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Ex-ante evaluation statement on further macro-financial assistance to Georgia

Accompanying document to the

Proposal for a Decision of the European Parliament and of the Council providing further macro-financial assistance to Georgia

Ex-ante evaluation statement

Further macro-financial assistance to Georgia

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1. PROBLEM ANALYSIS AND NEEDS ASSESSMENT

1.1. Introduction

The EU completed in early August 2010 the disbursement of a EUR 46 million macro-financial assistance (MFA) operation to Georgia approved by the Council in November 2009. The assistance, which was provided in the form of grants, was part of a pledge of two possible EU funded MFA operations of the same amount made by the European Commission at the International Donors' Conference of October 2008[1]. The approval of the second MFA was conditional on the continued existence of external financing needs over and above those covered by the IMF arrangement.

In a letter from 10 May 2010, the Georgian Minister of Finance requested the activation of the second part of the EC pledge, amounting to EUR 46 million. In this context, a European Commission team visited Georgia in early September to assess the country's macroeconomic situation and prospects in 2010-11, focusing on the balance of payments and budgetary needs.

The Commission considers that the activation of the second part of the MFA pledged in 2008 is warranted. Although the Georgian economy is recovering (following the double shock caused by the military conflict with Russia of August 2008 and the global financial crisis), the balance of payments and budgetary position remain weak and vulnerable. In particular, the lingering effects of the conflict with Russia, including the blockade of most direct trade with this country and the failure of foreign direct investment (FDI) inflows to recover to their pre-crisis level, combined with a still very sizeable current account deficit and substantial debt repayment obligations (with a serious bunching expected for 2012-14), leave the balance of payments fragile.

In this context, the Commission proposes a further MFA to Georgia, amounting to EUR 46 million. The EU MFA would be aimed at contributing to covering the country's external financing needs in 2009-11, as identified in cooperation with the IMF in the context of the IMF Stand-By Arrangement (SBA) of USD 1.17 billion, in place since October 2008. The proposed assistance would be provided half in grants and half in loans.

The new MFA would contribute to help Georgia to address the lingering economic consequences of the conflict with Russia and the global crisis. The new MFA will support the economic reform agenda of the government. It would reduce the short-term financial vulnerability still faced by the economy, while supporting reform measures (including those in the IMF and World Bank programmes) aimed at achieving a more sustainable balance of payments and budgetary situation over the medium-term. The assistance would also promote policy measures to strengthen public finance management (building on those of the previous operation and of the EU's sectoral budgetary support operation), as well as measures to foster economic and financial integration with the EU, in particular by exploiting the potential

[1] The total assistance pledged at this Donors' Conference by the EC amounted to up to EUR 500 million and was aimed at supporting the Georgian economy in the aftermath of the August 2008 armed conflict with Russia and in the context of the global financial crisis.

offered by the future Association Agreement, which aims at concluding a Deep and Comprehensive Free Trade Agreement (DCFTA)[2] between the two parties.

The proposed new MFA would be exceptional and limited in time and is intended to run in parallel to the SBA. It would complement support from international and bilateral donors.

1.2. Georgia's macro-economic situation

In the aftermath of the double shock of the military conflict with Russia of August 2008 and the global crisis, the Georgian economy is showing signs of recovery. Following two years of low or negative growth, 2010 is expected to see a revival of economic activity. While 2009 saw a contraction of real GDP by 3.9%, the first half of 2010 recorded a strong growth of 6.6% (on an annual basis). Manufacturing and transportation recorded the strongest increases, of 21% and 15% respectively. While the latest official projections and those included in the latest IMF Staff Report (issued in June 2010) expect real GDP to grow by 4.5% this year, VAT turnover data for the first half of the year suggest that growth may be significantly higher (probably in the order of 6 to 7 percent). Despite the recovery gaining ground already in late 2009, economic growth has not yet been translated into an improved situation on the labour market. The unemployment rate remained at a worryingly high level of 16.9% in 2009.

On the back of the economic recovery, the government has decided to tighten its budgetary and monetary policies. While the budget deficit reached 9.2% of GDP in 2009, the plan is to reduce it to 6.3% of GDP in 2010 and to 4.8% of GDP in 2011. However, there are reasons to assume that in 2010 an even higher degree of fiscal consolidation can be achieved: the authorities have introduced an explicit expenditure cap, which implies that a higher level of budgetary revenues would be translated into a stronger reduction of the budget deficit. Tax revenues in the second quarter of 2010 have been higher than what the last IMF review forecasted. Based on this trend, they could be at least 5% higher in 2010 than projected in the IMF programme, and under the above-mentioned cap would be fully saved, resulting in a lower than programmed deficit. For 2011, the authorities are planning to reduce real spending by 3% relative to 2010. By 2013, the government aims at reducing the budget deficit to 3% of GDP, implying a reduction of at least 6 percentage points of GDP relative to the 2009 peak. Monetary policy began to be tightened in the summer, with policy interest rate being somewhat increased, to keep inflation under control. This process is expected to continue. On the back of economic recovery annual CPI inflation is expected to pick up from its low of 3% at end-2009 to over 8% by end-2010. A further reason for the strong increase in inflation is the fact that almost half of the CPI basket in Georgia consists of food items, so that recent increases of cereals prices, especially those of wheat, previously imported from Russia, are expected to feed into the higher CPI. For the years 2010-2012, the monetary authorities foresee a target average inflation rate of 7%.

While the economic recovery seems to be taking hold, the economic situation remains vulnerable as the financing of the large current account deficit remains uncertain. Although the crisis, by weakening domestic demand, contributed to a halving of the current account deficit in 2009 (from 22.7% in 2008 to 11.7% of GDP), the deficit remains very large. The

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[2] While negotiations on the Association Agreement were launched in July 2010, negotiations on the Deep and Comprehensive Free Trade Agreement have been delayed due to insufficient progress in key trade-related reforms. Significant progress by Georgia in implementing the EC's key recommendations in the areas of technical barriers to trade, competition policy, food safety and intellectual property rights is a precondition for the launching of negotiations.

current account deficit is projected to reach 12.0% of GDP in 2010 and the situation is not expected to improve in 2011. The trade deficit, which is projected to reach 22.8% of GDP in 2010, is the main driver of the large current account deficit. The sharp contraction in the country's industrial and agricultural exports caused by the global crisis was reinforced by the trade embargo on some Georgian products imposed by Russia in 2006 and extended in 2008. Georgian exports to the EU countries have remained low and the possibilities offered by the GSP+ remain under-exploited. While a certain trade re-orientation and changes in export profile have recently taken place, Georgia's exports continue to lack diversification: three quarters of exports in the first quarter of 2009 were mineral products, including metals. Overall, Georgian export performance remains far below its potential.

Table 1: Georgia – Selected macroeconomic indicators, 2008-2012

	2008 Act.	2009 Prel.	2010 Proj.	2011 Proj.	2012 Proj.
	(Annual percentage change, unless otherwise indicated)				
National Accounts					
Real GDP growth	2.3	-3.9	4.5	4.0	5.0
Population (in million)(1)	4.4	4.4	4.4	4.4	4.4
Consumer price index, period average	10.0	1.7	4.6	5.3	5.0
Consumer price index, end-of-period	5.5	3.0	5.5	5.0	5.0
GDP per capita (in USD)	2,937	2,450	2,448	2,479	2,676
Unemployment rate (in percent)	16.5	16.9	…	…	…
	(in percent of GDP)				
Consolidated government operations					
Total government debt	25.0	37.1	46.1	49.3	47.1
o/w foreign-currency denominated	20.9	31.5	40.6	43.2	40.5
Revenue(2)	30.7	29.3	29.8	29.1	28.2
Expenses	28.5	30.1	27.7	26.5	25.5
Overall balance	-6.3	-9.2	-6.3	-4.8	-3.4
Total financing	6.3	9.2	6.3	4.8	3.4
Domestic	-2.3	3.3	-0.3	1.8	0.6
External	5.0	3.9	5.6	2.4	2.5
Privatization receipts	3.7	2.0	1.1	0.7	0.4
External sector					
Current account balance (in mn of USD)	-2,915	-1,259	-1,351	-1,488	-1,475
In percent of GDP	-22.7	-11.7	-12.0	-12.5	-11.5
Gross international reserves, end of period (in mn of USD)	1,480	2,111	2,264	2,359	2,289
In months of next year's imports of goods and services	3.4	4.1	4.1	4.1	3.7
Total external debt (in percent of GDP)	44.4	58.4	66.4	67.7	64.4
External public sector debt (in percent of GDP)	20.9	31.5	39.4	40.5	38.2
Foreign direct investment (percent of GDP)	12.2	7.1	6.5	8.2	8.6
Average exchange rate (Lari per USD)	1.48	1.67	…	…	…

Sources: Georgian authorities and IMF staff estimates

(1) Excludes Abkhazia residents
(2) Includes grants

In 2008, when the Georgian current account deficit was practically the double of its current size, Georgia experienced much higher net inflows of FDI (amounting to USD 1.5 bn) that allowed financing about half of the large current account deficit. During the crisis of 2008-09, the inflows of public sector financing, including the financial support of International Financial Institutions and bilateral donors, partially replaced the decreased FDI inflows. But, for 2010-11, the financing of the current account is still uncertain. FDI inflows, which were expected to recover, are now projected to decline even further in 2010. FDI inflows reached a meagre USD 75 million in the first quarter of 2010 and their moderate recovery of the second quarter (when they attained USD 200 million) will not allow them to reach even their 2009 level of USD 750 million. Only slow recovery in FDI inflows is expected in 2011. This disappointing performance of FDI inflows puts at risk the financing of the current account and the build up of international currency reserves and shows that foreign investor confidence, which experienced a dramatic blow due to the military conflict with Russia in 2008, has still not returned. It also reflects the loss of steam of the privatisation process as many of the most attractive state companies and assets have already been sold. At the same time, the official donor financing agreed at the 2008 International Donors' Conference has largely been disbursed as much of it was frontloaded. This means that in 2010-2011 Georgia will face a shortage of FDI inflows while public sector financing will partly dry up.

By December 2009, international reserves had recovered from a trough of USD 1.5 billion reached during the crisis to USD 2.1 billion, or 4.1 months of the next year’s imports. Yet, in the course of the first half of 2010, the level of reserves decreased again. In the first half of 2010, the monetary authorities intervened somewhat more actively in the exchange markets as depreciation pressures on the local currency were considered to be temporary. However, in June 2010 the authorities let the exchange rate to depreciate by 8% against the USD. Since then, no significant depreciation pressures have been observed and the authorities could reduce their level of intervention. By the end of September 2010, the level of gross international reserves held by the National Bank of Georgia was at USD 2.1 billion, which the IMF considers suboptimal in the medium term, particularly since it has partly been achieved by borrowing from the IMF. Net international reserves are at an even more worrying level, having actually declined from USD 850 million in September 2008 to USD 740 million in September 2010. Moreover, there is a risk that the higher current demand for the local currency experienced since July proves a seasonal phenomenon as stronger capital inflows related to the tourism receipts and remittances inflows might dry up in the winter. This, in turn, could lead to renewed depreciation pressures on the exchange rate market. Thus, while currently the pressures on the exchange market seem to be absent, they might re-appear later during the year and in early 2011 when tourism receipts and remittances inflows subside due to their seasonality.

Even long before the 2008 crisis, Georgia's financial system has been characterised by a widespread dollarization. Despite a recent decrease in the level of dollarisation from its peak of 75%, about 70% of bank loans are still held in foreign currency. This contributes to the reluctance of the monetary authorities to let the exchange rate to strongly depreciate as the majority of loans are unhedged, with creditor income being paid in local currency. To re-establish the effectiveness of the monetary policy tools of the NBG, monetary authorities have recently taken measures to promote the de-dollarisation of the economy and have reduced their level of intervention in the exchange rate market.

A further vulnerability in the balance of payments relates to the high level of external public debt and a significant need for a debt roll-over in the coming years. External public sector debt increased from only around 21% of GDP in 2008, to around 32% of GDP in 2009 and is expected to reach 41% of GDP in 2010. While the majority of the external public debt has medium and long-term maturities, substantial external debt repayment obligations will become due in 2012-15. Amortisations will rise markedly in 2013, when they are expected to amount to USD 750 million, reflecting the repayment of the Eurobond of USD 500 million issued in 2008 as well a substantial repurchases under the IMF's Stand-By Arrangement. This is expected to push up the debt service on medium- and long-term public debt to the equivalent of 40% of exports in 2013.

1.3. IMF Stand-By Arrangement and other donor support

In September 2008, the IMF approved an 18-month Stand-By Arrangement for Georgia, worth USD 750 million. In 2009, Georgia drew an amount equivalent to USD 410 million. During the third programme review, approved by the IMF Executive Board in August 2009, the Stand-By Arrangement was extended until 14 June 2011 and the financing package increased by about USD 424 million, bringing the total Stand-By Arrangement programme to USD 1.17 billion. In 2010, the IMF plans to disburse USD 446 million to Georgia, of which USD 298 million to the budget. The programme remains on-track: on 9 July 2010, the IMF Board completed the sixth review of the IMF Stand-By Arrangement, concluding that performance under the programme has been broadly satisfactory. The Board granted a waiver for the non-observance of the end-June quantitative performance criterion on the floor on net international reserves of the central bank and a waiver of applicability of the end-June performance criterion on the ceiling on cash deficit of the consolidated government[3]. The Board welcomed the fast pace of public deficit reduction that the Georgian authorities are aiming at for 2010. It qualified the recent tightening of monetary policy as an appropriate reaction warranted by downwards pressures on the domestic currency. Despite the fact that the economic recovery is gaining strength, the Board pointed out the risks associated with weak FDI inflows. Overall, the Board concluded that Georgia is in a good position to meet the objectives of the programme, which are to secure macroeconomic stability and growth based on private sector financing and investment. The completion of the sixth review of the Stand-By Arrangement allowed for an immediate purchase by Georgia of an equivalent of USD 74.8 million.

The next IMF review, which combines the seventh and the eight reviews, is scheduled for November 2010. Its successful conclusion will trigger a new IMF disbursement of about USD 150 million at the end of 2010. In 2011, two further tranches, amounting to around USD 53 million each, will be disbursed.

The World Bank has also been actively involved in the rehabilitation of the Georgian economy. The Country Partnership Strategy package endorsed in September 2009 envisages Bank Group financing of USD 740-900 million for the period of 2010-13. This includes the remaining IDA-15 financing, IBRD financing and IFC investments and lending. Development policy lending has been the core element of World Bank strategy in Georgia. Following a successful track record of reforms under 8 Poverty Reduction Support Operations, a programmatic series of three Development Policy Operations (DPOs) is currently being implemented. The first DPO, amounting to USD 85 million, was launched in July 2009. The second DPO, of USD 50 million, was approved by the Board in July 2010. The DPO program series aim at mitigating the economic downturn and facilitating recovery and preparing Georgia for post-crisis growth. They promote policy and institutional reforms in: (i) public finances, including improving efficiency and effectiveness of public expenditures, and public investment; (ii) social protection, including targeting and scaling up of the safety net system,

[3] Consolidated government is defined as the central government, local governments, extra-budgetary funds and Legal Entities of Public Law that provide general government services.

pensions, and improving health coverage for the poor, and (iii) specific measures to further improve the investment climate, including policy reforms related to the modernisation of tax and customs administration. The third DPO, in the order of USD 25 million, is expected to be approved in the summer of 2011.

The overall support package for 2008-2010 pledged by the international donor community at the 2008 Donors' Conference amounted to USD 4.5 billion, including USD 1 billion from the USA, USD 200 million from Japan, USD 173 million from the EU Member States and USD 2.4 billion from the Multilateral Financial Institutions. The total public sector commitment amounted to USD 2.6 bn and the disbursements related to this commitment have been largely frontloaded. According to the recent progress report of the United Nations and the World Bank on Georgia's Joint Needs Assessment, for the period from October 2008 to March 2010, donor commitments related to the general budget support have been honoured to 91%[4].

1.4. Georgia's external financing needs

Table 2 below summarises Georgia's external financing needs for the period 2009-11. The current account deficit is projected to remain very large, amounting to about between 12% and 13% of GDP in both 2010 and 2011. Projected net inflows in the capital and financial account, which were very negatively affected by the crisis and its aftermath, would only partly cover this difference. This reflects in part, as noted, developments in FDI, which after having declined in 2009-10, are expected to recover only gradually in 2011 due to lingering political uncertainties and the loss of steam of the privatisation process. Moreover, consistent with the IMF programme, a targeted rebuilding of official foreign exchange reserves is assumed.

All this leaves considerable external financing needs, to be covered by exceptional financing from the IFIs and bilateral donors. Based on the estimates provided by the IMF, total financing needs for the three years (2009-11), excluding those covered by private and non crisis-related official inflows, amount to around USD 2.4 billion. Out of this amount, the Breton Woods institutions are expected to provide around USD 1.5 billion, including some USD 900 million for the period 2010-11. The proposed new MFA would amount to EUR 46 million and, together with the last MFA operation, would cover around 14% of the residual financing needs for the period 2009-11 (around USD 850 million).

[4] The overall disbursement ratio to the public sector was of 44% of commitments. The disbursement ratio ranged from 91% for budget support, 89% for the activities related to the internally displaced persons and 12% for infrastructure. For the banking sector, the disbursement ratio was 66%.

Table 2: Georgia – External Financing Requirements and Sources, 2009-2011

	2009	2010	2011
		in million USD	
1 Current account balance[1]	**-1.378**	**-1.478**	**-1.594**
Trade balance	-2.399	-2.591	-2.661
Services	332	364	426
Income (net)	-150	-244	-287
Net transfers[1]	839	993	928
2 Capital and financial account	**1.090**	**673**	**1.172**
Capital account (net)	180	233	99
Financial account	910	440	1.073
Foreign direct investment (net)	765	659	884
Private sector borrowing (net) (excl FDI)	-68	-149	232
Public sector [1,2]	213	-70	-43
3 Errors and omissions	54	2	0
4 Gross reserves (- increase)	**-616**	**-205**	**-95**
5 Overall financing needs (1+2+3+4)	**-851**	**-1.007**	**-517**
6 Exceptional IFI financing	**614**	**685**	**227**
IMF purchases	340	450	106
World Bank (gross)	274	235	121
7 Residual financing gap (after IMF/WB)	**-237**	**-322**	**-290**
Financing of the gap			
ADB	105	149	160
USA	19	26	65
Other bilateral donors	12	32	9
EU structural budget support (ENPI)	78	46	25
		in million EUR	
EU MFA	15	54	23
New proposed MFA for 2010-11		23	23
MFA approved in November 2009	15	31	
Memorandum item			
Total MFA as % of the residual gap for 2009-11[3]		14	

Sources: IMF staff projections and Commission's estimates

[1] Excludes crisis-related official grants and loans

[2] Includes monetary authorities and general government. Includes repayments to the IMF.

[3] Assuming exchange rate of euro vis-à-vis the US dollar of 1.3

2. OBJECTIVES AND RELATED INDICATORS OF THE MACRO-FINANCIAL ASSISTANCE

2.1. Objectives

The objectives of the proposed MFA operation are to:

- Contribute to covering the external financing needs of Georgia and to alleviating budgetary financing needs.

- Support the fiscal consolidation effort and external stabilisation in the context of an IMF programme.

- Support structural reform efforts aimed at raising sustainable growth and increasing the transparency and efficiency of public finance management.

- Facilitate and encourage efforts by the authorities of Georgia to implement measures identified under the EU-Georgia ENP Action Plan and the Eastern Partnership so as to promote closer economic and financial integration with the EU, also in line with the plan to conclude a DCFTA between the two parties.

2.2. Indicators

The fulfilment of the objectives of the assistance will be assessed by the Commission, including in the context of the ex-post evaluation (see below), on the basis of the following indicators:

- Progress with macroeconomic and financial stabilisation, notably by assessing the degree of adherence to the IMF-supported programme.

- Progress with the implementation of structural reforms, notably the specific policy actions identified as conditions for disbursement of the assistance, which are included in the aforementioned Memorandum of Understanding. Particular emphasis will be put on the implementation of measures aimed at raising economic growth potential and improving public finance management.

- Progress in developing economic and financial integration and regulatory harmonisation with the EU.

- Progress in implementing of the priorities identified in the EU-Georgia ENP Action Plan and the Eastern Partnership.

3. DELIVERY MECHANISMS AND RISK ASSESSMENT

3.1. Delivery mechanisms

The proposed new MFA would amount to EUR 46 million, consistent with the pledge the EC made at the October 2008 International Donors' Conference. Regarding the form of the assistance, the Commission proposes to disburse half of the envisaged amount in grants and the other half in loans.

The full use of grants in the previous operation had to be understood as an exceptional decision justified by the very difficult circumstances Georgia found itself in late 2008. Given Georgia's level of development (as measured by its per capital income[5]) and debt indicators, and the recent improvement in the country's economic situation, it would not be reasonable to

[5] Georgia's per capita GDP was at EUR 1,774 in 2009, somewhat below Armenia's level of EUR 1921, but substantially above the level of Moldova, the poorest among the Eastern Partnership countries, with per capita GDP amounting to EUR 1,091.

expect the full amount of the assistance to be provided in grants. The blend of grants and loans would also be justified when considering that Georgia has been a blend country for the World Bank since January 2009. For the upcoming World Bank operations, the country is expected to receive one third of the World Bank assistance in the form of the IDA lending, while two thirds of the assistance are expected to be provided on IBRD terms. At the same time, there are reasons to provide part of the assistance as a grant. Georgia's public debt trends remain a matter of concern. Also, in the OECD Development Assistance Committee (DAC) List of official development aid recipients, Georgia is positioned in the lower middle income country group. Furthermore, Georgia is scheduled to repay the last part of its debt towards the EU's[6] previous MFA operations, amounting to EUR 13.6 million, in July 2011. Providing part of the assistance in the form of grant would help ensure a timely debt repayment towards the EU.

MFA is an untied and undedicated macroeconomic support instrument, which helps the beneficiary country meet its external financing needs, and may contribute to alleviating budgetary financing needs. The funds would be paid to the National Bank of Georgia. Subject to provisions to be agreed in the Memorandum of Understanding, including a confirmation of residual budgetary financing needs, the funds may be transferred to the Treasury of Georgia as the final beneficiary.

3.2. Risk assessment

There are fiduciary, policy, repayment and political risks related to the proposed MFA operation.

There is a risk that the macro-financial assistance, which is not dedicated to specific expenses (contrary to project financing, for example), could be used in a fraudulent way. In general terms, this risk is related to factors such as quality of financial circuits and management systems in the central bank and the ministry of finance, administrative procedures, control and oversight functions, security of IT systems and adequate internal and external audit capabilities.

To mitigate the risks of fraudulent use several measures will be taken. First, the Memorandum of Understanding, the Grant and Loan Agreements will comprise a set of provisions on inspection, fraud prevention, audits, and recovery of funds in case of fraud or corruption. Also, the assistance will be paid to a dedicated account at the National Bank of Georgia (NBG). Moreover, before the agreement on the Memorandum of Understanding is reached, the Commission services will conduct, with the support of external consultants, an Operational Assessment, in order to assess the reliability of financial circuits and administrative procedures that are relevant to this type of assistance and will determine whether the framework for sound financial management of macro-financial assistance is sufficiently effective in Georgia. In the light of this assessment, specific mechanisms applying to the management of the funds by the beneficiaries may be introduced in agreement with the national authorities. The Commission may also use other assistance instruments at its disposal to help the beneficiary authorities improve their public finance management systems if this area is not sufficiently covered by other donors. Against this background, special conditionalities on improving public finance management will potentially be required. Finally, the assistance will be liable to verification, control and auditing procedures under the

[6] This is the last outstanding repayment related to the loan of EUR 110 million provided to Georgia in 1998.

responsibility of the Commission, including the European Antifraud Office (OLAF), and the European Court of Auditors.

There is also a risk that the Government of Georgia will not comply with the IMF programme conditions, as the programme targets may turn out more difficult to reach than assumed and as political conditions in the country may change. However, the authorities have so far shown strong commitment to work with International Financial Institutions to implement the reform agenda. The positive experience of implementation under the previous MFA operation in Georgia bodes well in this respect.

There is also a risk, albeit limited, of a non-repayment of the loan component. The macroeconomic adjustment and reform programme supported by the proposed MFA operation and the IMF's Stand-By Arrangement should mitigate this risk, to the extent that it helps restore balance of payments and fiscal sustainability. Also, the provisioning of the Budget Guarantee Fund for external lending of the EU, in line with the rules governing the Guarantee Fund mechanism, is aimed at addressing possible adverse implications related to a non-repayment of the loan.

Consolidation of the democratic reforms and institutions is at the core of the EU’s relations with Georgia. There are some shortcomings in the independence of the judiciary and there is a need to strengthen a pluralistic media landscape. The ongoing process of constitutional reform is encouraging but there are uncertainties concerning the final direction that it will take. National parliamentary elections are scheduled for 2012, while presidential elections are due in 2013. Overall, risks of political instability or backtracking of democratic reforms remain manageable. Finally, a failure to find a peaceful resolution of the military conflict with Russia represents a significant political risk.

Having made a thorough assessment of the risks, the Commission services consider that there are sufficiently strong grounds to proceed with the MFA to Georgia.

The Commission services will maintain close contacts with the authorities during the implementation of the macro-financial assistance in order to address quickly any concerns that may arise.

4. ADDED VALUE OF EU INVOLVEMENT

Georgia is a strategically key partner country of the EU within the European neighbourhood. By helping the country overcome the economic shock caused by the conflict with Russia and the global crisis, the proposed MFA will contribute to promote macroeconomic and political stability in the Eastern Partnership region and closer economic and political ties between Georgia and the EU. By complementing the resources made available by the international financial institutions and other donors, it contributes to the overall effectiveness of the package of financial support agreed by the international donor community in the aftermath of the crisis.

In addition to the financial impact of the MFA, the proposed programme will strengthen the government's reform commitment and its aspiration towards closer relations with the EU. This result will be achieved, inter alia, through appropriate conditionality for the disbursement of the assistance. By emphasising certain reforms that are of particular importance for promoting regulatory convergence and economic integration with the EU, the MFA contributes to the objectives of the EU-Georgia Action Plan.

In a wider context, the proposed action fits well into the EU's general approach towards Georgia, which is one of a stronger engagement, as reflected in the opening of negotiations on an Association Agreement, a key component of which will be the conclusion of the Deep and Comprehensive Free Trade Area.

5. GENVAL CRITERIA ON MACRO-FINANCIAL ASSISTANCE

In October 2002, the Council reconfirmed a set of principles for the use of the European Union's macro-financial assistance (Genval criteria)[7]. The five criteria are: (i) the exceptional character of the assistance, (ii) its complementarity to financing of the International Financial Institutions (IFIs), (iii) the existence of policy conditionality attached to the assistance, (iv) the existence of political pre-conditions and, finally (v) strong financial discipline that needs to accompany the MFA.

5.1. Exceptional Character and Limited Timeframe

The MFA under preparation will be exceptional and limited in time and will run in parallel to the IMF Stand-By Arrangement. Georgia's financing gap in the balance of payments has its origin in the loss of investor confidence as a result of the armed conflict of autumn 2008, combined with the existence of a large current account deficit. The global financial and economic crisis brought an additional layer of uncertainty to the prospects of recovery of Georgia's economy. The government's aim has been to attract financing from the IFIs to boost public infrastructure investment in the short-term so as to maintain as much as possible economic growth until private capital inflows are resumed. However, the FDI inflows are expected to remain subdued in late 2010 and recover only slowly in 2011. Against this background and given the expected time of approval of the programme, the assistance is expected to be implemented during 2011. The disbursement of the first instalment could take place in the first quarter of 2011. The second instalment, conditional on a number of policy measures, could be disbursed in the third quarter of 2011.

5.2. Political preconditions

MFA is reserved to the third countries that are geographically close to the EU territory, that respect democracy and human rights and with which the EU has important political, economic and commercial ties. Georgia is a presidential democracy with regular, reasonably fair and free elections. Currently, under the 'second wave of democratic reforms', the State Constitutional Commission has prepared, as part of an open and participatory process, a draft of the new Constitution with the aim of establishing a better system of checks and balances, a further separation of powers and a more independent court system. The new Constitution is expected to be adopted by the Parliament still this year.

Georgia and the EU first established contractual relations in 1996 through a Partnership and Cooperation Agreement which entered into force in 1999. EU-Georgia relations have become closer since the adoption of the five-year European Neighbourhood Policy Action Plan in

[7] Council conclusions of 8 October 2002 on MFA and the accompanying letter of the Council President to the Commission President.

November 2006. Russia’s invasion of Georgia in August 2008 brought a sense of urgency for the need to enhance EU-Georgia relations. The EU, under the French Presidency, brokered a ceasefire and committed significant diplomatic efforts and financial resources to the delivery of immediate humanitarian aid and other assistance to the post-war recovery and continues to contribute importantly to the conflict resolution. An EU Monitoring Mission (EUMM) to the break-away regions of about 200 civilian observers has been deployed.

The extraordinary European Council held in Brussels on 1 September 2008 decided inter alia to step up relations with Georgia. Negotiating directives for a future EU-Georgia Association Agreement that will replace the current Partnership and Cooperation Agreement were adopted by the Council on 10 May 2010. Negotiations started on 15 July 2010, while negotiations on a Deep and Comprehensive Free Trade Area, to be established in the Association Agreement's framework, will be launched once the necessary pre-conditions for it have been met. During the Prague Summit on 7 May 2009, close EU-Georgia relations have entered a new phase with the launch of the Eastern Partnership of the European Union, a multilateral project endorsed by the Heads of state or government of the 27 EU Member States and the six partner countries including Georgia.

5.3. Complementarity

The proposed MFA would supplement the assistance being provided by the IMF in the context of the Stand-By Arrangement and by other donors, including the World Bank, helping to cover part of the residual balance of payments financing gap. The share of residual financing covered by the EU MFA would amount to 14% for the period 2009-11.

Regarding the complementarity with other EU instruments, the EU package of assistance to Georgia includes programmed funds under the ENPI envelope and crisis instruments (the Instrument for Stability, Humanitarian Aid and the Macro-Financial Assistance). The package also includes the costs for the EU Civilian Monitoring Mission in Georgia. Through the programmed sectoral budget support, the ENPI envelope has so far supported reforms in the area of public finance management, criminal justice sector, vocational education and training and regional development. For the period of 2011-2013 a new ENPI package of EUR 180 million has been allocated.

Project finance or technical assistance would not be suitable to address the macroeconomic objectives of the MFA. The key value added of the MFA in comparison to other EU instruments would be to alleviate the external financial constraint and to help create a stable macroeconomic framework, including by promoting a sustainable balance of payments and budgetary situation, and an appropriate framework for structural reforms. By helping to put in place an appropriate overall framework for macroeconomic and structural policies, MFA can increase the effectiveness of the actions financed in Georgia under other, more narrowly focused EU financial instruments. This positive effect is reinforced by the fact that MFA leverages its impact with the programmes of the IFIs, with which it is closely coordinated.

The MFA is to be discontinued as soon as the country's external financial situation has been brought back into a sustainable path. Afterwards, regular EU assistance instruments are meant to take over, notably the direct budget support provided under the ENPI Regulation.

5.4. Conditionality

As usual with the MFA instrument, the disbursements would be conditional on successful programme reviews under the IMF's Stand-By Arrangement and Georgia’s subsequent decisions to draw funds. In addition, the Commission and the Georgian authorities would agree on specific structural reform measures in a Memorandum of Understanding. In the context of the previous MFA operations, the Commission services have worked closely with the Georgian authorities on public finance management (PFM) reforms that aim at establishing a more transparent, coherent and accountable PFM system. While the policy conditionality of the last MFA operation referred exclusively to the PFM area, in the new MFA its scope would probably be enlarged, notably to measures aimed at fostering the economic and financial integration as well as regulatory harmonisation with the EU in selected areas, under the ENP Action Plan and taking into account the new context created by the plan to conclude an Association Agreement. Following the successful implementation of the last MFA in which the Georgian authorities demonstrated the political will and the capacity to implement structural reforms, the Commission believes that also this second MFA operation would contribute to the implementation of the government's agenda of structural reforms.

5.5. Financial Discipline

Regarding the grant component of the proposed assistance, aiming at the adoption of the European Parliament and Council decision on MFA to Georgia in the last quarter of 2010, the commitment appropriations in the 2011 EU budget would be used to finance the MFA grant element. The planned appropriations on the MFA budget line (01 03 02)[8] in 2011 are deemed sufficient to finance a grant amount of EUR 23 million to Georgia, subject to the final decision of the budgetary authority.

The loan component of the proposed assistance would be financed through the borrowing operation that the Commission will conduct on behalf of the EU. The budgetary costs of the assistance will correspond to the provisioning, at a rate of 9%, of the amounts disbursed in the Budget Guarantee Fund for external lending of the EU, from budget line 01 04 01 14 ("the provisioning of the Guarantee Fund"). Assuming that the loan disbursements will be made in 2011 for the amount of EUR 23 million and according to the rules governing the Guarantee Fund mechanism, the provisioning will take place in the 2013 budget.

To ascertain that the beneficiary has in place a sound financial management in line with the requirements of the Financial Regulation, the Commission services continue regular monitoring and intend to conduct an Operational Assessment that would provide an updated report on the reliability of financial circuits and administrative controls at the Ministry of Finance and the National Bank of Georgia since the last Operational Assessment (2005) and the joint WB-EU PEFA[9] study (2008).

[8] Commitment appropriations amount to EUR 98.9 million in 2010 and to EUR 99.9 million in 2011.

[9] The joint Public Expenditure and Financial Accountability (PEFA) study by the World Bank and the European Commission gave detailed information on Georgia’s budget preparation and execution as well as on control and oversight functions.

6. PLANNING OF FUTURE MONITORING AND EVALUATION

This assistance is of exceptional and macroeconomic nature and its monitoring and evaluation will be undertaken in line with the standard Commission procedures.

6.1. Monitoring

Monitoring will involve the review of reports and data provided by the authorities and by review missions to Georgia by Commission staff. To monitor the fulfilment of the objectives of the programme throughout the implementation period of the assistance, the Commission will use two types of indicators:

- Adherence to the IMF-supported programme, including compliance with macroeconomic performance criteria and structural reform benchmarks identified under the Stand-By Arrangement, as reported by the IMF in the context of the regular review of the programme.

- Progress in the implementation of structural policy indicators, which are to be agreed with the authorities of Georgia in a Memorandum of Understanding. In this process, the Commission services will monitor key areas of the public finance management system, as they will be identified in the update of the Operational Assessment, so as to have the relevant information on any changes in the control environment. Ahead of the disbursement of the second instalment the authorities will be asked to submit a compliance statement in relation to the MoU policy conditionalities. In addition, under the MoU monitoring system, the authorities will be obliged to submit quarterly reports of certain economic and reform indicators.

Although this assistance is centrally managed, where appropriate, the EU Delegation in Georgia will also be called to provide reporting. An annual report to the European Parliament and to the Council on the implementation of MFA is foreseen in the proposed text for a Decision of the European Parliament and of the Council.

6.2. Evaluation

Ex-post evaluations of macro-financial assistance operations are foreseen in the Multi-annual Evaluation Programme of the Commission's Directorate-General for Economic and Financial Affairs. An ex-post evaluation of the proposed macro-financial assistance to the Georgia will be launched within a period of two years after the completion of the operation. A provision for the ex-post evaluation is included in the proposed Decision for the assistance, and will also be included in the Memorandum of Understanding. Budget appropriations from the macroeconomic assistance budget line will be used for this evaluation.

7. ACHIEVING COST-EFFECTIVENESS

The proposed assistance would entail a high degree of cost effectiveness for several reasons:

- First, since the assistance would be leveraged by that provided by the international financial institutions, with which, as noted, it would be closely coordinated, its ultimate impact could be very significant compared to its cost. Moreover, in negotiating specific policy conditions, the Commission will be able draw on the expertise of those institutions, including the International Monetary Fund and the World Bank, and to influence their conditionality as well in ways that will take into account the EU's views.

- Second, part of the assistance would be provided in the form of loans, the budgetary impact of which is, in principle, more limited.

- Third, by providing a coordinated macroeconomic support to Georgia on behalf of the EU countries, the MFA would be more cost efficient than the provision of a similar total amount of financial support by EU Member States individually.

- In addition, the Commission will aim at achieving synergies with other EU policies and instruments (in particular ENPI as indicated above) used to support the implementation by the beneficiary of the relevant measures (notably in the area of public finance management). Where appropriate, links to related actions under the European Neighbourhood Policy or Eastern Partnership and to findings of the ENP Progress Reports on Georgia would be established.