



Report and Recommendation of the President to the Board of Directors

Project Number: 42477
November 2008

Proposed Loan Georgia: Emergency Assistance for Post-Conflict Recovery

CURRENCY EQUIVALENTS

(as of 16 October 2008)

Currency Unit	–	lari (GEL)
GEL1.00	=	\$0.70814
\$1.00	=	GEL1.41215

ABBREVIATIONS

ADB	–	Asian Development Bank
DEAP	–	Disaster and Emergency Assistance Policy
EAL	–	emergency assistance loan
EAPCR	–	Emergency Assistance for Post-Conflict Recovery
EC	–	European Commission
EU	–	European Union
FDI	–	foreign direct investment
GDP	–	gross domestic product
IDP	–	internally displaced person
IMF	–	International Monetary Fund
JNA	–	joint needs assessment
MAP	–	medical assistance program
MOF	–	Ministry of Finance
MTEF	–	medium-term expenditure framework
NBG	–	National Bank of Georgia
PEFA	–	public expenditure and financial accountability
PRSO	–	poverty reduction support operation
SME	–	small and medium-sized enterprises
SPA	–	State Procurement Agency
TSA	–	targeted social assistance
UN	–	United Nations

NOTES

- (i) The fiscal year (FY) of the Government and its agencies ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

Vice-President	X. Zhao, Operations 1
Director General	J. Miranda, Central and West Asia Department (CWRD)
Director	R. Subramaniam, Governance, Finance and Trade Division, CWRD
Team leader	D. Kertzman, Principal Financial Sector Specialist, CWRD
Team members	P. Desikachar, Principal Economist, CWRD
	J. P. Farinha Fernandes, Economist (Financial Sector), CWRD
	B. Konysbayev, Counsel, Office of the General Counsel
	N. Mannapbekov, Economist, CWRD
	L. Raquipiso, Economics Officer, CWRD

CONTENTS

	Page
LOAN SUMMARY	i
I. THE PROPOSAL	1
II. RECENT DEVELOPMENTS AND THE IMPACT OF THE AUGUST 2008 CONFLICT	1
III. ADB'S ASSISTANCE AND DEVELOPMENT PARTNER COORDINATION	7
IV. THE PROPOSED LOAN	10
A. Impact and Outcome	10
B. Outputs	10
C. Special Features	11
D. Financing Plan	12
E. Special Administrative Arrangements	13
V. EMERGENCY ASSISTANCE BENEFITS, IMPACTS, ASSUMPTIONS, AND RISKS	15
A. Benefits and Impacts	15
B. Risks and Mitigating Measures	15
VI. ASSURANCES	16
VII. RECOMMENDATION	16
APPENDIXES	
1. Design and Monitoring Framework	17
2. Macroeconomic and Reform Progress in Georgia	18
3. Overview of Government Reforms that Support Implementation of the Joint Needs Assessment	23
4. Development Partner Matrix	27
5. Georgia's Poverty Reduction Program	28
6. List of Ineligible Items	31
7. Summary Poverty Reduction and Social Strategy	32

LOAN SUMMARY

Borrower	Georgia
Classification	<p>Targeting classification: General intervention</p> <p>Sectors: Multisector (law, economic management and public policy; health, nutrition, and social protection)</p> <p>Subsectors: Economic management, public finance and expenditure management, social protection</p> <p>Themes: Sustainable economic growth, governance, inclusive social development</p> <p>Subthemes: Promoting macroeconomic stability, public governance, human development</p>
Environment Assessment	Category C. No adverse environmental impacts identified.
Social Sector Assessment	<p>Involuntary resettlement: category C</p> <p>Impact on indigenous peoples: category C</p>
Description and Rationale	<p>The August 2008 armed conflict with the Russian Federation (conflict) has shaken the key pillars of economic growth in Georgia. The major impact of the conflict is a sharp contraction in economic growth from a projected 9% in 2008 to 3.5%, precipitated by a steep decline in domestic and foreign investments. Georgia also faces a significant social burden of resettling over 120,000 internally displaced persons, and meeting the challenge of finding jobs for over 100,000 newly unemployed. There is major stress on Georgia's public finances arising from considerable shortfalls in revenue collections and a decline in privatization proceeds, and the banking system faces severe liquidity constraints. Infrastructure damage is tangible, but not large.</p> <p>The Emergency Assistance for Post-Conflict Recovery (EAPCR) is anchored on the joint needs assessment (JNA) involving multiple development partners. The JNA estimates that \$3.7 billion will be needed for Georgia's post-conflict recovery. Out of this, \$895 million will be needed for the recovery efforts immediately (for the period until March 2009), including \$480 million to meet immediate budgetary needs. The JNA calls for development partner support in three major areas:</p> <ul style="list-style-type: none">(i) rapid restoration of confidence;(ii) meeting social needs; and(iii) meeting critical investments to maximize recovery prospects. <p>To help Georgia address emergency needs under the JNA, the EAPCR will enable the Government to meet critical public</p>

expenditures through the budget and help cushion the adverse revenue shocks. The EAPCR will supplement the Municipal Services Development Fund Project recently approved by the Asian Development Bank (ADB). The United States has signed an agreement providing \$250 million to meet critical expenditures through the budget. The World Bank recently approved \$40 million in budget support using the Fourth Poverty Reduction Support Operation. The European Union is also expected to provide budgetary assistance in the near future.

The major outputs of the EAPCR are to ensure that:

- (i) the immediate incremental expenditure needs arising from the conflict are met; and
- (ii) the core public expenditure program for 2008 is delivered in accordance with the approved budget.

Impact and Outcome	The EAPCR will help Georgia to revitalize its economy back to pre-conflict levels of growth and social development. The outcome is adverse economic and social impact of the conflict mitigated.
Special Features	The EAPCR is anchored on the JNA and was prepared in close coordination with other development partners. EAPCR swiftly responds to the Government's urgent request to provide it with a cushion and help meet immediate and essential expenditures through the budget, as it adopts a counter-cyclical fiscal response to deal with the conflict.
Tranching	The loan will be disbursed in a single tranche upon declaration of loan effectiveness.
Financing Plan	The Government has requested a loan of Special Drawing Rights 46,879,000 (equivalent to \$70 million) from ADB's Special Funds resources for the EAPCR. The loan will carry interest at 1% a year and a maturity of 40 years, including a grace period of 10 years, with repayment of principal at 2% a year for the first 10 years after the grace period and 4% a year thereafter.
Period of Utilization	The expected closing date of the loan is 30 September 2009. The loan is planned to be fully utilized by the Government by 31 March 2009.
Executing Agency	The Ministry of Finance (MOF) will be the Executing Agency.
Disbursement	The loan proceeds will be used to meet essential expenditure needs and shall not be used to fund ineligible items under ADB's negative list.
Benefits	The adverse impact on economic growth from the conflict is unprecedented. The economic and social impact of the conflict is exerting budgetary pressures that were unexpected. The EAPCR

will assist the Government implement countercyclical fiscal measures aimed at preventing the economy from being locked into a downward growth spiral, particularly in the context of the ongoing global financial market turmoil.

Risks and Assumptions

While there are significant downside risks, Georgia's economy is well positioned to adjust to the temporary shocks of the conflict. External risks include (i) the protracted global credit crisis and recession, and (ii) rekindling of regional tensions. Domestic risks include (i) increased economic difficulties could set back reforms, (ii) countercyclical fiscal policy insufficient to kick-start growth, and (iii) weakening of the banking sector.

These external risks are mitigated by several factors. First, while a protracted global credit crisis will likely mean a reduction in financial flows to Georgia, it will trigger a needed refocus on strengthening the regulatory environment for the financial sector and increased reliance on internal deposit mobilization by banks. The deep structural reforms of the last 4 years have increased the resiliency of the economy to adjust to external shocks. Second, concerning the risk of increased regional tensions, intense efforts to reach a peaceful agreement are under way.

In terms of mitigating factors for domestic risks, first, with regard to the risk of dissipation of reform momentum, the Government launched the JNA within days of the outbreak of the conflict to ensure that there is a clear strategy for keeping the focus on reforms and secure the necessary resources for remaining on track. Second, the EAPCR is part of a broader stabilization package that includes the International Monetary Fund, World Bank, and other development partners. Hence the post-conflict confidence building is well coordinated and the overall impact in terms of ensuring the effectiveness of the countercyclical fiscal policy stance is thus expected to be positive. In regard to the risk of weakening of the banking sector, capital requirements have been conservative enough in the recent past to allow for the current counter-cyclical adjustments and JNA development partners are expected to provide support to this sector.

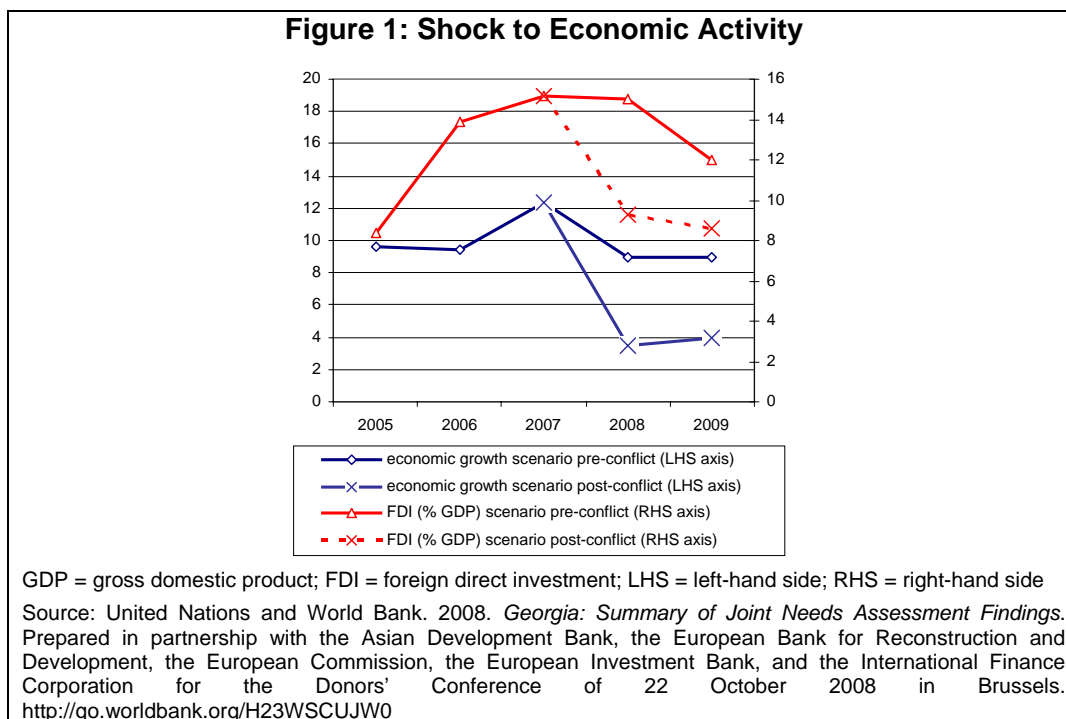
I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to Georgia for the Emergency Assistance for Post-Conflict Recovery (EAPCR or the loan).¹

II. RECENT DEVELOPMENTS AND THE IMPACT OF THE AUGUST 2008 CONFLICT

2. **Pre-Conflict Economic Performance.** Over the last 5 years, Georgia has implemented far-reaching macroeconomic, structural, and sector reforms that helped attract significant foreign direct investment (FDI) and strengthen public finances. Economic growth, supported by surging FDI inflows, averaged 10.5% over 2005–2007 and reached 12.4% in 2007. Prior to the August armed conflict with the Russian Federation (August conflict or conflict), growth was forecast to slow to 9% (still robust) during 2008 and 2009. Appendix 2 presents a summary of the macroeconomic and reform progress achieved prior to the August conflict.

3. **Conflict-Related Shocks to Growth Pillars.** The August conflict has shaken the key pillars of economic growth and stability in Georgia. The shocks include a steep decline in consumer, investor, and lender confidence; a sharp contraction in banking system liquidity; significant stress on public finances; 120,000 additional internally displaced persons (IDPs); and damage to physical infrastructure. As a result, real gross domestic product (GDP) growth is expected to slow down to 3.5% in 2008. Recovery could begin in the second quarter of 2009 with an increase in GDP growth to 4% in 2009 (Table 1 and Figure 1), but this will be contingent on the Government adopting adequate counter-cyclical fiscal measures.



4. Unless concerted and timely action is taken, the aftershocks of the August conflict could derail the reform momentum and deter private financial flows that have been at the heart of Georgia's strong economic performance sustained over the past 5 years. A firm and coordinated policy response to these risks is imperative, in the face of reemerging challenges of fiscal and monetary constraints. The macroeconomic effects from the conflict are summarized in paras. 5 through 14.

¹ The design and monitoring framework is in Appendix 1.

Table 1: Georgia Key Economic Indicators, Pre- and Post-August 2008 Conflict

Key Pre- and Post-conflict Economic Indicators	2007	2008		2009		2010		2011	
		Pre-conflict	Post-conflict	Pre-conflict	Post-conflict	Pre-conflict	Post-conflict	Pre-conflict	Post-conflict
Growth and Inflation									
GDP Growth rate (%)	12.4	9.0	3.5	8.0	4.0	7.0	6.0	7.0	6.0
Inflation (end of period) (%)	11.0	10.0	8.0	9.0	8.0	8.0	6.0	8.0	6.0
GNI per capita (\$)	1,990.0	2,510.0	2,370.0	3,160.0	2,830.0	3,770.0	3,280.0	4,270.0	3,610.0
Unemployment Rate (%)	1.3	12.5	13.9	12.0	14.5				
Investments and Balance of Payments									
Foreign Direct Investment (% GDP)	15.2	15.0	9.3	12.0	8.6	10.0	9.2	8.9	9.2
Foreign Direct Investment (\$ million)	1,535.0	2,081.0	1,201.0	1,845.0	1,169.0	1,775.0	1,398.0	1,825.0	1,564.0
Current Account Balance (% GDP)	(20.0)	(16.6)	(20.8)	(14.0)	(18.7)	(12.5)	(15.9)	(11.6)	(14.2)
External Public Debt (% GDP)	17.5	18.5	21.0	18.0	25.9				
Revenue and Expenditures									
Consolidated Public Revenues (% GDP)	29.2	28.5	27.7	26.9	26.0	26.4	25.5	26.4	25.1
Consolidated Public Revenues (\$ million)	2,954.0	3,944.0	3,575.0	4,111.0	3,529.0	4,642.0	3,871.0	5,344.0	4,258.0
Revenue Shortfall (post- versus pre-conflict) (\$ million)			(369)		(582)		(771)		(1,086)
Consolidated Public Expenditures (% GDP)	34.0	32.4	33.9	29.9	29.8	28.5	27.0	27.5	25.7
Consolidated Public Expenditures (\$ million)	3,433.0	4,494.0	4,379.0	4,566.0	4,051.0	5,001.0	4,104.0	5,548.0	4,368.0
Overall Fiscal Balance (% GDP)	(4.7)	(4.0)	(6.2)	(3.0)	(3.8)	(2.0)	(1.5)	(1.0)	(0.6)
Overall Fiscal Balance (\$ million)	(479.0)		(804.0)		(521.0)		(233.0)		(110.0)
Budgetary Financing (pre-conflict) and Exceptional Financing (post-conflict) Needs (\$ million)	(46)	64	481	272	453	149	0	(39)	25
Net Expenditure Cuts vs. Pre-conflict (\$ million)	..		(114)		(515)		(897)		(1,180)
Increased Expenditure Needs	..		316		350		154		108
Other Expenditure Cuts vs. Pre-conflict	..		(430)		(866)		(1,050)		(1,289)
Additional Public Investment Needs (\$ million)	..		309		656		761		710

() = negative; GDP = gross domestic product; GNI = gross national income.

Source: United Nations and World Bank. 2008. *Georgia: Summary of Joint Needs Assessment Findings*. Prepared in partnership with the Asian Development Bank, the European Bank for Reconstruction and Development, the European Commission, the European Investment Bank, and the International Finance Corporation for the Donors' Conference of 22 October 2008 in Brussels. <http://go.worldbank.org/H23WSCUJW0>

5. **Business Activity and Jobs.** There has been a slowdown in construction, tourism, and transport activities. In general, all businesses that depend on the banking system for credit have been seriously affected. The agriculture sector has been affected because of disruption in irrigation water supply from South Ossetia, Georgia and displacement of farmers in conflict-affected areas. The tourism sector, representing about \$200 million receipts and employing some 25,000 people, may face losses of up to 60% of receipts in 2008. Prior to the conflict, new private sector jobs offset job cuts from public sector reforms. The Government had estimated that sustained FDI inflows would have resulted in a net increase of about 250,000 jobs over the next 4–5 years, sufficient to decrease the unemployment rate to single-digit levels. However, with output declining as a result of the conflict, 100,000 jobs are expected to be lost in 2008.

6. **Fiscal Impact.** The economic downturn is expected to result in a major shortfall in revenue collection (\$370 million for 2008) compared with the pre-conflict period. The shortfall is likely to grow larger in 2009–2011 (Table 1). A multi-development partner joint needs assessment (JNA) was carried out in September 2008 to estimate the damage and economic loss resulting from the conflict and to develop estimates of the financial assistance required to reestablish conditions for a return to sustained growth (Box 1). The JNA has estimated total damages and funding requirements of over \$3.7 billion. The immediate challenge that Georgia faces is the rehabilitation of IDPs and maintenance of the social assistance system to protect the newly enlarged group of poor and vulnerable persons. Additional spending on account of conflict-related costs can to some extent be offset by trimming nonessential expenditures given the narrowing fiscal space. However, it is absolutely critical that the Government adopts a very clear countercyclical fiscal stance to reverse the ongoing economic downturn.

7. **Financial Sector Repercussions.** Immediately after the conflict broke out, large US dollar and lari deposit withdrawals from the banking system, together with the loss of banks' access to international capital markets, triggered a tightening of liquidity conditions. The sharp reduction in banks' capacity and willingness to lend is affecting economic activity. This is exacerbated by weakening consumer demand that has squeezed the profitability of many businesses, which could result in a deterioration of banks' loan portfolio quality. Already, the number of overdue loan service payments is increasing and there is risk of nonperforming loan ratios increasing in the future. Although the situation has stabilized, the need for vigilance continues.

8. **Investment Inflows.** FDI inflows and related privatization revenues, as well as portfolio investment inflows, have decelerated sharply; and the effect will persist over the medium term. Georgia's 5-year Eurobond spread increased from 465 basis points above US Treasury Bonds on 6 August to 700 basis points at the peak of the conflict, and subsequently widened to 1077 basis points by early October, partly as a result of heightened global risk aversion.

9. **Current Account Impact.** The sharp increase in the external current account deficit since 2003 reflects, to a large extent, higher imports of consumer goods as incomes increased, and higher imports of intermediate goods related to soaring FDI inflows. These inflows initially related to pipeline projects and subsequently broadened to other subsectors. The pre-conflict current account deficit was financed by FDI inflows. In the post-conflict situation, the current account deficit is expected to remain at around the same level but would now be financed increasingly by official transfers. The high requirements of external financing remain significant sources of macroeconomic vulnerability, especially in view of worsening conditions in international debt markets.

Box 1: Joint Needs Assessment for Economic Recovery in Georgia

On 20 August 2008, the Government of Georgia requested the World Bank to lead an assessment of the post-conflict needs to deal with the damage and economic loss that resulted from the armed conflict with the Russian Federation (conflict), and to develop estimates of the financial assistance required to address the losses and reestablish the conditions for a return to sustained growth. In response, a core team led by the World Bank, and consisting of the European Commission (EC) and the United Nations (UN)—together with technical sector teams comprising representatives of these institutions, the Asian Development Bank (ADB), European Bank of Reconstruction and Development, European Investment Bank, and International Finance Corporation—prepared a joint needs assessment (JNA) for economic recovery.

The JNA draws on reports prepared by the EC of initial estimates of conflict-related damages and those prepared by the UN of conditions in Abkhazia and South Ossetia, Georgia. Because of problems of access, field visits to these regions could not take place. The assessment of needs in these two regions is based on information and data from other parties, such as EC satellite imagery and assessments by the UN system. The report was guided by the post-conflict needs assessments methodology, which includes both (i) assessment of needs, and (ii) national prioritization and costing of needs in an accompanying transitional results matrix. The teams examined (i) the macroeconomic and banking impact of the conflict, (ii) the impact on the social sectors and on directly and indirectly affected populations, and (iii) infrastructure and environment.

Because the conflict resulted in shocks to key pillars of Georgian economic growth and financial stability, the JNA was also tasked to quantify countercyclical medium-term stabilization resource requirements for Georgia to avoid a sharper and more protracted economic downturn. It was therefore agreed with the Government that the JNA would also identify areas for new investments in order to bridge the period of a temporary decline in foreign investment (of uncertain duration), to provide Georgia with a basis for a rapid return to growth, and present an overall strategy for recovery as well as priority actions and investments based on this strategy.

The JNA estimates that \$3.7 billion from development partners will be needed for Georgia's post-conflict recovery. Of this, \$895 million will be needed for immediate recovery efforts, including \$480 million to fund the budgetary financing gap. Actions required are prioritized and are presented in three sequential time frames—the first of 6 months (to March 2009) (immediate); a second of a further 12 months (to March 2010); and a last phase of a further 12–18 months (up to September 2011), for a total of 3 years. The overall time frame is the estimated transition period where specific actions will be required to bring Georgia to its normal path of growth, when extraordinary development partner support can end. The initial phase (of 7 months ending in March 2009) has been tailored to allow for proper coordination and sequencing of the immediate humanitarian response, which is also reflected in the UN's Georgia Crisis Flash Appeal 2008.

The JNA identifies the need for development partner assistance in three major areas:

(i) **Support for the rapid restoration of confidence.** Rejuvenating economic growth will be the best way that Georgia can help itself. Development partners can help best by providing budget support in aid of countercyclical fiscal measures to ensure that critical economic and social needs are met.

(ii) **Support for social needs.** The resettlement of internally displaced persons and the post-conflict needs of affected populations are likely to require significant support.

(iii) **Support for critical investments.** In accordance with the JNA's assessment, certain high-value and high-yield investments are key to maximize recovery prospects. These are recognized as “core investments” in the report. Such financing would also help the country enhance economic security by broadening access and connectivity in energy and transport spheres.

The Government and development partners organized a Georgia Donor Conference on 22 October 2008 in Brussels, Belgium, under the auspices of the EC, where the Government formally sought development partner assistance along the above lines. Development partners have pledged a total of \$4.5 billion in support over 2008–2010, of which \$2 billion will be in the form of grants.

Sources: United Nations and World Bank. 2008. *Georgia: Summary of Joint Needs Assessment Findings*. Prepared in partnership with the Asian Development Bank, the European Bank for Reconstruction and Development, the European Commission, the European Investment Bank, and the International Finance Corporation for the Donors' Conference of 22 October 2008 in Brussels. <http://go.worldbank.org/H23WSCUJW0>; Joint World Bank-European Commission Press Release, 2008, 22 October. *World Bank*. <http://go.worldbank.org/M6E8IWBR80>

10. In addition, the nature of the conflict-induced shock has several immediate dimensions: (i) damage to infrastructure and property (roads, railways, and housing); (ii) increase in shipping and logistics costs; and (iii) crop harvest loss with irrigation water supply from Georgia's South Ossetia region cut off. Box 1 above summarizes key features of the JNA and Table 2 provides estimates of financial assistance needs.

**Table 2: Georgia Post-August 2008 Armed Conflict
Joint Needs Assessment Cost Estimates**
(\$ million)

Key Heads of Needs	Immediate Needs (to Mar 2009)	Core Investment (to Mar 2010)	Core Investment (to Sep 2011)	Total
I. Budget Support	480	450		930
II. Social Sector	294	448	506	1,248
Return, Relocation & Resettlement	169	268	359	796
Social Protection	45	42	35	122
Education	19	16	18	53
Health	29	59	87	175
Agriculture	28	53		80
Employment	5	11	7	22
III. Infrastructure	99	300	874	1,273
Transport	61	262	707	1,030
Energy	38	38	167	243
IV. Urban and Municipal Services	20	118	119	257
Water Supply and Wastewater	1	7		9
Urban and Municipal Roads	17	18	72	107
Urban Infrastructure, Housing and Public Buildings	1	81	35	117
Management contract related expense		12	12	24
V. Environment	2	2	3	7
Total	895	1,317	1,502	3,715
Banking Sector Funding Needs ^a	500	200		700

^a Unlike development partner financing for budget support or infrastructure, banking support will take the form of liquidity infusion or guarantees.

Source: United Nations and World Bank. 2008. *Georgia: Summary of Joint Needs Assessment Findings*. Prepared in partnership with the Asian Development Bank, the European Bank for Reconstruction and Development, the European Commission, the European Investment Bank, and the International Finance Corporation for the Donors' Conference of 22 October 2008 in Brussels. <http://go.worldbank.org/H23WSCUJW0>

11. **Government's Response.** The Government's response on the economic and social fronts to the August conflict has been swift and commendable. It immediately launched efforts to bolster the public's confidence that there is a clear strategy to address post-conflict challenges and emerge with a stronger economy. The launching of the JNA within days after the conflict was a key step to guide the rehabilitation and reconstruction process in a systematic manner. The fiscal, monetary, and financial sector authorities have coordinated very closely. When the lari came under pressure in August, the National Bank of Georgia (NBG) intervened to support the currency in accordance with its managed exchange rate policy regime. To shore up reserves depleted in defense of the lari and to bolster lari depositor confidence, the Government and NBG entered into a \$750 million standby arrangement with the International Monetary Fund (IMF).

12. To ease the liquidity squeeze faced by banks, NBG in coordination with the Financial Supervisory Agency adopted a countercyclical regulatory response comprising: (i) lowering reserve requirements, (ii) lowering the liquidity ratio requirement, (iii) introducing a special bridge financing facility, and (iv) introducing a refinancing window to provide a new benchmark policy rate.

13. Pressures are evident on the fiscal front. An amendment to the 2008 budget, submitted in September 2008 to Parliament, projects lower revenues than envisaged in the pre-conflict period; lower privatization receipts; higher expenditures as a result of the conflict; and a decrease in nonessential expenditures, which are insufficient to offset the decline in revenues and increased expenditures. Consequently, the revised estimates for the 2008 fiscal deficit are larger. If development partner support is not forthcoming, the Government would be forced to draw down on its cash balances at the NBG—a deficit-financing source that could soon be depleted. It is estimated that, with exceptional budget support of around \$480 million in 2008 and \$450 million in 2009, the Government will be able to keep the net expenditure cuts to a minimum (at the levels identified in Table 1). The Government's immediate financing requirements are summarized in Table 3.

Table 3: Georgia 2008 Emergency Budgetary Support Requirements and Indicative Financing Plan
(\$ million)

2008	Pre-conflict	Post-conflict	Difference
Revenue	3,944	3,575	(369)
Expenditures	4,494	4,379	(114)
Increase due to emergency needs arising from the conflict		+ 316	
Internally Displaced Persons		+ 106	
Social protection and health		+ 24	
Education		+ 14	
Reconstruction of damaged infrastructure		+ 172	
Decrease by cutting nonessential expenditures		(430)	
Deficit	550	804	254
Domestic funding sources			
Privatization		324	
Available financing		324	
Normal and exceptional financing gap	64	480	416
Contributions expected before the end of December 2008			
World Bank (approved on 2 October 2008)			40
United States (signed on 22 October 2008)			250
Asian Development Bank			70
European Union (planned for December 2008)			15
Total indicative assistance			375

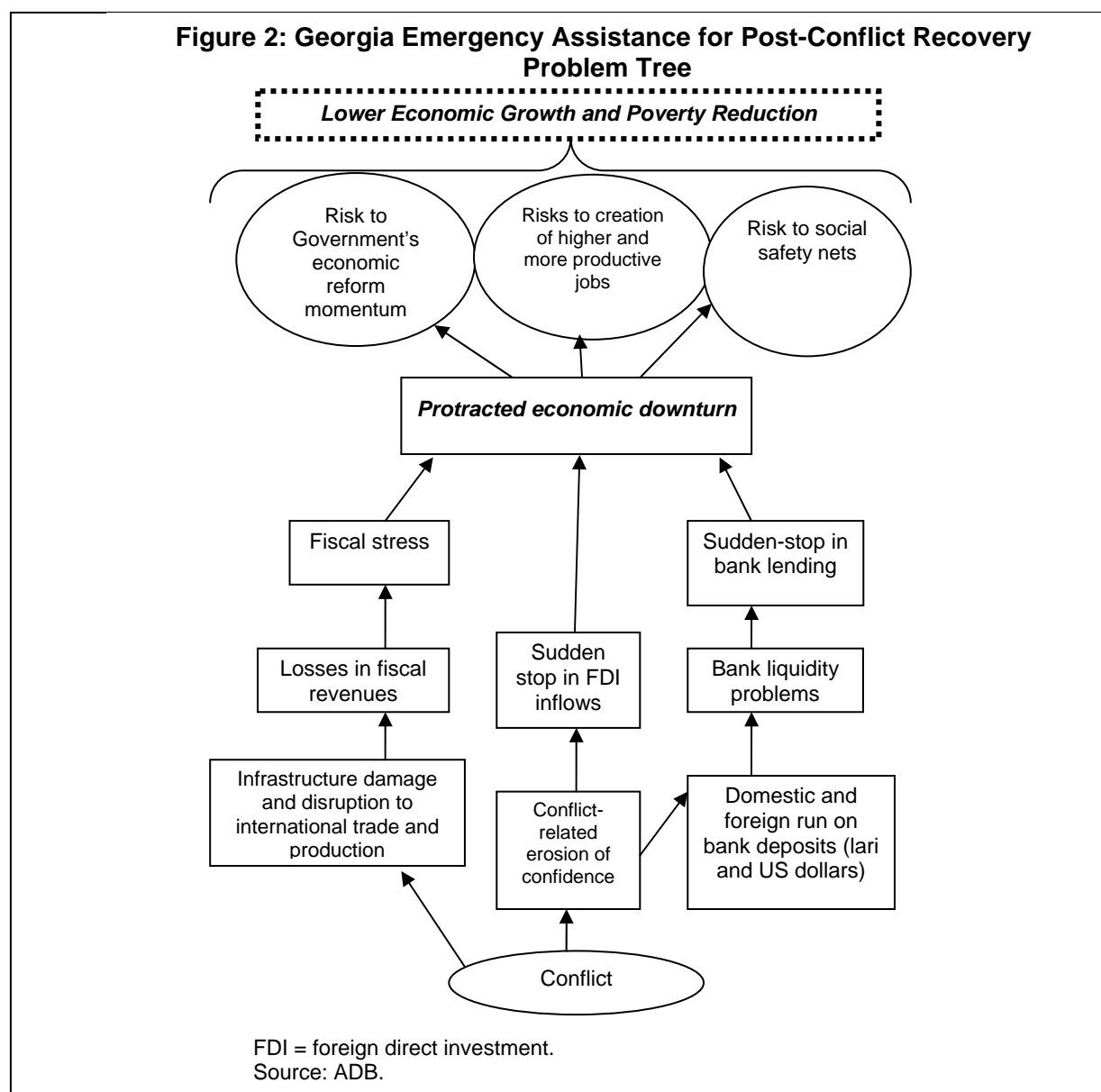
Notes:

1. The figures do not include other project-specific and non-budgetary support pledged by the development partners.
2. In addition to the above, the World Bank had already approved (April 2008) and disbursed (August 2008) \$22.7 million.
3. The Stand-by Arrangement approved by the IMF for \$750 million on 15 September 2008 is not included, as it is principally for shoring up foreign currency reserves.

Sources: ADB staff; United Nations and World Bank. 2008. *Georgia: Summary of Joint Needs Assessment Findings*. Prepared in partnership with the Asian Development Bank, the European Bank for Reconstruction and Development, the European Commission, the European Investment Bank, and the International Finance Corporation for the Donors' Conference of 22 October 2008 in Brussels. <http://go.worldbank.org/H23WSCUJW0>

14. In addition to the discussion above on the impact of the August conflict on Georgia's growth and stability, the challenges that Georgia faces as a result of the conflict are summarized in a problem tree presentation (Figure 2). The presentation highlights a possible sequence of outcomes that may arise from the conflict and the impact of these outcomes on the

Government's poverty reform program if the Government is unable to adopt the rehabilitation and counter-cyclical fiscal measures, with budgetary and other support from the development partners.



III. ADB'S ASSISTANCE AND DEVELOPMENT PARTNER COORDINATION

15. **Country Strategy and Program of the Asian Development Bank (ADB).** ADB's interim operational strategy for Georgia (2008–2009), approved in January 2008, focuses on (i) improving service delivery in municipal infrastructure within the evolving decentralization process, (ii) reducing road transportation constraints on economic activity, and (iii) upgrading and developing energy infrastructure.² These priorities were identified based on the following considerations: (a) alignment with the Government's development agenda, (b) selectivity in focusing limited resources on a small number of priority areas, and (c) complementarities with

² ADB. 2008. *Georgia: Interim Operational Strategy 2008–2009*. Manila.

other development partners. The strategy also highlights the need for ADB to be responsive to rapid changes in circumstances and the flexibility of ADB assistance modalities—a key advantage for Georgia's development under its newly established partnership with ADB.

16. ADB's Response to the August Conflict. ADB has responded swiftly in the aftermath of the conflict. Measures taken by ADB include:³

- (i) finalization and approval of \$40 million equivalent in investment support through the Municipal Services Development Fund (MDF) Project;⁴
- (ii) participation in the multi-development partner JNA exercise;
- (iii) close coordination with the principal development partners of Georgia, particularly the World Bank, IMF, European Union (EU), and United States, among others;
- (iv) internally mobilizing an additional \$70 million equivalent in Asian Development Fund resources to meet the emergency needs in Georgia;
- (v) designing the proposed Emergency Assistance for Post-Conflict Recovery (EAPCR) for Georgia.

17. Other Partners' Initiatives. Other development partners have taken a number of substantive steps in mobilizing assistance for Georgia. Table 4 lists the support, based on current information and data available to ADB. As several other countries and institutions are mobilizing support, the information presented below is only partial and should not be taken as authoritative.

Table 4: Immediate Development Partner Assistance for Georgia
(\$ million)

Development Partner Details	Amount
International Monetary Fund	750.0
<ul style="list-style-type: none"> 18-month stand-by arrangement providing exceptional access Financing support to rebuild gross international reserves and to help restore investor confidence 	
United States	
<ul style="list-style-type: none"> Budget support Emergency relief and rehabilitation support 	250.0 750.0
World Bank^a	
<ul style="list-style-type: none"> Supplemental Financing of Fourth Poverty Reduction Support Operation Municipal Development Fund 	40.0 40.0
European Union	50.0
<ul style="list-style-type: none"> Budget Support 	15.0
Government of the Netherlands	3.0
International Finance Corporation	
<ul style="list-style-type: none"> Trade finance and liquidity facility for banks 	200.0
Asian Development Bank	
<ul style="list-style-type: none"> Proposed Emergency Assistance for Post-Conflict Recovery Municipal Development Fund (approved in September 2008) Processing of a loan to a large bank in Georgia for onlending to small and medium-sized enterprises 	70.0 40.0 30.0

^a World Bank is also providing additional financing for the Second East–West Highway Project (Tbilisi–Gori) and for rural development and irrigation sectors.

Sources: ADB staff; IMF. 2008. *Georgia: Request for Stand-by Arrangement–Staff Report*. Washington, DC.

³ In addition, ADB is also exploring extending a liquidity facility to a commercial bank through its private sector operations window.

⁴ ADB. 2008. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Georgia for the Municipal Services Development Project*. Manila (Loan 2441, \$40 million equivalent).

18. **Structure and Modality of ADB's Proposed Loan.** In view of the post-conflict situation and the need for emergency assistance, the EAPCR combines several features, including

- (i) **Emergency assistance lending modality.** Given the need to ensure an effective and adequate counter-cyclical fiscal response as well as to meet critical post-conflict transitional safety net expenditures, the EAPCR will course assistance through the budget to help finance (a) essential economic and social expenditures linked to the conflict, and (b) other essential expenditures under the Government's financing plan. As outlined above, Georgia faces significant fiscal stress given the large revenue shortfall due to the adverse business environment, conflict-related expenditures (IDPs and other economic and social needs), and lower privatization receipts. Hence, ADB's emergency assistance loan modality that is designed to mitigate immediate losses is best suited to assist Georgia. The EAPCR satisfies the eligibility criteria for an emergency assistance loan (EAL) under ADB's *Disaster and Emergency Assistance Policy* (DEAP).⁵ See discussion in paras. 25–29 and Figure 2.
- (ii) **Relationship between cost and amount.** The JNA identifies an exceptional financing gap of \$480 million for 2008. ADB's financing of \$70 million equivalent will cofinance part of this gap, the balance coming from other development partners, including the World Bank, EU, and the United States.
- (iii) **Potential impact on economic, social, and governance needs identified.** The JNA has undertaken a scenario analysis of economic and social outcomes (a) with budget support, and (b) without budget support. This provides the rationale for ADB coursing its assistance through the budget to meet critical expenditures including conflict-related, with the imperative of securing better economic and social outcomes.
- (iv) **Full harmonization with development partners.** The EAPCR is fully anchored on the JNA, with the macroeconomic underpinnings provided by the JNA as well as the IMF's endorsement of the general macroeconomic directions of the Government, as evident in its approval of the standby arrangement.
- (v) **Policy dialogue.** ADB has reconfirmed that critical reforms relating to public financial management, investment climate, and social protection as included in the World Bank's poverty reduction support operation (PRSO)⁶ are being sustained despite the conflict. ADB will continue to work closely with the World Bank and other development partners to monitor the status of these reforms (Appendix 3). Sustained implementation of these reforms is critical for Georgia's economy recovery.
- (vi) **Flexibility in Determining Future Engagement.** The Government has requested ADB to help support longer-term infrastructure development and to sustain broad-based economic and sector reforms in 2009 and beyond.

⁵ ADB. 2004. *Disaster and Emergency Assistance Policy*. Manila.

⁶ The World Bank's fourth poverty reduction support operation (PRSO IV) was approved in April 2008 in the amount of \$22.7 million equivalent, and the funds were disbursed upon effectiveness in August 2008. Following the conflict, the World Bank approved a supplementary credit for \$40 million equivalent in October 2008, based on the same agenda as in PRSO IV.

19. **Other Recent and Ongoing Assistance.** A number of other development partners have been supporting public financial management, private sector development, and social safety net reforms in Georgia (Appendix 4). The Government of the Netherlands supports Georgia in several areas, including governance and oversight institutions. The program of the European Commission (EC) includes support in intergovernmental fiscal relations, auditing, and administrative reform. The EC, together with the World Bank, has just completed the Public Expenditure and Financial Accountability (PEFA) assessment for Georgia. The program of the United States Agency for International Development includes support in the areas of budgeting, treasury management, governance, anticorruption, and private sector development. The program of the Swedish International Development Agency includes support in public sector and in governance reforms. The program of the United Nations Development Program includes support in the areas of administrative and civil service reforms, poverty monitoring, and financial system modernization. The program of the Department for International Development of the United Kingdom has included support in developing the medium-term expenditure framework (MTEF), and health sector budget management. The European Bank for Reconstruction and Development focuses on investment promotion. German development cooperation through GTZ focuses on private sector development, while KfW focuses on development of SMEs. The Millennium Challenge Corporation program includes rehabilitation of key regional infrastructure, and delivery of regional and municipal services.

IV. THE PROPOSED LOAN

A. Impact and Outcome

20. The EAPCR will help Georgia revive its economy to pre-conflict levels of growth and social development, as envisaged in Georgia's long-term development strategy (2003–2015),⁷ and set forth in the Government's economic development and poverty reduction program (Appendix 5). The outcome envisaged is mitigation of the adverse economic and social impact of the conflict.

B. Outputs

21. The EAPCR will provide \$70 million equivalent in immediate short-term financial support to help the Government address revenue shortfalls, meet the transitional safety net needs arising from the conflict (including expenditures on social protection and IDPs) and sustain its core public expenditure program (including pensions, health care for poor, and other essential operations and maintenance needs). The Government will combine ADB's support effectively with that of other development partners and its own resources (Table 3). Following are the major outputs of the proposed EAPCR:

1. Output 1: Ensuring that the Immediate Incremental Expenditure Needs Arising from the Conflict are Met

22. The conflict has led to immediate additional expenditures associated with new IDPs, infrastructure reconstruction, social protection, and health and education, estimated at \$316 million in 2008. Damages have been amplified by massive displacement of people. The longer-term impacts, if not addressed, may become sizeable. Many schools are now used for housing new IDPs, and more than 90 schools have suffered damage from the conflict. With respect to health care, the health infrastructure in the conflict area has suffered considerably.

⁷ Government of Georgia. 2003. *Economic Development and Poverty Reduction Program*. Tbilisi.

2. Output 2: Ensuring that the Core Public Expenditure Program for 2008 is Delivered in Accordance with the Approved Budget

23. The JNA includes macroeconomic scenarios with and without financial support. It shows that countercyclical fiscal policy underpinned by fiscal support from development partners will avoid a deeper and longer economic downturn. With such, GDP growth in 2009 is estimated at 4%. However, without such support (severe impact scenario under the JNA) it is –7%. The EAPCR will help fund essential expenditures, including among others, pensions payments, IDP allowances, health care program for the poor, and critical operation and maintenance needs.

C. Special Features

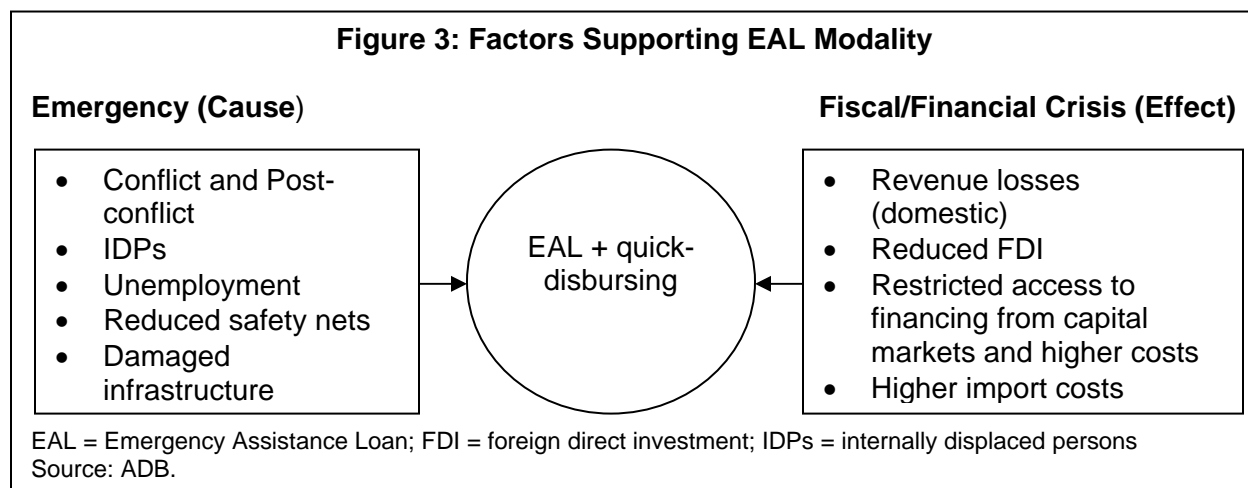
24. **Consultation and Coordination.** The EAPCR was prepared in close consultation with the Government and development partners, and responds directly to the JNA.

25. **Quick Disbursing Support.** In developing the EAPCR, ADB reviewed and considered two assistance modalities. The first was to support the ongoing PRSO-related reforms through a program loan. The second was to provide quick-disbursing support through an EAL to help meet essential expenditures through the budget, particularly those arising from the conflict.

26. ADB's DEAP and *Achieving Development Effectiveness in Weakly Performing Countries* (WPC Paper)⁸ provide an effective and suitable framework to promptly respond to immediate post-conflict needs. Specifically, the overarching objective of the DEAP is to provide ADB developing member countries in crisis with rapid funding support in the form of an EAL to rebuild high priority physical assets and restore economic, social and governance activities. The EAL modality therefore enables ADB to help the Government meet transitional safety net needs as well as other essential expenditures. The WPC Paper provides a flexible framework to ensure speedy and effective rehabilitation in post-conflict environments.

27. Taken together, the DEAP and WPC Paper enable ADB to effectively intervene in an emergency. The proposed EAPCR helps the Government achieve the objective of restoring economic, social and governance activities by focusing on the Government's immediate needs under the JNA. To that extent, ADB will be most effective by providing a special version of the EAL to restore the Government's immediate fiscal capacity to help it meet the sudden rise of incremental costs arising from the conflict, without diverting public funding from core Government programs, particularly social services. The EAPCR will help fund expenditures associated with physical and social costs arising from the conflict (emergency) and arising in connection with core Government programs by ensuring that adequate budgetary resources are available. The loan will also help avoid major disruption in the Government's fiscal position and further deterioration of socioeconomic conditions. Figure 3 provides an overview of the factors supporting the use of the EAL modality.

⁸ ADB. 2007. *Achieving Development Effectiveness in Weakly Performing Countries*. Manila. This paper updates the principles to be applied in assisting post-conflict countries, Under para. 60 of this paper, "weak performers" may include developing member countries that are considered to be in conflict or post-conflict. This classification is determined on a rolling basis and is not publicly disclosed, as the intention is not to impair in any way such developing member country's position as a member of ADB, but rather to draw attention to the challenges the country faces and to improve the effectiveness of ADB assistance. Thus application of the principles under this paper may be made to any post-conflict country.



28. The DEAP also encourages local procurement as a way to stimulate economic recovery and allows quick disbursement of EAL. The EAPCR is proposed to be released as a single tranche to help the Government meet essential expenditures under the revised 2008 budget, especially those arising from the conflict (see Table 3). Pursuant to ADB policies and procedures, the proceeds of the EAPCR will not be used to finance ineligible items, the list of which has been modified to enable ADB support to help the Government meet expenditures in the local currency or for locally procured goods (see Appendix 6).⁹

29. To effectively apply and use assistance instruments, the DEAP permits ADB operational policies to be interpreted liberally to ensure speedy and effective rehabilitation. Further, the WPC Paper allows, with the approval of ADB's Management or Board of Directors, as appropriate, relaxation of some of ADB's existing business processes. Therefore, application of the DEAP with relaxation of some of ADB's business processes and application of special features of the EAPCR described in paras. 25 through 29 are considered appropriate.

D. Financing Plan

30. **Proposed ADB Support.** The Government has requested a loan of Special Drawing Rights 46,879,000 (\$70 million equivalent) from ADB's Special Funds resources in support for implementation of the EAPCR. The loan will help the Government meet essential expenditures, including social and rehabilitation expenditures arising from the August conflict and contribute to addressing the current 2008 budget financing gap (Table 3). The loan will carry interest of 1% per year and a maturity of 40 years, including a grace period of 10 years, with repayment of principal at 2% a year for the first 10 years after the grace period and 4% a year thereafter.

⁹ As discussed in para. 26, ADB's *Achieving Development Effectiveness in Weakly Performing Countries Paper* enables flexible interpretation of ADB policies and procedures, including procedures under the DEAP. Under the DEAP, quick disbursement should cover only those imports necessary for an effective recovery (positive list approach). In contrast, the EAPCR prohibits the use of loan proceeds to fund ineligible items (negative list approach).

E. Special Administrative Arrangements

1. EAPCR Management

31. MOF will be the Executing Agency for the EAPCR.

2. Implementation Period

32. The proceeds of the loan will be released in a single tranche upon effectiveness. The expected closing date of the loan is 30 September 2009. The loan is planned to be fully utilized by the Government by 31 March 2009.

3. Disbursement Procedures and Fiduciary Arrangements

33. **Disbursement Procedures.** The loan will be disbursed into a Foreign Currency bank account at the NBG (FCA). The Borrower shall ensure that upon deposit of the proceeds of the loan into the FCA, MOF's treasury single account will be credited with the lari equivalent at the official exchange rate within 30 days of disbursement. The Government will ensure that the proceeds of the loan are used exclusively to fund the state budget expenditures in full compliance with the Government's public expenditure procedures and reporting rules. Proceeds of the loan shall not be used to fund ineligible items.

34. MOF will be responsible for preparing the withdrawal application and for maintaining the FCA. NBG will provide ADB with official notification that the amount of the loan has been credited to MOF's treasury single account (including the date, name and number of the FCA in which the amount has been deposited, subsequent conversion into lari, the date of such conversion and the lari amount).

35. **Fiduciary Arrangements.** Georgia has made good progress in implementing public financial management reforms (Appendix 3). These reforms have been integral to the Government's comprehensive anticorruption strategy (Box 2). The findings and conclusions of various assessments of Georgia's public financial management system have been incorporated within and are integral to the design of the EAPCR.¹⁰ Georgia's public expenditure management systems continue to be used for budget support operations financed by the World Bank and the EU, and are perceived to be sufficiently robust from a fiduciary standpoint. On this basis, the public financial management, control, and reporting arrangements of the Government are also considered sufficiently robust for the EAPCR. These are adequately complemented by regular state budget execution reporting mechanisms to the Parliament of Georgia. During each fiscal year, the Chamber of Control (COC)—the supreme audit institution of Georgia—undertakes an audit of all public expenditure programs. Moreover, the Government's public financial management reforms continue to be supported under the World Bank's multi-donor funded Public Sector Financial Management Reform Support Project. Since the funding is part of the JNA financing platform, tracking of the use of EAPCR funds will be closely linked with results monitoring under the Office of the Prime Minister. ADB will also work closely with the Government and other JNA donors to monitor results, track aid to the Government under the JNA, and assess the impact of such aid.

¹⁰ These assessments include: World Bank. Forthcoming. *Country Procurement Assessment*; World Bank. 2003. *Georgia: Country Financial Accountability Assessment*. Washington, DC; IMF. 2003. *Georgia: Report on the Observance of Standards and Codes: Fiscal Transparency Module*. Washington, DC; World Bank. 2002. *Georgia: Country Procurement Assessment Report*. Washington, DC; World Bank. 2003. *Georgia: Public Expenditure Review*. Washington, DC; and the 2007 Joint World Bank–European Commission Public Expenditure and Financial Accountability assessment, which is currently being finalized.

36. MOF, with NBG assistance, will maintain records of all transactions between the FCA and the treasury single account during the EAPCR's duration, in accordance with sound accounting practices. ADB reserves the right to request an audit of the use of loan proceeds, and in addition will receive a copy of the annual audited financial statements of NBG together with the audited budget execution reports for 2008 and 2009. The IMF has initiated an updated safeguards assessment of NBG in connection with the recently approved standby arrangement with Georgia.¹¹ The IMF update aims to confirm the findings of the off-site monitoring and identify any emerging safeguards issues. NBG publishes International Financial Reporting Standards financial statements that have been audited externally in accordance with international standards. Thus, the overall fiduciary risks are considered acceptable, taking into account the arrangements in place.

Box 2: Fiduciary Controls are an Integral Part of Georgia's Anticorruption Initiatives

During the past 5 years, Georgia has made significant progress in addressing corruption. In 2004, almost every element of the Government's reforms included an anticorruption agenda. The first step was the wholesale replacement of large sections of existing state institutions. To remove the old guard Government, officials were fired or required to reapply for their old jobs. To reduce incentives for corruption, salaries were raised.

To strengthen public sector accountability, efficiency, and transparency, the Government adopted and began implementing reforms that cut across public expenditure management, fiduciary activities, and public administration. Reforms aimed at strengthening budgeting and expenditure management, increasing transparency and efficiency in public procurement and financial management systems, strengthening public administration, and enhancing transparency and accountability of the public sector. Reforms include adoption and implementation of a medium-term expenditure framework, implementation of a treasury single account, restructuring of the Chamber of Control into a supreme audit institution, adoption and implementation of a national anticorruption strategy, broad-based anticorruption monitoring, and civil service reforms, among others. Implementation of these reforms helped reduce corruption. According to the World Bank Institute's Governance Indicators, Georgia's percentile rank for control of corruption indicator has improved from 31.6% in 2004 to 48.3% in 2007.

Sources: World Bank. 2008. *Program Document for a Proposed Fourth Poverty Reduction Support Operation*. Washington, D.C.; World Bank. 2008. *Supplemental Financing Document for a Proposed Supplemental Credit to Georgia for the Fourth Poverty Reduction Support Operation*. Washington, D.C.; Georgia Update on National Implementation Measure, Presentation at the 6th Monitoring Meeting of the Istanbul Anticorruption Action Plan, – Organization for Economic Cooperation and Development Headquarters, 13 December 2006; United Nations Development Program. 2008. *Georgia Human Development Report 2008*. Tbilisi.

4. Anticorruption Policy

37. ADB's *Anticorruption Policy* (1998, as amended to date) was explained to and discussed with the Government. Consistent with its commitment to good governance, accountability, and transparency, ADB reserves the right to investigate, directly or through its agents, any alleged corrupt, fraudulent, collusive, or coercive practices relating to the EAPCR. To support these efforts, relevant provisions of ADB's *Anticorruption Policy* are included in the loan regulations.

¹¹ IMF staff monitoring since the first safeguards assessment in 2002 indicates that NBG continues to comply with key safeguard requirements. During the 2004 assessment, the IMF was encouraged by the measures taken by NBG in the areas of financial reporting, internal audit, and cash management to strengthen procedures. Nonetheless, staff noted further room for improvement in these areas, as well as weaknesses in aspects of the internal control environment of NBG, particularly in the foreign exchange management and accounting functions. Together, the IMF and NBG devised and agreed on a set of measures to improve and strengthen NBG's fiduciary arrangements. After two sets of update reviews in 2005 and 2006, the IMF was satisfied that NBG had fully implemented all but three of the measures agreed upon in 2002.

5. Performance Monitoring and Evaluation

38. The JNA includes transitional results frameworks for the social sectors, including expected outcomes, baseline data, and priority activities. Relevant baseline indicators and targets have been incorporated into the design and monitoring framework (Appendix 1). The Office of the Prime Minister will oversee the overall status of the JNA. ADB will closely coordinate with the Government and other JNA donors on the status of targets and indicators under the design and monitoring framework.

V. EMERGENCY ASSISTANCE BENEFITS, IMPACTS, ASSUMPTIONS, AND RISKS

A. Benefits and Impacts

39. There are several benefits to the EAPCR. First, it will help the Government meet new social and rehabilitation expenditures arising from the August conflict, and other essential expenditures, through the budget. Secondly, the EAPCR aims at mitigating the impact of the conflict on the economy. The August conflict has resulted in a significant shock to the economic growth, and the EAPCR will assist the Government in implementing countercyclical fiscal measures aimed at checking and reversing the economic downturn. The IMF standby arrangement of \$750 million for 18 months provides balance of payment support and helps maintain investor confidence. Indications of support from development partners have been substantial but these pledges often take time to translate into the delivery of resources. Therefore, flexible and timely financing under the EAPCR is essential to address the budgetary needs of the social safety net, speed up rehabilitation, and reduce the risks of the economic downturn. Appendix 7 presents the summary poverty reduction and social strategy prepared for the EAPCR.

B. Risks and Mitigating Measures

40. There are currently downside risks and significant uncertainty regarding the time frame for the Georgian economy to adjust to this temporary shock. External risks include the (i) protracted global credit crisis and recession, and (ii) rekindling of regional tensions. Domestic risks include (i) increased economic difficulties could set back reforms, (ii) countercyclical fiscal policy insufficient to kick-start growth, and (iii) weakening of the banking sector. The external risks are mitigated by several factors. First, while a protracted global credit crisis will likely mean a reduction in financial flows to Georgia, it will trigger a needed refocus on strengthening the regulatory environment for the financial sector and increased reliance on internal deposit mobilization by banks. The deep structural reforms of the last 4 years have increased the resilience of the economy to adjust to external shocks. Second, in regard to the risk of increased regional tensions, intense efforts to reach a peaceful settlement are underway.

41. In terms of mitigating factors for domestic risks, first, with regard to the risk of dissipation of reform momentum, the Government launched the JNA within days of the outbreak of the conflict to ensure that there is a clear strategy for keeping the focus on reforms and that the necessary resources for remaining on track are secured. Second, support proposed under the EAPCR is part of a broader stabilization package, which includes the IMF, the World Bank, and other development partners—the overall impact in terms of ensuring the effectiveness of the countercyclical fiscal policy stance is thus expected to be positive. In regard to the risk of weakening of the banking sector, earlier capital requirements were conservative enough to allow for the current counter-cyclical adjustments, and JNA development partners are expected to provide support to this sector.

VI. ASSURANCES

42. In addition to the standard assurances, the Government has given the following specific assurances, which are incorporated in the legal documents:

- (i) The Government will work with ADB and other JNA development partners to monitor results, track aid, and assess the impact of support under the JNA.
- (ii) The Government shall update ADB on the implementation of the JNA and shall ensure that necessary support is provided to ADB to review and monitor the status of key indicators under the design and monitoring framework.
- (iii) The Government will ensure that the loan proceeds are used for financing its immediate budgetary expenditures arising from the conflict and recurrent budgetary expenditures incurred after August 2008 inclusive, to sustain delivery of the Government's core publicly funded program, in compliance with its public finance management procedures and reporting arrangements, and that such proceeds are not used to finance ineligible items as set forth in Appendix 6, and shall provide a certificate to ADB to this effect.
- (iv) The Government will furnish to ADB a certified copy of the state budget execution reports for 2008 and 2009 as submitted to the Parliament within six months after the end of the relevant fiscal year, with a certified English translation of the relevant parts. The Government will furnish to ADB a certified copy of the opinion of the Chamber of Control on such reports within eleven months after the end of the relevant fiscal year, with a certified English translation of the relevant parts.
- (v) The Government will provide ADB with a certified copy, in the English language, of the externally audited annual report of the National Bank of Georgia in accordance with International Financial Reporting Standards for the fiscal years 2008 and 2009 within six months after the end of the relevant fiscal year.
- (vi) The Government will ensure that ADB's *Environment Policy* (2002) and *Involuntary Resettlement Policy* (1995) are complied with in implementation of activities financed from the proceeds of the loan.

VII. RECOMMENDATION

43. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and, acting in the absence of the President, under the provisions of Article 35.1 of the Articles of Agreement of ADB, recommend that the Board approve the loan (with the special features described in paragraphs 25 through 29 above) in various currencies equivalent to Special Drawing Rights 46,879,000 to Georgia for the Emergency Assistance for Post-Conflict Recovery from ADB's Special Funds resources with an interest charge at the rate of 1% per annum; a term of 40 years, including a grace period of 10 years; with repayment of principal at 2% a year for the first 10 years after the grace period and 4% a year thereafter, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board.

C. Lawrence Greenwood, Jr.
Vice President

5 November 2008

DESIGN AND MONITORING FRAMEWORK

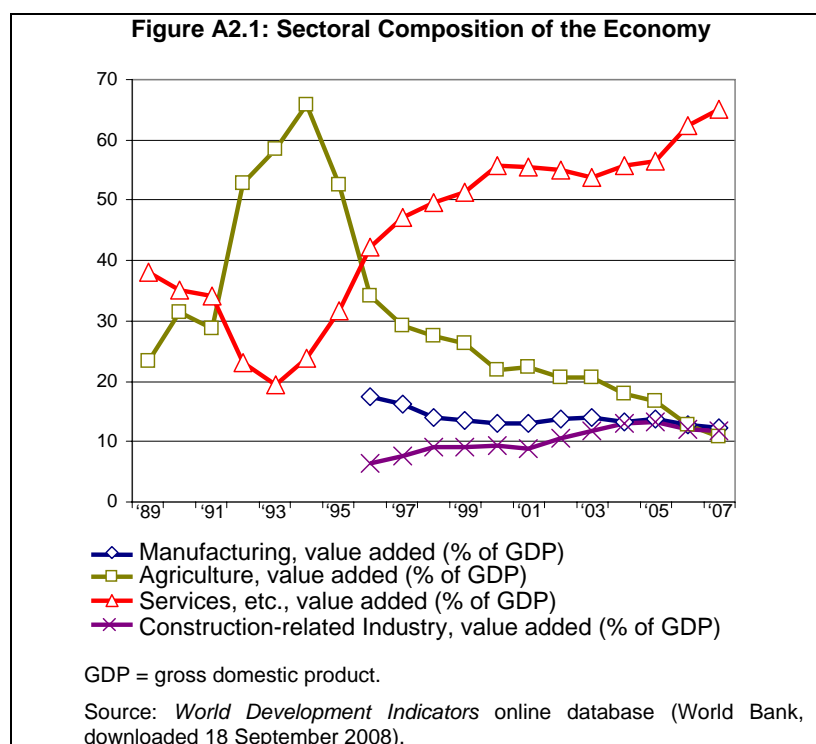
Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks
Impact Revitalization of the Georgian economy back to pre-conflict trajectory of growth and social development	Real GDP growth sustained at an average of more than 4% over 2008–2011	Department of Statistics, Government of Georgia Ministry of Finance	Assumption <ul style="list-style-type: none"> Investor and consumer confidence returns Risks <ul style="list-style-type: none"> Regional tensions Protracted global credit crisis and recession
Outcome Adverse economic and social impact of the conflict mitigated	Economic recovery begins in second quarter 2009 (GDP overall growth in 2009 at 4%) Resettlement of IDPs progresses	Department of Statistics, Government of Georgia Ministry of Finance Ministry of Labor and Social Affairs	Assumption <ul style="list-style-type: none"> Budgetary support from development partners Risks <ul style="list-style-type: none"> Countercyclical fiscal policy insufficient to kick-start growth Weakening of the banking sector
Outputs 1. Ensuring that the immediate incremental expenditure needs arising from the conflict are met 2. Ensuring that the core public expenditure program for 2008 is delivered in accordance with the approved budget	New poor, including IDPs, are provided with temporary emergency support Number of affected persons receiving targeted social assistance	Ministry of Finance Ministry of Labor and Social Affairs Ministry of Finance Ministry of Labor and Social Affairs	
Activities under the Loan 1. Budget financing gap cofinanced 2. Implementation of JNA monitored with regular reports			Inputs <ul style="list-style-type: none"> ADB loan: \$70 million equivalent

ADB = Asian Development Bank; GDP = gross domestic product; IDPs = internally displaced persons; JNA = joint needs assessment
 Source: ADB

MACROECONOMIC AND REFORM PROGRESS IN GEORGIA

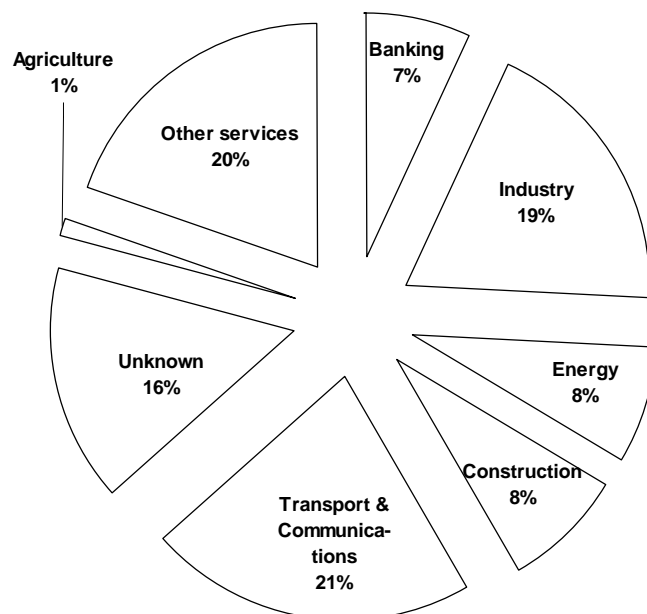
1. In the recent past, Georgia's economy has been successful at weathering external shocks¹ and maintaining high growth. Driven by rapidly rising foreign direct investment (FDI) flows, economic growth averaged 10.5% per year over the last 3 years and reached 12.4% in 2007. This is attributable to the favorable impact of the broad and credible economic and governance reform agenda being implemented in Georgia since 2003. Over the last 5 years, Georgia has implemented far-reaching strategic reforms centered on anticorruption measures that have established strong mechanisms of accountability and transparency in government. The reforms aim at developing a dynamic and competitive private sector as the main engine of growth, with the state playing a supportive role by providing basic public goods and services—as seen in improvements in education and health care delivery and the introduction of a well-targeted social safety net to protect the extreme poor.

2. Privatization efforts have been very successful in attracting foreign interest and significant capital inflows, which resulted in an expansion in economic activity in a range of non-tradable sectors. From financial services to wholesale and retail trade, construction, hotels and restaurants, and communications, a number of service sectors benefited significantly from the rising household incomes and the ongoing deepening of consumer lending (Figure A2.1). In 2007, strong inflows of FDI (Figure A2.2) and workers' remittances from abroad continued to accelerate the investment and consumption components of aggregate demand (Figure A2.3), bringing economic growth to 12.4%, and the highest rate of the last decade.



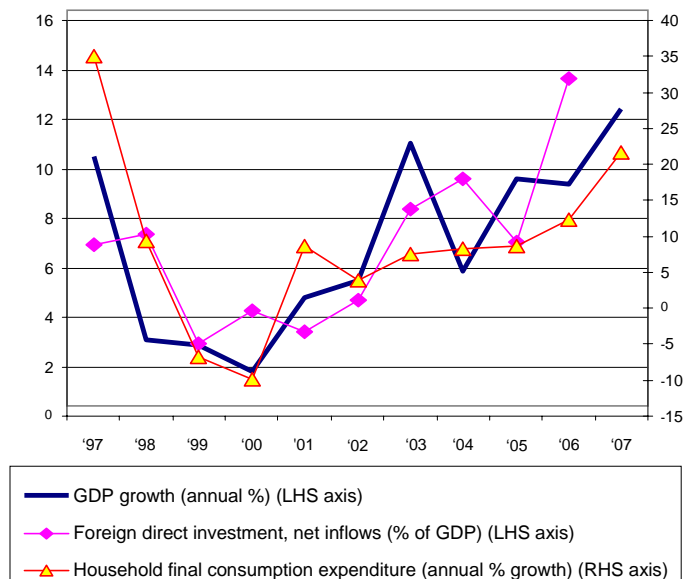
¹ For example, in 2006, all exports from Georgia to the Russian Federation were banned by Russian authorities (e.g., wine, mineral water, and numerous agricultural products) and the Georgian economy had to cope with a sharp increase in the cost of imported gas from the Russian Federation. (In 2005, the Russian Federation was both the leading export market and source of imports, including energy, so the disruption caused by the embargo was considerable.) However, strong internal demand sources, mainly investment and private consumption, fueled by strong capital inflows and workers' remittances from abroad, kept the economy growing that year in excess of 9%.

Figure A2.2: Sectoral Structure of Foreign Direct Investment in 2007



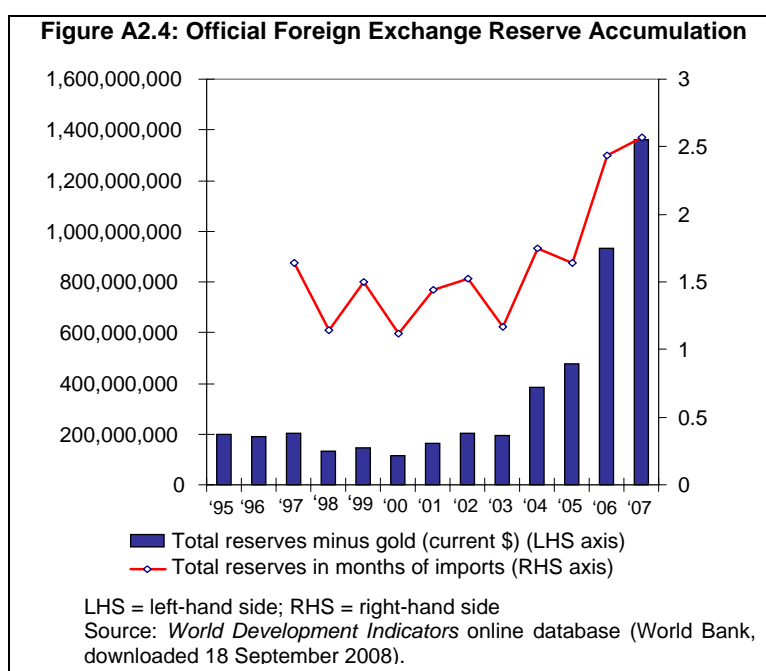
Source: United Nations Development Program. 2008. *Georgia Human Development Report 2008*. Tbilisi.

Figure A2.3: Aggregate Demand Sources of Growth



GDP = gross domestic product; LHS = left-hand side; RHS = right-hand side
 Source: *World Development Indicators* online database (World Bank, downloaded 18 September 2008).

3. Prudent monetary policies and fiscal reforms since 2003 have contributed to macroeconomic stability. The capital inflow bonanza helped finance the large current account deficit, and the buildup of foreign exchange reserves cushioned against shocks affecting the current and capital accounts of the balance of payments. In view of the significant dollarization of the economy and incomplete lending channels for effectiveness of traditional monetary policy tools, the Government's main macroeconomic stabilization strategy had been to pursue exchange rate stabilization. This was made possible by the expanding size of foreign exchange reserves initiated in 2003 (Figure A2.4).

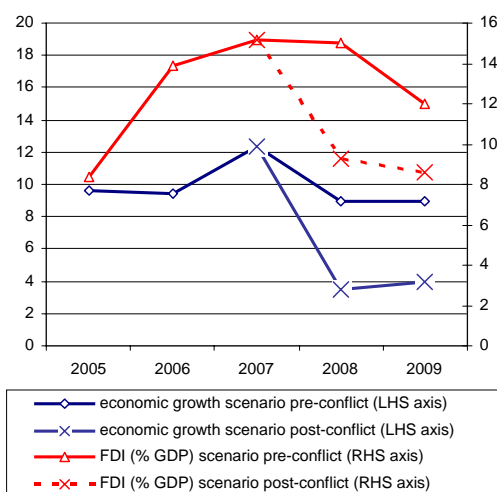


4. Foreign equity inflows have also assisted the strong fiscal consolidation reform agenda initiated in 2003, through increasing privatization proceeds. In addition, through strong improvements in tax revenue mobilization, the Government has been able to reverse its past record of recurrent failures to meet tax revenue targets, accumulation of domestic expenditure arrears (including on pensions and wages), and cash management problems. With tax revenues increasing from 14.1% of gross domestic product (GDP) in 2003 to 25.8% of GDP in 2007, the Government's capacity to increase social spending (to more than 5% of GDP) assisted in establishing social safety nets, which the Government deems crucial for attainment of its inclusive growth and poverty reduction agenda. Much-needed spending on priority items (e.g., key infrastructural rehabilitation) also increased.

5. Following years of sustained growth, the August conflict has resulted in an uncertain near-term outlook for Georgia. Earlier this year, most forecasts were confident that the economic growth trend of 8% for the past few years in Georgia would continue through 2008–2009. The situation changed dramatically after the August 2008 conflict. The current macroeconomic outlook for Georgia is now marked by increased uncertainty. Real GDP growth is expected to slow down to 3.5% against the earlier envisaged 9.0% for 2008 and rise modestly to 4.0% in 2009 (against the forecast of 9%) (Figure A2.5). A key driver for this is the loss in business confidence seen thus far, which in turn will affect FDI in key sectors like agriculture, tourism, and energy infrastructure. FDI inflows and related privatization revenues, as well as portfolio investment inflows, have already decelerated sharply. Direct economic damage caused

by the August conflict is estimated by the Government to cost the Georgian economy about \$1 billion in damaged infrastructure and environment and lost fiscal revenues and output. This is compounded by the consequences of erosion in consumer and investor confidence. This shock threatens to slow down economic growth and the pace of institutional reforms that Georgia achieved since 2003.

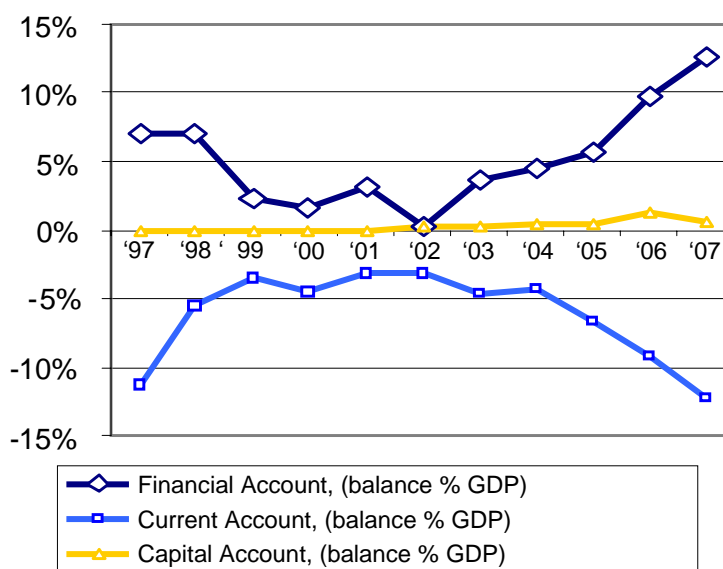
Figure A2.5: Shock to Economic Activity



GDP = gross domestic product; FDI = foreign direct investment; LHS = left-hand side; RHS = right-hand side

Source: United Nations and World Bank. 2008. *Georgia: Summary of Joint Needs Assessment Findings*. Prepared in partnership with the Asian Development Bank, the European Bank for Reconstruction and Development, the European Commission, the European Investment Bank, and the International Finance Corporation for the Donors' Conference of 22 October 2008 in Brussels. <http://go.worldbank.org/H23WSCUJW0>

Figure A2.6: Structure of Balance of Payments
(all figures are net of income earned)



GDP = gross domestic product.

Source: *International Financial Statistics* online database (International Monetary Fund, downloaded 18 September 2008).

6. The trade deficit is also expected to widen further in 2008, as export prospects have been affected by short-term damage to transport and shipment infrastructure, and high energy prices will continue to feed into a larger import bill. Against the earlier trend (until July 2008) when surpluses in both the capital and financial account more than covered the current account deficit (Figure A2.6), the sudden stop in FDI and in portfolio inflows that followed the conflict is (i) putting pressure on the lari, which the Government has countered in August 2008 by drawing down on official foreign exchange reserves in an attempt to stabilize the exchange rate; and (ii) aggravating the economic slowdown through a shortage of bank credits to enterprises. Georgia's 5-year Eurobond spread has widened to around 1,100 basis points above United States Treasury Bonds. Continued pressure on the currency had the potential to amplify the pass-through of high international prices of food and fuel onto domestic prices, which in view of the recently ignited global economic slowdown is less likely.

OVERVIEW OF GOVERNMENT REFORMS THAT SUPPORT IMPLEMENTATION OF THE JOINT NEEDS ASSESSMENT

A. Public Financial Management

1. The Government has launched comprehensive public financial management reforms centered on developing a medium-term expenditure framework (MTEF) to include an explicit forecast of medium-term policy directions and economic conditions.¹ The MTEF processes now cover all line ministries. Steps have also been taken toward developing results and performance indicators for some programs in different sectors. The Government has improved the policy content of the 2009 annual budget preparation and execution—including better linking of the MTEF to the budget cycle, developing and implementing the MTEF-based budgetary process, and increasing focus on improved efficiency of public expenditures. The *Basic Data and Directions* and MTEF for 2009–2012 was prepared in April 2008. While the quality of the analyses underpinning the policy initiatives presented in the sector strategies has improved, analyses generally remain weak. However, in light of the conflict, 2009 budget ceilings and the *Basic Data and Directions* and MTEF 2010–2013 will be revised and formulated in accordance with the outcome of the international development partner conference on Georgia held in late October 2008.

2. In the past, Georgia faced significant problems relating to extra-budgetary revenues and expenditures, manifested in weak budget execution and deviations between formulated and executed budgets. The Government introduced new accounting standards, including a fully operative treasury single account for the central Government and rules and guidelines for treasury operations at the central and decentralized level. The Government adopted and began implementation of an accounting reform strategy for producing annual consolidated financial statements in accordance with internationally accepted accounting and reporting standards, and began producing consolidated cash and commitment reports for the central Government and large cities. Subsequently, the Ministry of Finance (MOF) approved and the treasury service implemented the International Monetary Fund's (IMF's) *Government Finance Statistics Manual 2001* (GFSM 2001)-compliant functional budget classifications, and the treasury information system began producing reports on state budget expenditure execution according to these classifications.² The Government began producing consolidated cash and commitment reports for the central Government. As a prerequisite of the accounting reform, the Government adopted GFSM 2001-based budget classification. Line ministries and budget organizations have been trained in the new classifications. The cash-based treasury general ledger has been updated, incorporating the GFSM 2001 classification; and the 2008 budget execution report is being prepared according to the new classification.

3. There have also been significant improvements in the Treasury's rules and procedures on cash planning and management. Improved cash management systems, together with the real time settlement system linked to the National Bank of Georgia (NBG), has allowed for better predictability of available resources and its allocation to spending units. In addition, an electronic payment documents exchange system has been acquired and is currently being customized at the Treasury. The electronic treasury system is now running in a pilot exploration mode and respective regulations are being prepared.

4. The Government has undertaken steps to enhance transparency and efficiency following the recommendations of the country procurement assessment carried out by the World Bank in mid-2007. The Government adopted a new state procurement law, created the State Procurement Agency (SPA), and established government-wide processes for transparency

¹ Government of Georgia. 2006. *Basic Data and Directions for 2007–2010*. Tbilisi.

² International Monetary Fund. 2001. *Government Finance Statistics Manual 2001*. Washington, DC.

procurement. The SPA website (www.spa.ge) provides broad public dissemination of information about procurement practices. The Law on State Procurement, 2005, was subsequently amended to include state-owned enterprises, streamline procedures, and adopt international practices of retroactive financing in public procurement. Since the adoption of the new framework, public tenders have increased fivefold from 796 in 2005 to more than 3,500 in 2007. The number is expected to rise further as the monitoring capacity of SPA increases.

5. The Government adopted a new law on local government budgets and a transparent intergovernmental fiscal relations system in the budget preparation process. It continues to implement the reformed system of intergovernmental fiscal transfers and the new law on local government budgets, and finalized and began the rollout of a new integrated system for monitoring municipal budgeting and financial reporting. Until the August 2008 conflict, transfers were being fully funded—while the conflict has reduced the flow, the Government is fully committed to funding. The 2008 and 2009 budgets were prepared by municipalities under the new law and electronic systems for monitoring municipal expenditures have been introduced—MOF receives monthly reports from all municipalities on the execution of their budgets. Newly enacted budget rules were also implemented by municipalities for the 2008 and 2009 budgets.

B. Private Sector Development

6. The Government has adopted a new tax regime that has (i) simplified the Tax Code and substantially reduced the tax burden on firms and individuals by reducing the number of taxes, (ii) abolished exemptions and broadened the tax base, (iii) lowered some rates to facilitate compliance, and (iv) distributed the tax burden more equitably. The Government has also defined mechanisms and set parameters for reviewing and assessing the implementation of the new tax legislation, and introduced amendments to strengthen the effectiveness of the tax administration. As a result of these reforms, tax revenues increased from 18% of gross domestic product (GDP) in 2004 to 22% in 2006 and 25% in 2007. The qualitative improvement in tax policy has increased budget revenues and given the Government the opportunity to fund priority expenditures more effectively.

Table A3: Main Taxes and Tax Rates
(%)

Types of Taxes	Before 2005	2005–2007	2008
Income tax	12–20	12	25
			(unified with social tax in 2008 with stepwise reduction to 15% by 2011)
Social tax	27–33	20	Abolished
			(merged with personal income tax)
Corporate (profit) tax	20	20	15
Value-added tax	20	18	18
Customs duty	0–30	0, 5, 12	0, 5, 12

Sources: ADB staff; United Nations Development Program. 2008. *Georgia Human Development Report 2008*. Tbilisi.

7. The Government has further improved revenue collection administration by establishing a unified revenue service in MOF (including merging the Tax Department, Customs Department, and Financial Police) and enhanced revenue services aimed at developing a culture of voluntary compliance. Efforts are under way to build the necessary infrastructure of tax administration to improve the quality and efficiency of taxpayer services. Regional service houses have been established to provide taxpayers with instructions and guidance, and several large tax service centers are under rehabilitation.

8. The Government adopted a new Customs Code, which simplified customs requirements significantly, reorganized and re-staffed the Customs Department, and abolished the import tariff on almost 91% of items; on other items, the simple unweighted import tariff fell from 7.4%

in 2004 to 1.4% in 2007. As a result of these reforms, Georgia has an open and competitive trade regime. These reforms have significantly reduced the scope for corruption, and customs and border processing time for businesses. According to *Doing Business 2008*,³ the costs and procedures involved in importing and exporting a standardized shipment of goods in Georgia is in line with practices in the Organisation for Economic Co-operation and Development (OECD) countries. Recently, the Government reviewed and assessed the performance of the new Customs Code and made recommendations to improve performance and service standards. Several customs checkpoints have been restructured. Electronic value-added tax declarations have been implemented and the ASYCUDA WORLD system⁴ has been operationalized in pilot checkpoints. The customs methodology has also been revised. Customs procedures have been further simplified and risk-based inspection methodologies fully introduced. The Government intends to continue development and reporting of standard performance indicators to monitor performance and the progress with the reforms.

9. In summary, reforms have resulted in impressive increases in revenue collection. This has allowed the Government to start addressing basic infrastructure needs, which were essential to expand business opportunities. Georgia has substantially improved its rank among the “Doing Business” indicators, rising from 114th place in 2005 to 37th place in 2006 and 18th place in 2007. The 2007 *Doing Business* survey ranked Georgia as the number one reformer globally. Reforms have continued and Georgia has been ranked 15th in 2008. Significant improvements in the business environment were key to the surge in foreign direct investment inflows from under \$200 million (non-oil pipeline) in 2005 to \$1.5 billion in 2007.

C. Social Protection

10. Payment to beneficiaries under Georgia’s first targeted social assistance (TSA) program commenced in August 2006. Each household was thoroughly examined and assigned a score of need. This database is used to target various programs for the poor and vulnerable, including a health insurance program. Under the Government’s 2008 budget, GEL113.1 million (an increase over the GEL83 million budgeted for 2007) was allocated to finance the TSA. As of August 2008, the TSA program benefits 148,279 households (12.6% of all households in Georgia), with 406,718 members (10.7% of the population), which received an average monthly benefit of GEL50.92 per month. The total spending on targeted income support was budgeted at GEL113.1 million for 2008 (0.6% of projected GDP). The August conflict with the Russian Federation (conflict) has resulted in an increase in the number of people requiring social assistance. With regard to the population vulnerable to poverty because of the conflict, including the new internally displaced persons (IDPs), the Government is planning to support qualified persons through the TSA. The cost of including all new extreme poor in the TSA (assuming that none of them are currently benefiting) ranges from GEL1.53 million per month to GEL3.06 million per month, if the benefit level is about GEL17 per capita per month. In addition, about 25,000 IDP households will receive one-off cash assistance. The social protection system will continue to face increasing pressures as economic conditions tighten and the number of unemployed and those who have lost the means to sustain their livelihoods increase.⁵

11. Georgia has a universal system of income support for the elderly, where eligibility is conditioned upon reaching a certain age threshold (60 for women and 65 for men). Other categories covered by the system are people with disabilities and families who have lost a breadwinner. Benefits are flat (currently GEL70 per month) except for some special categories, which receive higher benefits (war veterans, retired officers from the army and Ministry of

³ World Bank. 2007. *Doing Business 2008*. Washington, DC.

⁴ The ASYCUDA WORLD system allows customs administrations and traders to handle most of their transactions—from customs declarations to cargo manifests and transit documents—via internet.

⁵ In addition, to address the rise in import prices of gas and large gas tariff increases in May 2007, the Government put in place an energy lifeline tariff system to protect vulnerable groups and a gas subsidy.

Interior, members of Parliament). Overall, in August 2008, 838,130 people receive pensions. Total spending on pensions and special categories benefits in 2008 is budgeted at GEL773.5 million (state pensions GEL722.7 million and special allowances GEL50.8 million). The August conflict has not had any adverse effect on the delivery of pensions thus far.

12. The health care system in Georgia continues to face significant challenges. Health service utilization rates are the lowest in Europe and Central Asia, with less than two outpatient visits per capita and less than five inpatient visits per 100 people. Out of pocket expenditures for treatment are a major barrier to seeking care. Only 43% of the poorest quintile seeks care for chronic illnesses compared to 62% of the richest quintile, and 73% of the chronically ill cite lack of resources as the main reason for not utilizing health services. Three million Georgians—out of a population of 4.4 million—need to cover almost three quarters of their expenditures on health services through out-of-pocket payments.⁶ Illness is one of the causes of falling into poverty, as 10% more individuals fall below the poverty line after incurring hospitalization expenses.

13. The Government has launched an ambitious 4-year plan to improve equity and access to essential quality health services, especially for the poor and vulnerable. Specifically, the Government defined a basic benefit package of health care services with universal coverage for all of the population, and introduced a medical assistance program (MAP) of comprehensive health care services for the poor. All households who qualify for TSA and whose score is below 70,000 qualify for the MAP—a package of medical services provided to beneficiaries through publicly financed insurance premium bought through private insurance companies (currently GEL11 per beneficiary per month). The MAP covers (i) outpatient services not provided by the primary health care program; and (ii) a range of inpatient services, including costs of chemotherapy and radiation therapy, and labor and delivery costs. The program has been found to increase utilization of health services by the poor. It currently has about 750,000 beneficiaries. In parallel, the Government increased budgetary allocations to the health care sector in the MTEF 2007–2010. For 2008, the amount budgeted is GEL75 million, about one third of overall public spending on health. As a result of the conflict, the cost of providing new IDPs with the medical assistance package amounts to an additional GEL1 million–GEL2 million per month, assuming the cost per capita of GEL11.2 per month.

⁶ World Bank. Forthcoming. *Georgia Poverty Assessment 2008*.

DEVELOPMENT PARTNER MATRIX

Sector/Thematic Area	Activities
Governance and Public Sector Management	<p>World Bank. Public Sector Financial Management Reform Support Project; pooled funding supports this project; World Bank, DFID, and the governments of Netherlands and Sweden contributed funds</p> <p>DFID. Support in MTEF, civil society public policy reform, and reform of civil registration</p> <p>UNDP. Public Service Bureau, strengthen transparency and effectiveness of Parliament, national human rights education and information dissemination strategy, protection and promotion of human rights, capacity within the public defender's office, customs reform</p> <p>EU TACIS. Institutional, legal, and administrative reform in the areas of rule of law, intergovernmental fiscal relations, auditing, and institutional capacity building in tax and customs administration; PEFA assessment jointly with the World Bank</p> <p>German Development Cooperation through GTZ. Support legal and justice reform and Georgian Chamber of Control</p> <p>USAID. Reform national governance; improve tax and customs administration systems; business climate reform, budgeting, treasury management</p> <p>Government of the Netherlands. Governance and oversight institutions</p> <p>SIDA. Public sector and governance reform</p> <p>German Development Cooperation through KfW. Debt restructuring in the electricity sector</p>
Health and Social Protection	<p>World Bank. Primary Health Care Development; Social Investment Fund</p> <p>EU TACIS. Addressing the social consequences of transition, with a focus on primary health care, social assistance</p> <p>DFID. Support primary health care, building capacity in key ministry departments and associate structures, support to health and social policy development</p> <p>USAID. Increase immunizations (health sector); support for promoting women's health program (reproductive health); strengthen health systems (health sector)</p>
Poverty Reduction	<p>World Bank. Poverty reduction support operations</p> <p>UNDP. Implementation of the Economic Development and Poverty Reduction Program of Georgia; SME Development Program</p>
Private and Finance Sector Development	<p>EBRD. SME credit line, equity investment and syndicated loans and mortgage loan to banks, support for financial sector strategy</p> <p>IFC. Georgia Corporate Governance Project, business enabling environment</p> <p>German Development Cooperation through KfW. Equity Participation Credit Guarantee Fund for SMEs</p> <p>USAID. SME growth: (ii) increasing access to credit, (iii) developing land market, (iv) increasing agribusiness productivity, (v) promoting Georgian exports, and (vi) economic livelihood and local economic development</p> <p>UNDP. Modernization of Financial System of Georgia (first phase and second phase)</p> <p>Millennium Challenge Corporation. Georgia Regional Development Fund activity</p> <p>German Development Cooperation through GTZ. Private sector promotion</p> <p>First Initiative. Bond Market Development Project</p>

DFID = Department for International Development of the United Kingdom; EBRD = European Bank for Reconstruction and Development; EU = European Union; IFC = International Finance Corporation; MTEF = medium-term expenditure framework; PEFA = Public Expenditure and Financial Accountability; SIDA = Swedish International Development Agency; SME = small and medium-sized enterprises; TACIS = Technical Aid to the Commonwealth of Independent States; UNDP = United Nations Development Program; USAID = United States Agency for International Development.

GEORGIA'S POVERTY REDUCTION PROGRAM

1. Georgia's first long-term development strategy (2003–2015) was set forth in the Government's Economic Development and Poverty Reduction Program.¹ The program provided a broad framework for poverty reduction but lacked the clear prioritization needed in the face of a limited resource envelope and the Government's capacity constraints. In 2004, a reform-minded Government came into power and ushered in significant political and economic developments (the Rose Revolution). The Government's medium-term reform agenda is reflected in the budget document *Basic Data and Directions for 2007–2010*, which was first developed in 2005 and updated annually since then.² The budget document emphasizes the need to improve governance and reduce corruption, and is premised on the development of a dynamic and competitive private sector as the main engine of growth, with the state playing a supportive role by providing basic public goods and services. Complementary reforms are also envisaged to ensure that the population benefits from growth through improvements in education and health care delivery, and the introduction of a well-targeted social safety net to protect the extreme poor. These institutional and structural reforms are supported by prudential macroeconomic policies.

2. Following the presidential elections in January 2008 and the formation of a new cabinet, the Government issued a 5-year program of key priorities for 2008–2012—"United Georgia without Poverty," which was approved by Parliament on 31 January 2008.³ The program identifies a number of economic, political, and social objectives including (i) social programs—spending one third of the state budget to spend on social programs for the next 5 years; (ii) employment generation—creating 200,000 new jobs over the next 5 years; and (iii) reducing poverty—halving the number of social program beneficiaries in the next 5 years, increasing the minimum monthly pension to \$100 over the next 5 years; and providing access to state-funded health insurance for 1.2 million people, including socially vulnerable, teachers, military and law enforcement personnel, and employees of state agencies.⁴

3. Georgia has implemented far-reaching and strategic reforms over the past 5 years with impressive results. The key outcomes are as follows:

- (i) Foreign investment doubled from 8.4% of gross domestic product (GDP) in 2005 to an estimated 16% in 2006–2007.
- (ii) Tax revenue collection increased from 14.1% of GDP (GEL1.2 billion) in 2003 to 25.8% of GDP (GEL4.3 billion) in 2007.
- (iii) Social spending by the Government increased by more than 5%.
- (iv) Five years ago, Georgia had only 7 hours of electricity per day per household. Today, Georgia has electricity 24 hours a day, 7 days a week, and exports electricity to neighboring countries.
- (v) Five years ago, Georgia did not have a targeted social assistance program. Today, its program covers 148,000 households reaching more than 600,000 beneficiaries.

¹ Government of Georgia. 2003. *Economic Development and Poverty Reduction Program*. Tbilisi.

² Government of Georgia. 2006. *Basic Data and Directions for 2007–2010*. Tbilisi.

³ International Development Association and International Finance Corporation. 2008. *Country Partnership Strategy Progress Report for Georgia (FY2006–FY2009)*. Washington, DC.

⁴ World Bank. 2008. *Proposed Fourth Poverty Reduction Support Operation*. Washington, DC (\$22.7 million equivalent, 25 April); World Bank. 2008. *Supplemental Financing Document for a Proposed Supplemental Credit*. Washington, DC (\$40 million equivalent, 16 September).

4. An assessment of the impact of economic growth and social spending on poverty is under way. Official poverty indicators show some improvement over 2005–2007, with the overall poverty rate declining from 24.1% in 2005 to 23.3% in 2006 and 21.3% in 2007. However, the quality of the data is a concern, stemming partly from rapid turnover in staff in the Government's Statistics Department. As a cross-check, the World Bank and the Ministry of Labor and Social Protection conducted a living standards measurement survey in Fall 2007, and preliminary analysis of the results show an overall poverty rate of 23.6% for 2007. A full poverty assessment in early FY2009 will discuss the differences and suggest strategic policy and investment options for poverty reduction efforts going forward. However, some observations can be made at this time. The rapid increase in social spending, including the introduction of the targeted social assistance program in 2006, has likely improved the situation of the extreme poor.

5. The August conflict has resulted in an additional 130,000 internally displaced persons (IDPs), of which about 40,000 may not be able to return to their homes in the conflict zone. In addition, around 150,000 people living on farms on the agricultural plain north of Gori are suffering from severe crop and livestock losses because irrigation water has been cut off and other conflict-related damage. Preliminary estimates point to unemployment increasing from 13.3% in 2007 to 15.1% in 2008 and 17% in 2009. The effect on poverty is expected to be more pronounced, with poverty increasing by 2 percentage points in 2008 and 3 percentage points in 2009. As a result, pressures on social spending are rising. The proposed Emergency Assistance for Post-Conflict Recovery Loan will help address these budgetary impacts, arising from the conflict. Table A5 presents current and proposed Asian Development Bank support for implementation of Georgia's medium-term development plan.

Table A5: Current and Proposed Asian Development Bank Support for the Implementation of Georgia's Medium-Term Development Plan

Georgia's Medium-Term Development Plan Objectives	ADB Support	
	Interim Operational Strategy	Proposed Assistance
1. Enabling Income and Employment Generating Growth		
1A. Addressing Corruption and Governance Issues		X
1B. Removing Administrative Barriers to Private sector investment		X
1C. Increasing Access to Financial Services	Loan to the Joint Stock Commercial Bank of Georgia ^a	
1D. Improving Electricity and Gas Infrastructure	Municipal Services Development Project ^b	
1E. Improving Transport Infrastructure	Future road projects	
1F. Improving Access to Rural Infrastructure and Services	Municipal Services Development Project	
1G. Enabling Sustainable Use of Forestry and Other Natural Resources		
2. Improving Human Development and Social Protection		
2A. Addressing Corruption and Governance Issues		X
2B. Improving Management of the Education System		
2C. Improving Management of the Health Sector		
2D. Improving Management of Pensions and Social Security System		X
2E. Improving Municipal and Community Provision of Basic Infrastructure	Municipal Services Development Project	
3. Improving Efficiency in Public Services		
3A. Addressing Corruption and Governance Issues		X
3B. Improving Public Expenditure Management		X
3C. Improving Country Financial Management and Procurement Systems		X
3D. Modernizing the Judiciary		
3E. Strengthening Intergovernmental Fiscal Relations		X
3F. Improving the Management of the Civil Service		

^a ADB. 2007. *Report and Recommendation of the President to the Board of Directors for a Proposed Senior Loan to the Joint Stock Commercial Bank of Georgia*. Manila.

^b ADB. 2007. *Report and Recommendation of the President to the Board of Directors for a Proposed Loan to Georgia for the Municipal Services Development Project*. Manila.

Source: ADB.

LIST OF INELIGIBLE ITEMS

No withdrawals shall be made in respect of:

- (i) expenditures for goods included in the following groups or subgroups of the United Nations Standard International Trade Classification, Revision 3 (SITC, Rev. 3), or any successor groups or subgroups under future revisions in the SITC, as designated by ADB to the Borrower:

Table A6: Ineligible Items

Chapter	Heading	Description of Items
112		Alcoholic beverages
121		Tobacco, unmanufactured; tobacco refuse
122		Tobacco, manufactured (whether or not containing tobacco substitute)
525		Radioactive and associated materials
667		Pearls, precious and semiprecious stones, unworked or worked
718	718.7	Nuclear reactors, and parts thereof, fuel elements (cartridges), nonirradiated for nuclear reactors
728	728.43	Tobacco processing machinery
897	897.3	Jewelry of gold, silver, or platinum-group metals (except watches and watch cases) and goldsmiths' or silversmiths' wares (including set gems)
971		Gold, nonmonetary (excluding gold ore and concentrates)

Source: United Nations.

- (ii) expenditures for goods or services procured from countries that are not members of ADB;
- (iii) expenditures for goods supplied under a contract that any national or international financing institution or agency will have financed or has agreed to finance, including any contract financed under any loan or grant from ADB;
- (iv) expenditures for goods intended for a military or paramilitary purpose or for luxury consumption;
- (v) expenditures for narcotics;
- (vi) expenditures for environmentally hazardous goods, the manufacture, use, or import of which is prohibited under the laws of the Borrower or international agreements to which the Borrower is a party; and
- (vii) expenditures on account of any payment prohibited by the Borrower in compliance with a decision of the United Nations Security Council taken under Chapter VII of the Charter of the United Nations.

SUMMARY POVERTY REDUCTION AND SOCIAL STRATEGY

Country/Title: Georgia: Emergency Assistance for Post-Conflict Recovery (EAPCR)
--

Lending/Financing Modality:	Emergency Assistance Loan	Department/ Division:	Central and West Asia Department Governance, Finance and Trade Division
-----------------------------	---------------------------	-----------------------	---

I. POVERTY ANALYSIS AND STRATEGY

A. Linkages to the National Poverty Reduction Strategy and Country Partnership Strategy

The Government's Economic Development and Poverty Reduction Program aims to raise the welfare of the population in Georgia. This means improving the quality of life of each person, along with the sustainable socioeconomic development of the country. To achieve this goal, two strategic objectives have been defined: (i) fast and sustainable economic development, and (ii) reduction of poverty. To achieve these strategic objectives, the Government's priorities include (i) improvement in governance (including improvement in public administration and reduction of corruption), (ii) macroeconomic stability, (iii) improvement in the structural and institutional environment (including improvement in the business and investment climate), (iv) development of human capital through improving health conditions, and (v) improving living standards for those below the poverty line and reducing vulnerability levels.

The EAPCR's outputs which are to ensure that (i) immediate incremental expenditure needs arising from the August 2008 conflict are met, and (ii) the core Government program for 2008 is delivered in accordance with the approved budget, are broadly in line with the Government's poverty reduction strategy.

The poverty reduction strategy of the Asian Development Bank^a (ADB) is based on three pillars: (i) pro-poor economic growth, (ii) social development, and (iii) good governance. ADB's interim operational strategy for Georgia (2008–2009),^b approved in January 2008, focuses on (i) improving service delivery in municipal infrastructure within the evolving decentralization process, (ii) reducing road transportation constraints on economic activity, and (iii) upgrading and developing energy infrastructure. These priorities were identified based on the following considerations: (i) alignment with the Government's development agenda, (ii) selectivity in focusing limited resources on a small number of priority areas, and (iii) complementarity with other development partners. The interim operational strategy also highlights the need for ADB to be responsive to rapid changes in circumstances, and the flexibility of ADB assistance modalities—a key advantage for Georgia's development under its newly established partnership with ADB. The Government has requested a loan of \$70 million from ADB's Special Funds resources for the EAPCR.

B. Poverty Analysis

Targeting Classification: General Intervention

1. Key Issues

An assessment of the impact of economic growth and social spending on poverty is under way. Official poverty indicators show some improvement over 2005–2007, with the overall poverty rate declining from 24.1% in 2005 to 23.3% in 2006 and 21.3% in 2007. However, the quality of the data is a concern, stemming partly from rapid turnover in staff in the Statistics Department. As a cross-check, the World Bank and the Ministry of Labor and Social Protection conducted a living standards measurement survey in Fall 2007, and preliminary analysis of the results shows an overall poverty rate of 23.6% for 2007. A full poverty assessment in early FY2009 will discuss the differences, and suggest strategic policy and investment options for poverty reduction efforts. However, some observations can be made at this time. The rapid increase in social spending, including the introduction of the targeted social assistance program in 2006, has likely improved the situation of the extreme poor. Additionally, poverty appears to be more concentrated in rural areas and secondary cities.

The conflict that erupted in August 2008 has resulted to an additional 130,000 internally displaced persons (IDPs), of which about 40,000 may not be able to return to their homes in the conflict zone. In addition, around 150,000 people living on farms on the agricultural plain north of Gori are suffering from severe crop and livestock losses because irrigation water was cut off and other conflict-related damage. Preliminary estimates point to unemployment increasing from 13.3% in 2007 to 15.1%–17.4% in 2008. The near-term outlook is of a rise in unemployment of up to 100,000. Depending on the severity of the economic impact of the conflict, it is estimated that around 100,000–280,000 Georgians may fall into poverty by the end of 2009, increasing the overall poverty incidence from 23.6% in 2007^c to 25.9%–30.0% and the extreme poverty incidence from 9.3% to 11.3%–13.4%.^d People who are already poor might be pushed deeper into poverty, thus increasing the overall poverty gap and severity of poverty.

The poverty impact estimates stem from (i) projected effects of the loss of property, productive assets, and livelihood, as well as the displacement that was caused by the conflict, some of which is expected to be permanent; and (ii) the

projected adverse impact the conflict might have on the overall Georgian economy through a slowdown in economic activities and potential loss of jobs and household incomes. The economic slowdown might cause job loss, a decrease in household income, and eventually a loss of purchasing power, pushing affected households below the poverty line. In the case of a severe economic slowdown, the ensuing fiscal constraints may adversely affect the Government's ability to deliver social transfer and services, further aggravating the social situation.

Social transfers, especially pensions, play a very important role as a source of household income and contribute significantly to poverty reduction. Without pensions, the poverty incidence would increase from 23.6% to 32.9%, and poverty would become much deeper and more severe. Targeted social assistance reduces poverty by 2 percentage points. This program is targeted well—71% of its beneficiaries are among the consumption poor. In addition, it significantly increases the income of poor households—by 72% for all poor households, and by 105% for extreme poor households (10% of the population).

2. Design Features

The EAPCR's pro-poor design includes mitigating the social impact of the August 2008 conflict. The Government's approach, supported by the EAPCR, is to assist the newly poor and vulnerable population through the existing social protection mechanisms to the extent possible. The key elements of Georgia's social protection system are summarized below.

Targeted social assistance. In August 2006, following 18 months of intense institutional development and capacity building, the Government of Georgia introduced a targeted social assistance (TSA) system. The system uses a proxy-means testing methodology for assessing and ranking the welfare of households, which have registered with the database on the poor and vulnerable population established and managed by the State Agency for Administration of Social Transfers. The agency's database currently contains data on 42% of all households in Georgia.

All of these households had registered with the agency as households in need of support. They were visited by a qualified social worker who collected data on the household's economic and social status, the data was electronically verified and cross-checked, "a score of need" was automatically calculated for each household, and each household was formally informed about it. Households with a score below 57,000 receive regular monthly income support. In August 2008, this benefit was received by 148,279 households with 406,718 members (10.7% of the population); the average monthly benefit per household was GEL50.92. The total spending on targeted income support was budgeted at GEL113.1 million for 2008 (about 0.6% of projected gross domestic product). In 2007, a monitoring survey to assess the performance of TSA was carried out. The survey found that TSA is efficiently administered and performs very well in reaching the target poor population.

Pensions. Georgia has a universal system of income support for the elderly, where eligibility is conditioned upon reaching a certain age threshold—60 for women and 65 for men. Other categories covered by the system are people with disabilities and families that have lost a breadwinner. Benefits are flat (currently GEL70 per month), except for some special categories such as war veterans, retired officers from the army and the Ministry of Interior, members of Parliament, and others who receive much higher amounts. Overall, 838,130 people received pensions in August 2008. Total spending on pensions and special categories benefits in 2008 is budgeted at GEL773.5 million (state pensions GEL722.7 million and special allowances GEL50.8 million). Pensions are delivered on time and the conflict has not had any adverse impact on their delivery so far.

Medical assistance program for the poor and vulnerable. All households that are registered with the agency and whose score is below 70,000 are beneficiaries of the medical assistance program. This program is essentially a package of medical services provided to beneficiaries through a publicly financed insurance premium (currently GEL11.2 per capita per month; projected to increase to GEL15 in 2009). Currently, 750,000 Georgians are beneficiaries of this program. The program is funded by the state budget (for 2008, the amount is budgeted at GEL75.0 million, making up about one-third of overall public spending on health in Georgia).

Cash payment to the internally displaced population since 1992. All 1992 IDPs—about 220,000—are receiving IDP allowance amounting to GEL25 per person per month for those residing in private housing and GEL28 per person per month for those placed in collective centers.

Social care services. The system of social care services in Georgia is limited and mostly focused on children deprived of parental care and children with disabilities. Georgia is in the process of implementing a child welfare reform aimed at deinstitutionalization of child care.

II. SOCIAL ANALYSIS AND STRATEGY

A. Findings of Social Analysis

The social sectors in Georgia were confronted with a number of structural, institutional, policy, and governance issues that needed to be addressed to improve performance and outcomes. Resources spent on social assistance programs were insufficient to make a real difference to the extremely poor. Moreover, they were thinly spread over too many fragmented programs, targeted mostly based on status, merits (veterans and other deserving citizens), or a social category (disabled, orphans, elderly, etc.). Program implementation was weak, the staff were poorly trained and paid, the record-keeping practice was outdated, benefit delivery had room for leakage, and monitoring and evaluation barely existed.

Even though social transfers are not sufficient to move households out of poverty, they play an important role in poverty alleviation (particularly pensions as the largest program). The new Government inherited significant arrears in pensions and other social benefit payments. In the short to medium term, major challenges facing the state pension system are (i) to continue paying pensions on time, (ii) to increase pensions to about 25%–30% of the average wage (from a replacement rate of about 20%), and (iii) to improve pension administration. In the long run, Georgia faces a challenge of developing an affordable, fiscally sustainable, diversified pension system that would protect the elderly against poverty and provide for consumption smoothing. Under the new Government's program, pensions and social assistance benefits were significantly increased, all arrears were cleared, and payment of these benefits commenced on a regular basis. In pensions, a strategy for long-term pension reform was adopted, and the corresponding legal framework was created for an affordable, equitable, and fiscally sustainable protection of the elderly against poverty. Overall, the pension system was simplified and streamlined.

The health sector continues to face significant challenges. Health outcomes are stagnant or are worsening. Early childhood mortality and maternal mortality have yet to show a positive trend. Noncommunicable diseases are on the rise. Out-of-pocket expenditures for treatment are still a major barrier to seeking care. The new Government's program aims to sustain improved health care services. Increased public financing for health care and better targeting of primary care to the poor are gradually improving the utilization of health care services.

The impact of the conflict on Georgians living in the conflict-affected areas has been considerable. Their lives have suddenly been uprooted and the future is uncertain for many of them. Damages have been amplified by the massive displacement of people. The longer-term impacts, if not addressed promptly, may be sizeable. Human capital and the country's social fabric could be weakened and private sector activity in the affected areas severely hampered. Those already poor might fall deeper into poverty, and many of the newly vulnerable may become poor. The affected population is largely rural and poor. As with the rest of the population, the poor will be supported through the targeted social assistance program; it is important that equity considerations require identical treatment of the poor. The conflict led to a rise in the number requiring social assistance, thereby adding to the administrative burden. It is estimated that an additional 100,000 people who have been affected by the conflict, directly or indirectly, are now vulnerable and thus in need of social protection assistance. A possible economic deceleration, combined with increasing food prices, would lead to a deepening of poverty and food insecurity among the vulnerable. The costs of the targeted social assistance program will rise and the proposed assistance will help address these budgetary impacts.

B. Consultation and Participation

1. Provide a summary of the consultation and participation process during the project preparation.

Extensive consultations were conducted with the Government [including the Ministry of Finance (MOF); National Bank of Georgia; Financial Supervisory Agency; Revenue Service]; private sector (including American Chamber of Commerce, Bank Republic/Société Générale); and other development partners (including World Bank, United States Agency for International Aid, German development cooperation through GTZ, European Bank for Reconstruction and Development, European Union).

2. What level of consultation and participation (C&P) is envisaged during the project implementation and monitoring?
☐ Information sharing ☒ Consultation ☐ Collaborative decision making ☐ Empowerment

3. Was a C&P plan prepared? ☒ Yes ☐ No

If a C&P plan was prepared, describe key features and resources provided to implement the plan (including budget, consultant input, etc.). If no, explain why.

A list of key agencies and individuals to be consulted are drawn up prior to the loan processing mission.

C. Gender and Development			
1. Key Issues. The EAPCR has no specific gender implications.			
2. Key Actions. Measures included in the design to promote gender equality and women's empowerment—access to and use of relevant services, resources, assets, or opportunities and participation in decision-making process: <input type="checkbox"/> Gender plan <input type="checkbox"/> Other actions/measures <input checked="" type="checkbox"/> No action/measure			
III. SOCIAL SAFEGUARD ISSUES AND OTHER SOCIAL RISKS			
Issue	Significant/Limited/ No Impact	Strategy to Address Issue	Plan or Other Measures Included in Design
Involuntary Resettlement	No impact		<input type="checkbox"/> Full Plan <input type="checkbox"/> Short Plan <input type="checkbox"/> Resettlement Framework <input checked="" type="checkbox"/> No Action
Indigenous Peoples	No impact		<input type="checkbox"/> Plan <input type="checkbox"/> Other Action <input type="checkbox"/> Indigenous Peoples Framework <input checked="" type="checkbox"/> No Action
Labor <input checked="" type="checkbox"/> Employment opportunities <input type="checkbox"/> Labor retrenchment <input type="checkbox"/> Core labor standards			<input type="checkbox"/> Plan <input type="checkbox"/> Other Action <input checked="" type="checkbox"/> No Action
Affordability	No impact		<input type="checkbox"/> Action <input checked="" type="checkbox"/> No Action
Other Risks and/or Vulnerabilities <input type="checkbox"/> HIV/AIDS <input type="checkbox"/> Human trafficking <input checked="" type="checkbox"/> Others (conflict, political instability, etc), please specify: <u>Social instability</u>	The EAPCR addresses other risks such as social instability by swiftly responding to the Government's request to help fund the essential social development expenditures arising from the August conflict.		<input type="checkbox"/> Plan <input type="checkbox"/> Other Action <input checked="" type="checkbox"/> No Action
IV. MONITORING AND EVALUATION			
Are social indicators included in the design and monitoring framework to facilitate monitoring of social development activities and/or social impacts during project implementation? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No			

^a ADB. 2004. *Fighting Poverty in Asia and the Pacific: The Poverty Reduction Strategy of the Asian Development Bank*. Manila.

^b ADB. 2008. *Georgia: Interim Operational Strategy 2008-2009*. Manila.

^c Using consumption as a welfare indicator and following World Bank methodology for poverty measurement, 23.6% of Georgians were found to be poor and 9.3% very poor. The rural population was poorer than the urban: 29.7% versus 18.3% for overall poverty and 12.4% versus 6.7% in the case of extreme poverty. Poverty in Georgia is thus predominantly rural—it makes 59% of the total poor and 62% of the extreme poor. The incidence of poverty varies considerably across Georgia. The highest incidence is observed in Shida Kartli (59.4%), followed by Kakheti (46.3%), and Mtskheta-Mtianeti (40.6%). The lowest incidence of poverty is found in Tbilisi (12.9%), Samegrelo (14.4%), and Kvemo-Kartli (17.3%). Employment status is strongly correlated with poverty. Households headed by wage earners experience the lowest rates of overall poverty (12.7%) and extreme poverty (4.4%). Among the employed, households headed by the self-employed in agriculture face the highest poverty risk. In contrast, households headed by someone who is unemployed or out of the labor force face a substantial risk of poverty.

^d An alternative estimate of the poverty impact of the conflict was simulated using the 2007 living standard measurement survey data set and assuming that the purchasing power of the population clustered above the poverty lines would decline by 5%, 10%, and 20%. If the purchasing power declines by 5%, the extreme poverty rate would rise to 10.4% and the overall poverty rate would increase to 26.3%. If the decline is 10%, these rates would increase to 11.8% of the population in the case of extreme poverty and 28.9% in the case of overall poverty. A 20% decline in the purchasing power would increase the overall poverty rate by 43% to 33.8%. Similarly, the extreme poverty rate would jump by 53%, affecting 14.3% of Georgia's population.