small. Also, current revenues and tax revenues in Georgia for the last three years had reached only about two-thirds of current government spending, leading to a large primary deficit. Even if the revenue from the autonomous areas were taken into account, the broad picture would not change significantly.

Responding to a question raised by Mr. Szczuka on the type of sequencing the staff had in mind when expressing the willingness to support Georgia's request for exceptional financing and as to whether a new Fund-supported program would be considered a precondition for supporting such a request, the staff representative considered that, in the normal course of the staff's work, the economic program would be negotiated with the authorities, and the external outlook as well as the level of external support from exceptional financing would be one element of that. There was a necessity of having an agreement with the authorities, and Board approval would be required before Georgia could submit its request for any debt rescheduling. With regard to Turkmenistan, the Board had already considered that problem in the past. Prior to submitting the third annual ESAF arrangement to the Board in July 1998, there had been informal Board meetings on that matter—given that Turkmenistan was by far Georgia's largest bilateral creditor. That fact would also have to be given due consideration once an arrangement for Georgia would be considered by the Board.

Mr. Yakusha made the following concluding statement:

> I would like to express my appreciation to the staff for their work on Georgia. I would also like to do so on behalf of my Georgian authorities as well as my appreciation of your personal involvement, in matters relating to Georgia.
>
> The resumption of the dialogue with Georgia is of utmost importance for the authorities, and I hope that the new mission chief for Georgia is going to be selected not long after the new government in Georgia is in place.
>
> I would like to raise one general issue. Despite declaring its participation in the fiscal and monetary policy transparency pilot project, Georgia has delayed the respective reports, owing to resource constraints in view of the numerous initiatives that have been started subsequently, like the standards initiatives and the Financial Sector Assessment Program. It is important that the initiative which was started is followed up until its completion. In the case of the transparency pilot project, that is particularly desirable. There is an example in my constituency that a Minister of Finance has used a published fiscal transparency report in order to bolster his position in the cabinet by underlining that the view he expressed was not only his own, but also that of the international community. Therefore, I would urge Fund management to consider the need to complete all initiatives that the Fund has started. With respect to Georgia that would help the authorities in their efforts to increase and enhance transparency.
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> With respect to Mr. Chelsky's remark on the purchase of luxury cars by the authorities, I would like to stress that one has to take the political and the security situation in the country into account. Hence there is a need for armored vehicles, and their purchase is justified.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. Directors observed that, while progress had been made in macroeconomic stabilization and structural reform, the momentum of the reform program had flagged, growth had slowed, and little headway had been made in addressing deep-seated fiscal problems since the end of 1997. Although the external environment had been difficult, the main sources of weakness had been policy slippages. Directors observed that weak governance and widespread corruption had played a major role, and stressed that these problems needed to be addressed urgently. They noted that the economy continued to face large external and internal imbalances that posed a significant threat to macroeconomic stability.

Directors emphasized that a significant strengthening of fiscal policy was crucial for placing the economy on a sustainable path. In addition to undermining growth prospects, the persistence of a large fiscal deficit has steadily built up a debt overhang which, in the absence of a concerted and coordinated adjustment program, would eventually have adverse consequences for inflation and the exchange rate. Directors noted with concern that interest payments now accounted for one-third of central government revenue. Directors also noted that the failure to pay adequate attention to the equity issues raised by the tax and spending policies of the government had implications for the sustainability of economic reforms.

Against this background, Directors regretted that the 2000 budget fell well short of the required fiscal adjustment and, in particular, that the tax administration and enforcement measures needed to generate a sustainable increase in revenues had not been implemented. Some Directors also expressed regret about the reduction in tax rates on petroleum products, which had more than reversed the increases on fuel excises introduced under the ESAF-supported program.

With the ratio of tax revenue to GDP being one of the lowest in the region, Directors stressed the urgent need to address Georgia's failure to collect adequate tax revenues. Moreover, as the level of tax rates on income, goods, and services was broadly appropriate by international standards, the emphasis should be placed on improved tax administration and collection.

Directors expressed regret that the chronic shortfall in revenue in the face of limited checks on spending had led to further accumulation of expenditure arrears. In welcoming the new initiative aimed at establishing an expenditure control system, they emphasized that the key components of a policy to alleviate poverty were the elimination of arrears on wages, pensions, and social expenditures, and the need to remain current on new outlays. In order to do so, Directors urged the authorities to undertake a comprehensive review of government expenditure with the objective of rationalizing its operations, achieving efficiency gains, and improving targeting.

Directors emphasized the importance of maintaining prudent monetary policy as a key condition for price and exchange rate stability. They noted that the floating exchange rate regime had served Georgia well and remained appropriate, given the low level of gross international reserves and the uncertainty about the competitiveness of the tradable goods sector. Directors welcomed the authorities' steps in strengthening the banking supervision and prudential regulations, including the recent increase in the minimum capital requirement. They stressed that continuing reforms of the banking system remained important.

Directors stressed the importance of pressing ahead with the authorities' agenda for structural reforms. The execution of the outstanding agenda for large-scale infrastructure privatization, including in the telecommunications and energy sectors, and the completion of the overhaul of the legal and regulatory frameworks were viewed as important.

Directors stressed that a bold and front-loaded strategy to tackle corruption and improve governance would be essential not only to improve revenue and expenditure performance, but also to attract the long-term capital needed for restructuring the economy and to bring about sustained high-quality growth. Much still remains to be done to develop the institutional and legal underpinnings of a market economy and provide a reliable framework for improving governance and strengthening the rule of law. Directors urged the authorities to use their strong political mandate to press ahead with the needed reforms.

Directors welcomed the recent efforts by the authorities to improve basic macroeconomic statistics, including the revisions in the national accounts. At the same time, they urged the authorities to improve the compilation and coverage of the balance of payments as well as the national accounts.

Directors noted that Georgia's external outlook remained difficult and that a combination of a strong adjustment and structural reform program and international financial support would be required to close the large external financing gaps. On the basis of such a program, Directors would support Georgia's request to bilateral creditors for exceptional financing for a new multilateral rescheduling agreement, in which they would encourage Turkmenistan also to take part. Directors noted that the Fund stood ready to assist the authorities in designing an appropriate economic program that could attract the support of the international community, and stressed that such a program would include strengthened fiscal adjustment and strong anti-corruption and governance-improving measures. In view of the sizable slippages in fiscal policy implementation recently, there was a need for Georgia to establish a track record on revenue collection, expenditure management, and governance issues, which would help in establishing the basis for a resumption of Fund financial assistance.

It is expected that the next Article IV consultation with Georgia will be held on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/00/42 (4/19/00) and EBM/00/43 (4/21/00).

3. RELEASE OF INFORMATION—EXPERIENCE WITH BASEL CORE PRINCIPLE ASSESSMENTS

The Executive Board approves the proposed transmittal of the paper on the Experience with Basel Core Principle Assessments and the conclusions following the discussion by the Executive Board as set forth in SM/00/77 (4/12/00).

Adopted April 19, 2000

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by an Advisor to Executive Directors, and by Assistants to Executive Directors as set out in EBAM/00/56 (4/19/00) is approved.

APPROVAL: May 24, 2001

SHAILENDRA J. ANJARIA
Secretary