ADB

Report and Recommendation of the President to the Board of Directors

INTERNAL

Project Number: 54271-002
October 2022

Proposed Policy-Based Loan for Subprogram 2 Georgia: Fiscal Resilience and Social Protection Support Program

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 23 September 2022)

Currency unit	–	lari (GEL)
GEL1.00	=	$0.3519
$1.00	=	GEL2.8413

ABBREVIATIONS

ADB	–	Asian Development Bank
COVID-19	–	coronavirus disease
CWRD	–	Central and West Asia Department
EU	–	European Union
GDP	–	gross domestic product
GSE	–	Georgian Stock Exchange
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
NBG	–	National Bank of Georgia
OP	–	operational priority
PBL	–	policy-based loan
PEFA	–	public expenditure and financial accountability
PSOD	–	Private Sector Operations Department
QFA	–	quasi-fiscal activity
SDG	–	Sustainable Development Goal
SOE	–	state-owned enterprise
TA	–	technical assistance

NOTE

In this report, “$” refers to United States dollars.

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PROGRAM AT A GLANCE

1. Basic Data

Project Number: 54271-002

Project Name	Fiscal Resilience and Social Protection Support Program (Subprogram 2)	**Department/Division**	CWRD/CWPF
Country	Georgia	**Executing Agency**	Ministry of Finance
Borrower	Georgia		
Country Economic Indicators	https://www.adb.org/Documents/LinkedDocs/?id=54271-002-CEI		
Portfolio at a Glance	https://www.adb.org/Documents/LinkedDocs/?id=54271-002-PortAtaGlance		

2. Sector

Sector	Subsector(s)	ADB Financing ($ million)
✓ **Public sector management**	Public expenditure and fiscal management	43.00
	Reforms of state owned enterprises	23.00
Finance	Finance sector development	17.00
	Money and capital markets	17.00
	Total	**100.00**

3. Operational Priorities

- ✓ OP1: Addressing remaining poverty and reducing inequalities
- ✓ OP2: Accelerating progress in gender equality
- ✓ OP3: Tackling climate change, building climate and disaster resilience, and enhancing environmental sustainability
- ✓ OP6: Strengthening governance and institutional capacity

Climate Change Information

GHG reductions (tons per annum)	0
Climate Change impact on the Project	Low

ADB Financing

Adaptation ($ million)	14.61
Mitigation ($ million)	2.08

Cofinancing

Adaptation ($ million)	0.00
Mitigation ($ million)	0.00

Sustainable Development Goals

SDG 1.1, 1.5
SDG 5.5
SDG 8.10
SDG 9.1
SDG 10.4
SDG 12.6
SDG 13.a
SDG 16.6
SDG 17.1, 17.3, 17.4

Gender Equity and Mainstreaming

Some gender elements (SGE) ✓

Poverty Targeting

General Intervention on Poverty ✓

4. Risk Categorization: Complex

5. Safeguard Categorization

Environment: C **Involuntary Resettlement:** C **Indigenous Peoples:** C

6. Financing

Modality and Sources	Amount ($ million)
ADB	**100.00**
Sovereign Programmatic Approach Policy-Based Lending (Regular Loan): Ordinary capital resources	100.00
Cofinancing	**0.00**
None	0.00
Counterpart	**0.00**
None	0.00
Total	**100.00**

Currency of ADB Financing: Euro

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan (PBL) to Georgia for subprogram 2 of the Fiscal Resilience and Social Protection Support Program.[1]

2. The program aims to strengthen Georgia's fiscal resilience to shocks, addressing institutional fragilities in fiscal management and social protection. Subprogram 2 deepens and completes reforms initiated in subprogram 1, supporting Georgia's economic recovery from the coronavirus disease (COVID-19) crisis amid a context of heightened regional and global economic uncertainty. Prior actions included in subprogram 2 (i) improve institutional capacity for management of fiscal risks stemming from disasters triggered by natural hazards and climate change, and state-owned enterprises (SOEs); (ii) deepen domestic debt markets for government securities and capital market development to mitigate exposure to currency and refinancing risks; and (iii) strengthen adequacy and fiscal sustainability of social protection programs to protect the livelihoods of Georgia's aging population.

II. PROGRAM AND RATIONALE

A. Background and Development Constraints

3. **Georgia's V-shaped recovery.** Georgia's sound policy response to the COVID-19 crisis generated a robust economic recovery in 2021.[2] Gross domestic product (GDP) growth rebounded sharply from –6.8% in 2020 to 10.4% in 2021.[3] Similarly, the share of people living below the national poverty rate—which increased from 19.5% in 2019 to 21.3% in 2020—reached a historic low of 17.5% in 2021.[4] Initial concerns about potential spillovers from the Russian invasion of Ukraine have not materialized and did not alter the economic outlook for 2022.[5] Instead, economic performance is expected to remain robust on account of an increased influx of migrants from the Russian Federation and strong growth in remittances and exports.[6] Improved external inflows are expected to narrow the current account deficit to 7.5% of GDP in 2022, down from 10.1% in 2021.[7] GDP is forecast to grow by 7% in 2022 (footnote 3).

4. **Sound macroeconomic management and positive outlook**. Countercyclical fiscal expenditure to mitigate the impact of the COVID-19 pandemic in 2020 resulted in a breach of the

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[1] The programmatic approach and subprogram 1 were approved on 29 October 2020. Asian Development Bank (ADB). 2020. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 to Georgia for the Fiscal Resilience and Social Protection Support Program*. Manila.

[2] ADB. 2022. *Asian Development Outlook: Mobilizing Taxes for Development*. Manila.

[3] ADB. 2022. *Asian Development Outlook Update: Entrepreneurship in the Digital Age*. Manila.

[4] Geostat. Poverty and Gini Coefficients (accessed 19 June 2022).

[5] In 2021, the Russian Federation and Ukraine together accounted for 22.0% of exports, 21.0% of remittances, and 25.4% of tourism inflows. Weaker export demand and lower remittances and tourism revenues were initially expected to hurt growth and widen the current account deficit. However, following the Russian invasion of Ukraine, remittances and tourism revenues have increased, while increased income from higher commodity prices largely offsets the downside effect of higher fuel prices. International Monetary Fund (IMF). 2022. *Request for a Stand-By Arrangement; Staff Report; And Statement by the Executive Director for Georgia*. Washington, DC.

[6] During the first half of 2022, remittances increased by 65.0% year-on-year and are forecast to grow by 35.0% in 2022. Goods exports grew by 35.6% year-on-year between January and June 2022 and total exports are expected to grow by at least 20% in 2022.

[7] The current account deficit is expected to widen slightly in nominal terms but is forecast to decline slightly in relation to GDP, from 10.1% in 2021 to an expected 7.5% in 2022. ADB. 2022. *Asian Development Outlook Update: Entrepreneurship in the Digital Age*. Manila.

fiscal rules for the fiscal deficit and public debt.[8] In compliance with the Economic Liberty Act, 2011, the government adopted a credible fiscal adjustment plan to ensure compliance with the fiscal rule by 2023. After peaking at the fiscal rule limit of 60% of GDP in 2020, public debt dropped to 49.4% in 2021 and is expected to decline further to 39.6% of GDP in 2022.[9] The fiscal deficit declined during 2020–2021 (from 9.3% to 6.3% of GDP) and is expected to remain slightly above the 3% threshold in 2022 (at 3.1% of GDP) before dropping to 2.7% of GDP in 2023.[10] Annual average inflation is expected to increase to 11% in 2022 from 9.6% in 2021, above the 3.0% target of the National Bank of Georgia (NBG) (footnote 3). In response to inflationary pressures driven by global food and energy inflation, the NBG is expected to maintain a tight monetary policy for the remainder of 2022. Georgia's macroeconomic outlook is stable and expected to sustain robust and inclusive economic growth, underpinned by strong institutions, credible fiscal and monetary policies, sustainable debt levels, and proven commitment to structural reforms (footnote 5).

5. **Downside risks to the outlook are significant.** Negative spillover effects from the Russian invasion of Ukraine and sanctions against Russian Federation were broadly compensated by strong remittances, increased business activity and investment, and higher trade turnover that resulted from the diversification of transport routes and destination markets for cargo. However, prolonged instability and additional sanctions may yet dampen the economic outlook, pressuring Georgia's external balance and its currency, and giving rise to inflationary pressures, particularly on food and energy. This could result in higher expenditures to protect vulnerable households from inflationary pressures. Moreover, pandemic-related risks remain a threat to economic recovery as vaccine hesitancy and difficulties in reaching rural regions have slowed vaccination progress.[11] A rapid increase in hospitalizations could place pressure on the health care system and result in additional health care spending.[12] Renewed lockdowns could disrupt supply chains and trigger capital outflows, and depreciation of the lari and resulting inflationary pressure. Finally, monetary policy surprises—in the form of unexpected rate hikes by systemically important central banks, driven by expectations of entrenched inflation—could trigger capital flight and currency depreciation pressures, and result in higher debt-servicing costs and higher inflation.[13] While domestic monetary policy tightening in response to rising prices has not yet hindered growth, medium-term inflationary pressures could increase, driving additional rate hikes by the NBG.

6. The downside risks to Georgia's economic recovery are magnified by longstanding institutional fragilities in fiscal management and social protection, including (i) exposure to fiscal risks stemming from SOEs and disasters triggered by natural hazards and climate change; (ii) exposure to currency and refinancing risks stemming from excessive reliance on external debt; and (iii) exposure to demographic risk stemming from a fiscally unsustainable pension system. These institutional gaps compound the potential impact of external shocks on macroeconomic stability and threaten the livelihoods of the most vulnerable segments of the population.

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[8] The Economic Liberty Act, adopted in 2011 and effective since 2014, established numerical upper limits for general government debt (60% of GDP) and the budget balance (3% of GDP).

[9] The expected public debt-to-GDP ratio for 2022 has been revised to 39.6% from an original estimate of 51.1% of GDP as a result of better-than-expected economic performance and appreciation of the lari.

[10] Higher-than-expected tax revenue collection in the first half of 2022 is expected to narrow the fiscal deficit to 3.1% against an original estimate of 4% in 2022.

[11] As of 13 September 2022, only 34.2% of Georgia's population is fully immunized. Data available on: https://ourworldindata.org/covid-vaccinations (accessed 13 September 2022).

[12] In the 2022 budget, the authorities allocated 0.8% of GDP towards COVID-19-related health care spending, compared with 2.1% of GDP in 2021.

[13] IMF. 2021. *World Economic Outlook: Managing Divergent Recoveries*. Washington, DC.

7. **Exposure to specific fiscal risks stemming from state-owned enterprises.** Weak financial performance by SOEs can translate into high fiscal costs. The materialization of explicit and implicit contingent liabilities stemming from SOEs leads to unplanned fiscal transfers that can hinder fiscal adjustment efforts and disrupt macroeconomic stability. While the authorities have taken important steps to improve disclosure of contingent liabilities stemming from SOEs in the annual Fiscal Risk Statement, Georgia's large SOE sector remains a net draw on the budget and a significant source of fiscal risks.[14] During 2014–2020, net fiscal transfers to SOEs totaled GEL2.8 billion, or 5.6% of GDP. At the same time, the share of SOE equity capital owned by the government—equivalent to 16.4% of GDP in 2020—generated little or no return. The authorities remain unable to impose credible hard budget constraints on these SOEs, and soft budget constraints generate significant fiscal risks, including (i) preferential access of SOEs to financing and inadequate financial oversight, (ii) unfunded quasi-fiscal activities (QFAs), and (iii) weak SOE corporate governance. These sources of fiscal risk are largely concentrated within the group of seven major SOEs (para. 21), which account for more than 50.0% of annual turnover of SOEs and 67.8% of losses suffered by SOEs in 2020.[15]

8. **Preferential access to financing: overleveraging and currency risk.** The Ministry of Finance (MOF) has limited oversight over SOEs' access to debt financing. Limited restrictions in access to onlending at the government's cost of borrowing provide SOEs with a competitive advantage over private counterparts and reduces incentives for financial discipline. By the end of 2020, outstanding nonmarket debt held by Georgia's seven largest SOEs totaled GEL2.7 billion, or 5.4% of GDP, 98.7% of which was denominated in foreign currency. Including market debt, the debt held by these seven SOEs amounts to GEL4.6 billion, or 8.1% of GDP, entirely denominated in foreign currency. This implies significant exposure to currency risk by the government. A 30% depreciation in the lari from its December 2021 value would result in additional fiscal transfers of GEL3.06 billion, or 5.0% of GDP.[16] Limited restrictions in access to debt financing at preferential terms with no added margin to align with market pricing, reduce incentives for efficiency and financial discipline by these SOEs and has contributed to excessive recourse to debt. During 2014–2020, the aggregate debt-to-equity ratio of these SOEs increased from 100% to 381%. Undercapitalized and highly exposed to currency risk, these SOEs are expected to continue to incur foreign exchange losses, and to potentially seek restructuring by debt write-offs or equity injections from the general government budget.

9. **Unaccounted and unfunded quasi-fiscal activities**. Unfunded noncommercial service obligations by SOEs contribute towards poor financial performance.[17] Currently, explicit QFAs are selectively reported in the MOF's Fiscal Risk Statement. However, the absence of a formal mechanism that ensures comprehensive identification and quantification of QFAs—both explicit and implicit—masks the full significance of QFAs on SOEs' financial performance and ultimately

[14] Georgia has 364 SOEs, which are classified as either public corporations (52) or general government units, to be compliant with the IMF's Government's Finance Statistics Manual 2014 (294). IMF. 2021. *Georgia: Technical Assistance Report: Draft Public Corporation Strategy*. Washington, DC.

[15] These are (i) JSC Georgia State Electrosystem, (ii) LLC Enguri HES, (iii) JSC Georgia Oil and Gas Corporation, (iv) JSC Georgia Railways, (v) LLC Georgia Gas Transportation Company, (vi) LLC Georgia Airport Union, and (vii) LLC Georgian United Water Company. During 2014–2020, these SOEs experienced declines in return on equity (from 4% to –29%), return on assets (from 2% to –6%), and the current ratio (from 200% to 69%), while the debt-to-equity ratio increased from 100% to 381%.

[16] The average debt to total assets of the SOEs (listed in footnote 15) would increase by more than 35 percentage points. Government of Georgia. *Fiscal Risk Statement 2021*. Tbilisi.

[17] Explicit QFAs include the provision of free electricity to the territory of Abkhazia by LLC Enguri HES, and the subsidizing of passenger transportation costs from revenue generated from cargo turnover by Georgian Railway. In the absence of QFAs, both SOEs would have run profits instead of losses in 2019 and 2020. Together, these two SOEs comprise 20% of total turnover of all SOEs.

as sources of fiscal risk. Further, the absence of a QFA framework hinders assessment by the authorities on whether a chosen policy objective can be achieved more cost-effectively.

10. **Weak corporate governance and performance**. Georgia's legal and regulatory framework does not mandate the establishment of independent supervisory boards for SOEs. As a result, only 32 out of 346 SOEs have supervisory boards. Among these, few enjoy limited autonomy to independently carry out strategic oversight over the company and perform key roles, including the approval of strategy and capital expenditure, and managerial appointments, and ensuring the integrity of financial and risk management systems. Women are underrepresented on the boards- out of 132 members, only 18 are female. The absence of key corporate governance standards that empower boards to manage SOEs in accordance with a clear commercial mandate undermines financial discipline, accountability, and transparency, and ultimately contributes to financial underperformance and increased exposure to fiscal risks.

11. **Fiscal risks stemming from climate change and natural hazards**. Climate change poses a significant threat to fiscal stability in Georgia.[18] By the 2090s, the average temperature in Georgia is projected to increase by 1.4°C to 4.9°C above the 1986–2005 baseline.[19] An increasing average temperature is expected to result in more frequent heat waves and droughts; a rapid retreat of glaciers, thereby impacting hydropower generation; and more volatile precipitation patterns, resulting in more frequent floods.[20] The macroeconomic and fiscal impact of climate change is expected to be significant but remains unaccounted for. The direct fiscal cost of increased natural hazard frequency is compounded by other climate change related risks stemming from at-risk infrastructure, long-run power contracts, guarantees, and loans to SOEs that may be affected by changing weather patterns.[21] Without structural reforms to accommodate climate risk into public financial management, climate change in Georgia could increase public debt to 111% of GDP by 2069 and reduce GDP per capita by 13% by 2090 (footnote 21).

12. **Exposure to currency and refinancing risks.** Domestic debt markets in Georgia are insufficiently liquid to provide backing as a reliable source to raise funding for public expenditure. Despite efforts to reduce reliance on foreign borrowing, 80.5% of government debt was denominated in foreign currency in 2021, equal to 39.8% of GDP. High levels of external government debt increase public exposure to currency and refinancing risks, heighten vulnerability to external shocks, and limit the effectiveness of fiscal and monetary policies in mitigating the effect of such shocks.

13. **Shallow and underdeveloped capital market.** Georgia's capital markets remain shallow and underdeveloped and do not play a significant role in financial intermediation. The equity market is thin and illiquid, with only eight listed companies on the Georgia Stock Exchange. Market capitalization was equal to just 4.0% of GDP as of May 2022.[22] Annual turnover of shares is almost non-existent, and the overall investor base is limited. Although the size of the domestic nongovernment bond market in local currency has increased, it is dominated by international financial institutions. Institutional investors such as insurance companies and asset management

[18] Government of Georgia, Ministry of Environmental Protection and Agriculture. 2021. *Fourth National Communication of Georgia Under the United Nations Framework Convention on Climate Change*. Tbilisi.
[19] ADB and World Bank Group. 2021. *Climate Risk Country Profile: Georgia.*
[20] Hydropower plants provided 73.9% of Georgia's electricity, with natural gas combustion generating 25.2% and wind power generating about 1% in 2019. International Energy Agency. 2022. *Georgia Energy Profile*. Paris.
[21] IMF. 2022. *Technical Assistance Report: Updating the Balance Sheet and Quantifying Fiscal Risks from Climate Change.* Washington, DC.
[22] Georgian Stock Exchange: About GSE.

companies have a very limited impact in the capital markets because of the limited variety of financial instruments that serve their investment needs. [23]

14. **Small and illiquid markets for government debt**. The market for government debt is impaired by a small pool of available government bonds with limited volumes. While there is a regular primary issuance calendar, secondary trading is very limited. Auctions of debt securities through 5-year maturity occur regularly but issue sizes can be as small as GEL15 million. The government began issuing benchmark bonds in 2018 but the outstanding stock remains small at the right tenors, and total amounts are still insufficient to effectively liquid tenors, reduce liquidity risk, and support secondary trading. The primary dealership pilot system, introduced under subprogram 1, helped support activity in the primary and secondary markets for government securities, but its impact is limited by the relatively small stock of government bonds outstanding and the fact that only one bond issue (the 5-year government bond) is included as part of the primary dealership pilot system.

15. **The fiscal impact of population aging.** Georgia's population is aging rapidly: the share of its population aged 65 years and above is projected to grow from 14.2% in 2010 to 21.1% in 2030. [24] The country's old-age dependency ratio is expected to increase from 25.9 in 2015 (four working age adults per older adult) to 55.9 in 2060 (two working age adults per older adult).[25] At the same time, the share of the population eligible for universal pensions is set to increase from 21.2% in 2021 to 27.6% in 2040, raising pension expenditures to more than 10% of GDP. Maintaining the real value of universal pension payouts would increase the primary deficit by between 1.9% and 3.3% of GDP by 2069 and could lead to government debt increasing to between 88.0% and 122% of GDP in the same period. Georgia's savings rate is relatively low compared with the world average, which suggests low financial self-reliance among future retirees and high dependence on universal pensions and the income of working adults.[26]

16. **Completing operationalization of an occupational defined contribution pension scheme (pillar II scheme).** The pillar II pension scheme established under subprogram 1 creates an additional source of old-age income for workers.[27] While the pillar II scheme has largely been implemented, operational weaknesses remain. First, according to estimates carried out by the Pension Agency, there may be a GEL200 million shortfall in contributions since inception of the scheme, and as many as 40,000 employees remain unregistered. The estimated shortfall amount represents about 18% of all contributions made. The absence of an enforcement mechanism could result in an increase in under-contributions, diminishing the volume of potential pension assets in the future. Second, the investable options available to the Pension Agency, which accumulates assets at an average rate of GEL65 million per month, are very limited. Total assets under management amount to about GEL2.4 billion. Investment limits on foreign currency exposure and the limited size and liquidity of the domestic investment universe push the scheme to invest predominantly in Georgian certificates of deposit, term deposits, and current accounts which, while beneficial in supporting the liquidity of the domestic banking system, do not serve the best interest of participants.

[23] IMF and World Bank. 2021. *Georgia Financial Sector Assessment*. Washington, DC (December).
[24] United Nations Population Fund. 2017. *Ageing and Older Persons in Georgia*. Tbilisi.
[25] Government of Georgia, Ministry of Economy and Sustainable Development. 2016. *Reform of the Universal Pension Benefit and Introduction of a Supplementary Pension Scheme*. Tbilisi.
[26] Georgia's gross national savings in 2021 was low (totaling 12.1% of GDP, up slightly from 11.5% in 2020) compared with the world average of about 22%. World Bank. *Gross National Savings* (accessed 19 July 2022)
[27] Supplementary Note on Pension Reform (accessible from the list of linked documents in Appendix 2).

17. **Additional pension savings for Georgia's working population.** The universal and the pillar II mandatory pension schemes combined are projected to replace about 37% of pre-retirement wages for an average wage earner having at least a 35-year employment history. Most workers need to accumulate additional pension assets to ensure an adequate income in old-age. The absence of a legal framework that incentivizes accumulation of additional voluntary savings magnifies the fiscal risks associated with inadequate old-age income for retirees.

18. **Alignment with national development plans and ADB's priorities.** The program is aligned with the overarching development objective of Georgia's Government Program for 2021–2024: inclusive economic recovery from the COVID-19 crisis achieved, underpinned by macroeconomic stability.[28] The program is also in line with the Asian Development Bank (ADB) country partnership strategy for Georgia, 2019–2023 and the Sustainable Development Goals (SDGs).[29] The SDGs supported by the program include (i) building the resilience of the poor and those in vulnerable situations and reducing their exposure and vulnerability to disasters triggered by natural hazards and other economic, social, and environmental shocks and disasters (SDG 1.5); (ii) promoting gender equality (SDG 5.C); (iii) extending social protection systems and floors (SDG 1.3); and (iv) sustaining per capita economic growth (SDG 8.A). Finally, subprogram 2 links to four of ADB's Strategy 2030 operational priorities (OPs): (i) OP1: addressing remaining poverty and reducing inequalities (through support for pension reform, which is expected to lead to a higher replacement rate of pensions and mitigate old-age poverty); (ii) OP2: accelerating progress in gender equality (through gender-sensitive targets integrated into the prior actions); (iii) OP3: tackling climate change, building climate and disaster resilience, and enhancing environmental sustainability (through support to public and fiscal risk management functions); and (iv) OP6: strengthening governance and institutional capacity.[30]

B. Policy Reform, ADB's Value Addition, and Sustainability

19. **Reform accomplishments and revisions.** During the processing of subprogram 2, ADB and the authorities agreed to revise prior actions proposed during approval of subprogram 1 to better reflect the implementation process:[31]

- (i) Prior action 8 on supporting the adoption of a strategy to develop retail participation on government bond markets, was deferred to a post-program partnership framework introduced in subprogram 2. This will ensure that the authorities undertake a comprehensive assessment of new cost-effective financial technology options being used by other countries that offer simpler, cheaper, and more flexible options.
- (ii) A new prior action has been introduced, supporting revision of the Law of Georgia on Funded Pensions to reduce concentration limits of the pillar II pension scheme and enhance its participation in local capital markets as an institutional investor.
- (iii) Five indicative prior actions (1, 2, 6, 7, and 12) have been strengthened with additional sub-actions to reflect the process of implementation more accurately and better capture development impact.

All prior actions in subprogram 2 have been completed.

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[28] Government of Georgia. 2021. *Government Program for 2021–2024: Toward Building a European State*. Tbilisi.

[29] ADB. 2019. *Country Partnership Strategy: Georgia, 2019–2023—Developing Caucasus's Gateway to the World*. Manila.

[30] ADB. 2018. *Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific*. Manila.

[31] Supplementary Note on Revisions in the Policy Matrix (accessible from the list of linked documents in Appendix 2).

20. **Reform area 1: Management of public exposure to fiscal risks is strengthened.** The objective of this reform area is to strengthen management of public exposure to specific fiscal risks, reducing vulnerability to unplanned fiscal transfers and strengthening credibility of the medium-term fiscal framework. Subprogram 1 supported the establishment of a dedicated fiscal risk unit responsible for identification and disclosure of fiscal risks stemming from SOEs and public–private partnerships. Subprogram 2 builds on the achievements of subprogram 1 and further strengthens institutional capacity for efficient management of fiscal risks stemming from (i) disasters triggered by natural hazards and climate change, and (ii) SOEs.

21. To strengthen financial oversight over SOEs, the authorities approved a government decree requiring seven SOEs (footnote 16) to obtain MOF approval for any investments or debt above GEL5 million (or 1% of the value of the enterprise assets, whichever is less).[32] The government decree also mandates that supervisory boards of SOEs adopt MOF-approved statements of corporate intent that (i) identify clear and quantifiable financial and nonfinancial key performance indicators; (ii) establish risk limits for each SOE; (iii) identify QFAs carried out by the SOE; and (iv) propose a formal mechanism to account for and fund QFAs, including noncommercial service obligations. These prior actions will strengthen financial oversight of SOEs through increased financial controls and adequate monitoring of financial performance.[33] In turn, increased financial oversight mitigates fiscal risks stemming from privileged access to finance by SOEs and unaccounted and unfunded QFAs.[34] To address fiscal risks stemming from weak corporate governance of SOEs, the authorities approved a Corporate Governance Code that defines key principles of corporate governance, including merit-based appointments of independent supervisory board members by all public corporations (at least 25% of supervisory board members should be women).[35] This prior action mitigates public exposure to fiscal risks stemming from weak corporate governance practices in SOEs that leads to poor financial performance. Increasing the transparency and financial sustainability of enterprises will also play an important role in their integration into the capital market.

22. **Addressing climate risk.** To support integration of climate risk into public financial management systems, the MOF expanded the scope of the Fiscal Risk Statement to include a quantification of fiscal risks related to climate change. Credible estimates of how climate change will affect debt sustainability, sovereign creditworthiness, and public finances in the medium term are essential to inform the formulation of evidence-based fiscal policies for climate action.[36]

23. **Reform area 2: Domestic debt markets for government securities and capital markets deepened.** The objective of this reform area is to strengthen macroeconomic resilience to downside shocks by reducing exposure to currency and refinancing risks associated with high external debt. To deepen local capital markets, subprogram 1 supported an increase in the net issuance of benchmark securities, the establishment of a primary dealership pilot system, the mandated publication of an annual medium-term debt strategy, and the approval of an investment funds law. Subprogram 2 builds on these reform objectives and deepens the domestic market for government securities anchored on a time-bound road map for capital market development. Subprogram 2 supports an increase in net issuance of domestic debt, to raise the tradeable supply

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[32] In 2021 the major SOEs collectively held 99.4% of onlending by the MOF, equivalent to 4.5% of GDP, and represented more than 50% of total net worth of all SOEs.

[33] IMF. 2016. *How to Improve the Financial Oversight of Public Corporations*. Washington, DC.

[34] IMF. 2020. *Managing Fiscal Risks From State Owned Enterprises*. Washington, DC.

[35] These include shareholder rights; supervisory board membership; independence criteria and merit-based selection procedures; roles and responsibilities of the board, its committees, and executives; internal control systems for risk management; and principles of transparency and accountability.

[36] M. Catalano; L. Forni; and E. Pezzolla. 2019. *Climate Change Adaptation: The Role of Fiscal Policy*.

of bonds during 2022–2025 from GEL1.2 billion to GEL1.4 billion. Domestic debt stock in this period is expected to increase from 9.8% to 12.3% of GDP, and external debt is expected to decline from 29.8% to 25.4% of GDP.[37]

24. In addition to expanded issuance, subprogram 2 supports the introduction of a new tenor to the primary dealer system to provide an opportunity for better price discovery and support relative value trading opportunities that are expected to increase bond market activity. By increasing net issuances in local currency and promoting activity in the primary and secondary markets for government debt, the authorities expect to increase liquidity and predictability in the market and create an enabling environment for capital market development. To further develop domestic capital markets, the authorities developed a time-bound Capital Market Development Strategy for 2022–2028, providing market participants with strategic clarity as to the vision and objectives for capital markets. To enhance the local bond market, subprogram 2 supports the approval of a legal framework for securitizations and covered bonds. Together, these laws will create new classes of debt instruments, provide more tradeable investments for market participants, facilitate access to new participants—corporate and others—to the financial market, and allow banks and other underlying asset providers to free up idle capital.

25. The development of capital markets helps reduce exposure to the volatility of capital flows and currency and refinancing risks associated with high levels of foreign currency debt. In the medium term, deeper local capital markets help secure a stable source of funding during normal times and increase efficiency of monetary and fiscal countercyclical policies in times of crisis, strengthening economic resilience against shocks.[38] Better capital market infrastructure will also help deepen the secondary market for government securities, making additional lari-denominated financial resources available to market participants, including the public sector. This will minimize public exposure to refinancing and currency risk.

26. **Reform area 3: Adequacy and fiscal sustainability of social protection programs strengthened.** The overall objective of this reform is to increase the wage replacement rate of pensioners in a fiscally sustainable manner. Under subprogram 1, the authorities indexed increases in the universal pension scheme and established the foundations for operationalization of the pillar II pension scheme. Under subprogram 2, the government completed the pension reform by fully operationalizing the pillar II pension scheme and approving the legal framework for voluntary private pensions (pillar III).

27. To increase compliance in the mandatory funded pension scheme, the Revenue Authority and the Pension Agency signed a memorandum of understanding delineating roles and responsibilities in the enforcement of mandatory pension contributions by all registered employers. This prior action will limit non- and under-contributions by participants, ensuring compliance with the Georgian Law on Funded Pensions.

28. To expand the investment options available to pillar II pension participants and enhance the participation of the scheme in the domestic capital markets as an institutional investor, the Pension Agency adopted a long-term investment policy. The investment policy commits to a 2% positive real return under a low-risk investment portfolio. The investment policy also incorporates a responsible investment framework that commits the Pension Agency to integrating environmental, social, and governance factors into the evaluation and management of public

[37] Government of Georgia. 2021 . *Medium-Term Debt Strategy 2022-2025*. Tbilisi.
[38] G. Abuselidze. 2018. Georgia's Capital Market: Functioning problems and development directions in association with European Union. *Journal of Applied Economic Sciences* 13(7): pp. 1929–1938.

investment objectives, provided they enhance long-term financial performance. To enable the Pension Agency to offer a wider range of investment portfolios to participants based on varying risk appetites, the government amended the Georgian Law on Funded Pensions to relax the scheme's concentration limits. This prior action is expected to double the investable universe available to the pension scheme, encouraging new debt issuance by local corporations and supporting capital market development.

29. To encourage Georgian workers to accumulate additional voluntary savings to generate a third source of old-age income, the program supports the adoption of a legal framework that provides a flexible, secure, and transparent structure under robust supervision to accommodate voluntary occupational and individual pension savings on defined contribution principles (pillar III). It allows different groups and individuals to make individualized choices balancing current consumption and savings for old-age needs based on their own circumstances, while allowing portability between various pension scheme providers. It ensures transparency of reporting and disclosure standards, and sound accounting and reporting requirements consistent with international standards that are vital to raise confidence in supplementary pension schemes.

30. **Sustainability and post-program partnership framework**. The post-program partnership framework introduced in subprogram 2 reflects the government's commitment to sustaining accomplishments in all three reform areas. The measures to ensure sustainability include (i) developing a road map for integration of climate risk within the medium-term expenditure framework to inform budget planning and public investment management;[39] (ii) supporting reforms that enable public listing of key public corporations to support capital market development; (iii) approving the legal and regulatory framework for issuance of other bond types to diversify the product mix, promote investor interest, and deepen the yield curve structure; (iv) assessing the impact of equalization of retirement age on gender disparities; and (v) developing a public relations campaign to raise awareness on the potential need for additional savings under the pillar III framework. The measures may lead to a new program to support reform of specific SOEs and capital market development.

31. **One ADB approach**. Staff from ADB's Private Sector Operations Department (PSOD) and the Central and West Asia Department (CWRD) collaborate closely to promote sustainable finance in Georgia. In subprogram 2, PSOD and CWRD promoted the inclusion of a framework for green and gender bond issuance in the Capital Market Development Strategy for 2022-2028 which were complemented by two non-sovereign operations by PSOD: (i) issuance of a green bond in compliance with the International Capital Market Association's Green Bond Principles in the Georgian Stock Exchange (GSE); and (ii) a gender bond in compliance with the International Capital Market Association's Social Bonds Principles in the GSE.[40] The proposed green bond transaction will be the first green bond and the largest debt security to be listed in the GSE as part of ADB's market development efforts. The gender bond transaction will be the first of its kind in Central and West Asia and one of the first few in an ADB developing member country. Additionally, PSOD and CWRD coordinated in the design of a policy action supporting revision of the concentration limits to pension schemes managed by the Pension Agency, allowing it to play a more prominent role in local capital market development.

32. **ADB's past engagement**. ADB has been a long-term key partner for fiscal management and social protection in Georgia, providing programmatic lending and technical assistance (TA).

[39] Government of Georgia, Ministry of Environment and Natural Resources Protection. 2017. *Georgia's Nationally Determined Contribution to the United Nations Framework Convention on Climate Change.* Tbilisi.
[40] International Capital Markets Association. 2021. *Voluntary Process Guidelines for Issuing Social Bonds*. Zurich.

ADB approved the Emergency Assistance for Post-Conflict Recovery in 2008,[41] and the Growth Recovery Support Program in 2009.[42] These programs supported the design of fiscal measures aimed at addressing the economic and social impact of the global financial crisis, compounded by the armed conflict with Russian Federation in August 2008. To strengthen social services and social protection in the aftermath of the 2008 war, ADB approved the Social Services Delivery Program in 2010, supporting increased efficiency in the management of public resources for social service delivery.[43] In 2014–2016, to sustain the thrust of reforms to fiscal management and social protection, ADB approved the Domestic Resource Mobilization Program that strengthened the institutional and legal framework for effective debt management—centralizing debt management functions—and supported the approval of a reform plan for the pension system.[44] The COVID-19 Active Response and Expenditure Support Program, approved in 2020, supported the government in implementing its response package to protect the lives and livelihoods of Georgians, especially the poor and vulnerable segments of the population, including the elderly, through additional pension support.[45]

33. **ADB's value addition.** ADB's long-term engagement and structured policy dialogue with the government helped prioritize and strengthen policy reforms. For reform area 1, ADB's sector expertise and ongoing programmatic engagement with specific SOEs provided a strong knowledge base to inform reforms aimed at reducing exposure to fiscal risks stemming from SOEs.[46] Through TA, ADB supported the drafting of the annual fiscal risk statements and provided policy advice guiding SOE reform.[47] For reform area 2, familiarity with the investor base gained through ADB's Private Sector Operations Department provided crucial insights used in the design of reforms that support capital market development. ADB's TA for Strengthening Domestic Resource Mobilization supported the drafting of the strategy for capital market development securitization and covered bonds laws.[48] Finally, ADB's leading role as provider of TA to pension reform since inception of the reform process in 2014—reform area 3—placed ADB in a unique position to steer the direction of the pension reform completed under this program (footnote 48). ADB's financial support will help the government bridge its financing gap for 2022 at less onerous terms than it would otherwise be able to achieve, thus contributing to debt sustainability in the long term. The financing support provided under the program is complemented by other ADB

[41] ADB. 2008. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Georgia for Emergency Assistance for Post-Conflict Recovery*. Manila.
[42] ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loans to Georgia for the Growth Recovery Support Program*. Manila.
[43] ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Georgia for the Social Services Delivery Program*. Manila.
[44] ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy Based Loans for Subprogram 1 to Georgia for Improving Domestic Resource Mobilization for Inclusive Growth Program*. Manila.
[45] ADB. 2020. *Report and Recommendation of the President to the Board of Directors: Proposed Countercyclical Support Facility to Georgia for COVID-19 Active Response and Expenditure Support Program*. Manila.
[46] Reforms to Joint-Stock Company Georgian State Electric are supported under ADB. 2021. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Loan to Georgia for Electricity Transmission Sector Reforms Program.* Manila; Reforms of United Water Supply Company are supported by ADB under ADB. 2020. *Report and Recommendation of the President to the Board of Directors: Proposed Loans and Administration of Technical Assistance Grant to Georgia for the Sustainable Water Supply and Sanitation Sector Development Program.* Manila. Reforms to Georgia Amelioration are supported under ADB. 2020. *Technical Assistance to Georgia for Preparing the Water and Resources Sector Development Program.* Manila. Support to reform of Georgia Airport Union is provided under ADB. 2020. *Small Scale Technical Assistance to Georgia for the Georgia Airport Sector Assessment*. Manila.
[47] ADB. 2018. *Technical Assistance to Georgia for Preparing the Second Domestic Resource Mobilization Program.* Manila.
[48] ADB. 2014. *Technical Assistance to Georgia for Strengthening Domestic Resource Mobilization*. Manila.

sector development loans and PBLs, which together contribute to 12.5% of Georgia's financing gap for 2022.

34. **Lessons.** ADB's experience provided three key lessons that have been incorporated into subprogram 2. First, politically sensitive policy reforms such as the SOE reform require strong and common positioning among key development partners. The adoption of a complementary and well-coordinated agenda between ADB, the International Monetary Fund (IMF), and the World Bank was critical to ensure the momentum of this reform. Second, reforms that require significant interagency coordination within the government, such as the introduction of voluntary private pensions, require active mediation by a trusted third party such as ADB to ensure convergence of perspectives. Third, reforms aimed at developing local capital and money markets require regular interaction between the authorities and market players. ADB has played an important convener role between the MOF and the investor base.[49] A programmatic approach for PBL, combined with TA, was deemed a suitable modality and approach because its flexibility enables prior actions to be adjusted to better reflect changing priorities, and allowed ADB to take advantage of windows of opportunity when these emerged.

35. **Coordination with development partners.** The program was prepared in close consultation with other development partners providing TA or engaged in policy dialogue with Georgia. On fiscal risk management, ADB coordinated closely with the IMF to ensure complementarity between the program and the IMF's Stand-By Arrangement, adopting a common strategy to strengthen the MOF's financial oversight over SOEs. Close coordination with the IMF on SOE reform allowed ADB to leverage its policy advice towards SOE reform. On public debt management and capital market development, ADB coordinated closely with the World Bank, the European Union (EU), the European Bank for Reconstruction and Development, and the United States Agency for International Development. Reforms to the pension system were coordinated with Agence Française de Développement, the EU, and the United Nations Development Programme. Coordination with the EU proved critical to ensure the proposed reforms are aligned with the vision of the Association Agreement signed between Georgia and the EU in 2014. ADB liaised with the IMF and the World Bank to ensure alignment of macroeconomic and fiscal assessments. Finally, ADB coordinated closely with all development partners providing budget support to Georgia in 2022 (Table 2) to ensure complementarity in the provision of budget support.[50]

C. Expected Outcome of the Reforms

36. The program is aligned with Georgia's overarching development objective: inclusive economic recovery from the COVID-19 crisis achieved, underpinned by macroeconomic stability (footnote 28). The program's outcome is effective management of risk exposure by the public sector and enhanced and fiscally responsible social protection of vulnerable people. The effectiveness of the transmission mechanism between the policy reforms and the proposed outcome is monitored through targeted outcome indicators.[51] Two of the program's three original outcome indicators have been achieved earlier than envisioned under subprogram 1. As of December 2021, the external government debt-to-GDP ratio had been contained below 40% of GDP (at 39.8%), and the percentage of employees registered in the contributory pension scheme has increased to 93% which is 13% above the initial target set under subprogram 1. These targets

[49] Independent Evaluation Department. 2018. *Validation Report: Improving Domestic Resource Mobilization for Inclusive Growth Program in Georgia.* Manila.
[50] ADB coordinated closely with the IMF on public debt management and fiscal risk management support, and with Agence Française de Développement, the European Union, and the World Bank on reforms to the pension system.
[51] Program Impact Assessment (accessible from the list of linked documents in Appendix 2).

have been revised upward, and additional outcome indicators to monitor the impact of prior actions were introduced in subprogram 2. The program is on track to achieve the remaining original outcome indicator included in subprogram 1 by 2023: domestic debt as a share of total government debt is expected to increase from the 2018 baseline of 18.7% to 24.8% in 2022 and surpass the 25% target by 2023.

D. Development Financing Needs and Budget Support

37. Based on the projected fiscal deficit, the government's development financing needs for 2022 are projected at $803 million, of which $386 million will be funded through foreign sources and the remainder through domestic sources. The loan amount is 12.5% of the projected development financing needs for 2022. Climate change mitigation is estimated at $2.08 million and climate adaptation at $14.61 million. The government holds significant liquidity in the form of deposits that are available to weather downside risks, if necessary. A Stand-By Arrangement agreed with the IMF in June 2022 provides additional assurances that the financing gap can be closed. ADB's budget support in 2022 will total $100 million, or 12.5% of the financing gap.

Table 1: Development Financing Needs and Budget Support ($ million)

Item	2022
Financing gap	803.0
Budget support (estimated as of June 2022)	386.0
Asian Development Bank	100.0
France (Agence Française de Développement)	160.0
International Monetary Fund	Not applicable
World Bank	126.0

PBL = policy-based loan.
Source: Asian Development Bank estimates.

38. The Government of Georgia has requested a regular loan of €100,190,000 ($100,000,000 equivalent)[52] from ADB's ordinary capital resources to help finance subprogram 2. The loan will have a 15-year term, including a grace period of 3 years; an interest rate determined in accordance with ADB's Flexible Loan Product; a commitment charge of 0.15% per year; and such other terms and conditions set forth in the draft loan agreement. Based on the straight-line method, the average maturity is 9.25 years, and the maturity premium payable to ADB is 0.10%.

E. Implementation Arrangements

39. The MOF will be the executing agency. The Ministry of Economy and Sustainable Development, the NBG, and the MOF are the primary implementing agencies. The implementation period is December 2020–November 2022[53] for subprogram 2.[54] The proceeds of the loan will be disbursed in accordance with ADB's *Loan Disbursement Handbook* (2017, as amended from time to time).

III. DUE DILIGENCE

40. **Poverty and gender.** Despite Georgia's high human development ranking and improved

[52] €1.001904 = $1.00 as of 19 September 2022.
[53] In subprogram 1, ADB estimated that the implementation period for subprogram 2 would be from October 2020 to October 2021. However, a political standstill following legislative elections in November 2020 significantly delayed implementation of many of the reforms envisioned in the program. Therefore, the implementation period was extended by 1 year at the government's request.
[54] List of Ineligible Items (accessible from the list of linked documents in Appendix 2).

living standards, inequalities persist, and poverty remains a key challenge. While the share of the population living below the national poverty line has declined from 26.2% in 2013 to 17.5% in 2021, absolute poverty rates declined slowly despite robust economic growth. During 2014–2020, the proportion of people living on less than $1.9 per day (2011 purchasing power parity) declined slightly from 4.9% to 4.2%, while the share of Georgians living on $3.2 per day or less (2011 purchasing power parity) declined marginally from 17.8% to 17.0%.

41. Women's economic participation remains a challenge in Georgia. During 2011–2021, the labor participation rate for men increased from 62% to 67% while the rate for women increased from 40% to 46%, pointing to significant differences in entering the labor market.[55] Gender differences in wages are also significant: women earn less than two-thirds of men's average monthly salaries. In 2020, the ratio of women's to men's wages was 67.6%, which is 3.8 percentage points higher than in 2019 (63.8%). Because of their significantly lower wages and higher longevity in an aging population, pension reform is necessary to mitigate old-age poverty and the disproportionate effects it would have on women. As of January 2022, 68% of people in retirement age are women, a figure that is likely to remain high. Pension reforms that provide new sources of retirement income to older adults will help address old-age poverty among women. While subprogram 1 was classified as *effective gender mainstreaming*, political instability during 2021 delayed some key reform initiatives which would have a very significant impact on gender. The program is classified as *some gender elements*.

42. **Safeguards**. The loan is categorized *C* for environment, involuntary resettlement, and indigenous peoples. A matrix of potential environmental and social impacts and measures for each prior action has been prepared and results show that the project will not cause involuntary resettlement and environmental impacts.[56] The policy actions have been assessed and these are not expected to have any direct or indirect environmental or involuntary resettlement impacts or impacts on indigenous peoples. Investment activities prohibited under ADB's Safeguard Policy Statement (2009) will be excluded.

43. **Governance**. Georgia's public financial management systems have improved significantly thanks to the implementation of the Public Financial Management Reform Strategy 2018–2021, that minimizes the risks associated with poor financial management of the program.[57] According to the most recent public expenditure and financial accountability (PEFA) assessment, Georgia has sound systems in place for strategic budget planning, execution, accounting, and reporting.[58] Notable improvements in fiscal discipline are reflected in (i) less variance of expenditure outturn from the budget, i.e., fewer administrative transfers of budgetary funds; (ii) robust execution rates for revenue; and (iii) stronger oversight of aggregate fiscal risk from SOEs and public–private partnerships, which the program supports. Georgia improved its strategic allocation of resources through its multiyear budgeting tool and the preparation of costed sector strategies. Finally, the use of resources for service delivery has become more efficient, with more effective payroll controls, internal audit, timelier and more regular reconciliation of accounts, and an expansion of the scope and nature of follow-up audits.

44. **Risks and mitigation measures.** The overall risk for the program is *moderate*. Major risks and mitigating measures are summarized in Table 2 and described in detail in the risk assessment

[55] Geostat. 2021. *Women and Men in Georgia*. Tbilisi.
[56] Matrix of Potential Environmental and Social Impacts and Measures (accessible from the list of linked documents in Appendix 2).
[57] Government of Georgia. 2018. *Public Financial Management Reform Strategy 2018-2021.* Tbilisi.
[58] PEFA Secretariat. 2018. *Georgia: Public Expenditure and Financial Accountability (PEFA) Assessment 2017*. Washington, DC: World Bank.

and risk management plan.[59]

Table 2: Summary of Risks and Mitigating Measures

Risks	Mitigation Measures
Prolonged and intensified armed conflict in Ukraine due to Russia's invasion and additional sanctions on the Russian Federation lead to capital outflows, lower exports, depreciation pressures, and food and energy price increases.	The Asian Development Bank will continue consulting closely with the Ministry of Finance, National Bank of Georgia, and other development partners regarding the impact of the Russian invasion of Ukraine on Georgia's economy, with monthly updates carried out under ADB's technical assistance for Preparing the Second Domestic Resource Mobilization Program.[a] With ADB's support, the authorities have taken some pre-emptive mitigating measures, including (i) accelerating fiscal consolidation by maintaining expenditure levels despite better-than-expected performance in revenue collection, (ii) accumulating foreign currency reserves, and (iii) maintaining a tight policy rate and remaining open to further hikes. With ADB's support, the government stands ready to implement targeted food and energy subsidies to the most vulnerable segments of the population to ensure food and energy security.
Implementation is delayed as a result of weak government coordination, including with development partners; constraints in technical and institutional capacity; and delays resulting from the need for overstretched staff to respond to external shocks.	Policy dialogue with the government, capacity development of the implementing agencies in coordination with development partners, and regular monitoring of the policy actions under the Fiscal Resilience and Social Protection Support Program through technical assistance will ensure timely implementation of reforms.

[a] ADB. 2018. *Technical Assistance to Georgia for Preparing the Second Domestic Resource Mobilization Program.* Manila.
Source: Asian Development Bank.

45. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government, the MOF, and the Ministry of Economy and Social Development and the National Bank of Georgia.

IV. ASSURANCES

46. The government has assured ADB that the implementation of the program shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement, as described in detail in the loan agreement.

V. RECOMMENDATION

47. I am satisfied that the proposed policy-based loan would comply with the Articles of Agreement of the Asian Development Bank and recommend that the Board approve the loan of €100,190,000 to Georgia for subprogram 2 of the Fiscal Resilience and Social Protection Support Program, from ADB's ordinary capital resources, in regular terms, with interest to be determined in accordance with ADB's Flexible Loan Product; for a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Masatsugu Asakawa
President

18 October 2022

[59] Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

POLICY DESIGN AND MONITORING FRAMEWORK

Country's Overarching Development Objective
Inclusive economic recovery from the COVID-19 crisis achieved, underpinned by macroeconomic stability[a]

Outcome	**Risks and Critical Assumptions**
Effective management of risk exposure by the public sector and enhanced and fiscally responsible social protection of vulnerable people.	R1: Global economic outlook worsens substantially, putting pressure on Georgia's external balance and its currency, increasing the burden of debt denominated in foreign currency, and causing inflationary pressure. R2: A new wave of COVID-19 transmission burdens public health systems and triggering another nationwide lockdown.

Prior Actions: Subprogram 1 (Completed: December 2018–October 2020)	**Prior Actions: Subprogram 2 (Completed: December 2020–November 2022)**	**Outcome Indicators[b]**	**Post-Program Partnership Framework (November 2022–December 2024)**
Reform Area 1: Management of public exposure to fiscal risks strengthened.			
1.1. MOF fully operationalized a dedicated Fiscal Risk Management Division, which assess and quantify public exposure to fiscal risks stemming from SOEs and PPPs which are more likely to materialize as a result of the COVID-19 crisis, staffed with at least 6 technical staff of which at least 75% are women. 1.2. MOF-approved PPP Guidelines which include methodological guidelines for the assessment of contingent liabilities and VfM methodology for PPP evaluations and completes PPP framework that ensures adequate identification, monitoring, and reporting of fiscal risk stemming from PPPs. 1.3. MOF, through the Fiscal Risk Management Division, expanded the scope of the FRS to include (i) disclosure and discussion of methodological instructions to identify, quantify, finance and report quasi-fiscal activities of SOEs; (ii) assessment of impact of COVID-19 on the likelihood that fiscal risks stemming from SOEs materialize in the short-medium-term; (iii) expansion of fiscal risk analysis of SOEs from 12 to 13 individual SOEs; (iv) discussion on effect of SOE sectorization on Public Finance Statistics, including impact on the Law of Georgia on	2.1 To strengthen MOF's financial oversight over SOEs and reduce public sector exposure to specific fiscal risks, the government approved government decree,[c] with immediate effect, mandating: (i) MOF approval of any investment or decision to contract debt above GEL5 million (or 1% of the value of the public corporations' assets) by seven public corporations;[d] and (ii) MOF approval of Statements of Corporate Intent[e] of seven SOEs (footnote 1) which define (a) the SOE's scope of business; (b) financial and nonfinancial objectives and key performance indicators; and (c) explicit quasi-fiscal activities,[f] including noncommercial service obligations, to be funded by the state budget. 2.2 To strengthen corporate governance, accountability, and transparency in SOE management, the government approved a Corporate Governance Code by government decree, effective immediately, which define rules on corporate governance of SOEs including: (a) merit-based appointments of members of independent supervisory boards and CEOs by all public corporations (at least 25% of supervisory Board members should be women); (b) establishment of Audit, and Remuneration, Nomination and Governance Committees within all supervisory boards.	By November 2023: a. External government debt—GDP ratio contained below 35%[i] of GDP (2020 baseline: 47.6%; as of 2021: 39.8%) (Source: IMF Art IV Review) b. Public debt-to-GDP brought below 45 %. (2021 baseline: 49.4 %) (Source: IMF Article IV Review) c. Debt to total assets of SOEs brought below 85% (2021 baseline: 95%) (Source: Fiscal	All public corporations publish MOF approved SCI which define the public corporations' scope of business; financial and nonfinancial objectives; risk limits; explicit quasi-fiscal activities; and a mechanism to account for, and fund noncommercial service obligations. MOF effectively integrates climate risk into the medium-term fiscal framework to inform budget preparation and public investment management, which include a framework for organized fiscal management of disaster and climate risks.

Prior Actions: Subprogram 1 (Completed: December 2018–October 2020)	Prior Actions: Subprogram 2 (Completed: December 2020–November 2022)	Outcome Indicators[b]	Post-Program Partnership Framework (November 2022–December 2024)
Public Debt; (v) analysis of SOEs from sectoral perspective, with the aim of normalizing financial statements from SOEs; (vi) assessment of stock of PPP liabilities based on International Public Sector Accounting Standards (IPSAS32) and VfM methodology for PPPs included in the recently approved PPP Guidelines; and (vii) Include draft discussion of fiscal risks stemming from natural disasters affecting municipalities.	2.3 To strengthen identification, monitoring and disclosure of fiscal risks stemming from climate change the government submitted to Parliament an upgraded FRS that includes quantification of fiscal risks stemming from disasters triggered by natural hazards and climate change. The FRS is submitted annually to Parliament as a supplement to the state budget documents.	Risk Statement 2023) d. Fiscal deficit brought below 3% of GDP. (2021 baseline: 6.3%) (Source: IMF Article IV Review)	
Reform Area 2: Domestic debt markets for government securities and capital markets deepened.			
1.4. MOF and NBG commenced Primary Dealer Pilot with appropriate rights and obligations and primary dealers rules published and primary dealers system to promote activity on the primary and secondary markets, ensuring decreased public reliance on external debt to finance future fiscal stimulus packages as the one needed to mitigate the adverse socioeconomic impacts of COVID-19. 1.5. MOF issued ministerial decree which mandates that the Debt Management Strategy is updated, approved and published on its website on an annual basis to increase predictability of the market for government domestic debt securities. 1.6. MOF issued benchmark bonds with nominal value of at least GEL2 billion in 2020 to increase investor interest towards Georgian government securities and promote capital market development, which in turn ensures the growth of GEL liquidity. 1.7. Parliament approved new Investment Funds Law needed to develop investment fund legal, regulatory, and tax framework and creating an enabling environment for the development of capital markets in Georgia.	2.4 To support price discovery and transparency in the government securities market, MOF, primary dealers[g] and the NBG approved amendments to the memorandum of understanding on the primary dealership system—with immediate effect—by adding a 2-year bond, and mandating that primary dealers disclose and make publicly available all pre-trade and post-trade figures for all securities included in the primary dealership system. 2.5 To transparently communicate to bond market participants commitments to an issuance program that deepens the domestic debt market for government securities, the government published Medium-Term Debt Management Strategy 2022–2025 approved by government decree that (i) requires that domestic debt comprise 28% of the public debt stock by FY2025; (ii) requires a net increase in domestic issuance of at least GEL1.2 billion annually starting in FY2022. 2.6 To promote mobilization of domestic private financial resources and minimize government reliance on external financing the government, in collaboration with NBG, approved a Capital Market Development Strategy 2022–2028 by government decree. The Strategy includes a commitment to develop a green bond framework.[h]	By November 2023: e. Domestic government debt increased to at least 11% of GDP (2021 baseline: 9.6%) (Source: National Bank of Georgia Statistical Publication) f. Share of domestic debt increased to at least 25% of total general government debt (2018 baseline: 18.7%; as of 2021: 19.5%) (Source: IMF Article IV Review) g. Turnover velocity in secondary market for government securities increased to 25%.	MOF approves a strategy to promote development of retail market for government securities The government amends the Law of Georgia on Public Debt, broadening the scope of public debt statistics towards a public sector balance sheet approach and expand benchmark issuance to ensure inclusion in JP Morgan's GBI-EM index Inclusion in the JP Morgan EM Index.

Prior Actions: Subprogram 1 (Completed: December 2018–October 2020)	Prior Actions: Subprogram 2 (Completed: December 2020–November 2022)	Outcome Indicators[b]	Post-Program Partnership Framework (November 2022–December 2024)
	2.7 To deepen capital markets and create a new class of debt instruments and allowing access to new participants to the market including corporate investors, the government submitted Law on Securitization to Parliament. 2.8 To widen the range of investment instruments available to investors and deepen capital markets the government submitted the Law on Covered Bonds to Parliament.	(2021 baseline: 10%) (Source: NBG) h. Number of publicly listed companies increased to at least 10. (2022 baseline: 15) (Source: GSE) i. At least one green bond issued in compliance with the ICMA's Green Bond Principles issued in GSE. (2022 baseline: 0) (Source: GSE) j. At least one Gender Bond issued in compliance with the ICMA's Social Bond Principles issued in GSE. (2022 baseline: 0) (Source: GSE)	
Reform Area 3: Adequacy and fiscal sustainability of social protection programs strengthened.			
1.8. Parliament approved revised budget in 2020 which includes an increase of at least GEL30 in universal pension payout for pensioners aged 70 and above, 65% of whom are women, to mitigate the adverse impact of the COVID-19 crisis on old-age poverty. 1.9. Parliament approved amendment to the Law of Georgia on State Pensions which	2.9 To expand participation and confidence in the pension system, the MOF, signed a memorandum of understanding with the Pension Agency, effective immediately, delineating functions and roles of the Revenue Service in the enforcement of mandatory pension contributions by all formal employers, in compliance with the Law of Georgia on Funded Pension.	By November 2023: k. Share of employed persons registered under the contributory pension scheme	The government to carry out diagnostic exercise to assess impact of equalization of retirement age on gender disparities. Pension Agency to implement educational

Prior Actions: Subprogram 1 (Completed: December 2018–October 2020)	Prior Actions: Subprogram 2 (Completed: December 2020–November 2022)	Outcome Indicators[b]	Post-Program Partnership Framework (November 2022–December 2024)
introduces a rules-based mechanism for increases in payouts for universal pension beneficiaries, 70% of whom are women. 1.10. Government of Georgia establishes and operationalizes an independent public Pension Agency for administration of the new supplementary contributory pension scheme (Pillar II pension scheme) where at least 50% of staff are women. 1.11. Pension Agency ensured registration of 100% of formal employers and collected contributions from at least 90% of registered employers, as well as, and associated contributions from the government and employees. 1.12. Pension Agency adopted an interim Cash and Cash-Equivalent Investment Policy allowing investments to be managed without any undue risk and ensuring transfer of all contribution payments into individual interest-bearing accounts.	2.10 To expand the investment options available to Pillar II pension participants and enhance the participation of the scheme in the domestic capital markets as an institutional investor, the government submitted proposed amendment to Law of Georgia on Funded Pension to Parliament that revises concentration limits and investment mandate restrictions of the Pension Agency. These amendments include: (a) increase in total share of securities outstanding from a single issuer from 10% to up to 25%; (b) total share of covered bonds/securitized assets outstanding from 0 % to up to 25%; and (c) total share of single issue of Covered Bonds/ securitized assets from 0 % to up to 40%. 2.11 To enhance the management of pension assets, the Pension Agency approved a long-term Investment Policy Document, effective immediately, which regulates investment of pension assets in accordance with the corresponding investment mandate defined by the Law of Georgia on Funded Pensions. The Investment Policy Document include a responsible investment framework, which ensure integration of ESG factors into the evaluation and management of investments. 2.12 To enable Georgian workers to accumulate additional voluntary savings and generate a third source of old-age income for retirees, of which 68% are women, the government submitted the Law of Georgia on Voluntary Private Pension to Parliament.	increases to at least 95%[j] (2018 baseline: 0%; as of June 2022: 93%) (Source: Pension Agency) l. Volume of assets managed under Pillar III Pension Framework increased to at least GEL60 million. (2021 baseline: 0) (Source: NBG)	campaign to raise awareness among pension beneficiaries ahead of introduction of medium and high-risk portfolios, and develop public relations campaign to raise awareness on need for adequate replacement rate, particularly for women, complementing Pillar II pension with additional private savings.

Budget Support Asian Development Bank Subprogram 1: $200,000,000 (ordinary capital resources) Subprogram 2: $100,000,000 (ordinary capital resources)

CEO = Chief Executive Officer, COVID-19 = coronavirus disease, ESG = environment, social and governance, ESM = environmental protection, social responsibility and management, GSE = Georgia Stock Exchange, FRS = Fiscal Risk Statement, GDP = gross domestic product, GSE = Georgia Stock Exchange, ICMA = International Capital Market Association, IMF = International Monetary Fund, MOF = Ministry of Finance, NBG = National Bank of Georgia, PPP = public–private partnership, R = risk, SCI = Statements of Corporate Intent, SOE = state-owned enterprise, VfM = value-for-money.

[a] Government of Georgia. 2021. *Program for 2021-2024: Towards Building a European State*. Tbilisi.
[b] Under subprogram 2, additional outcome indicators have been added (b, c, d, f, g, h, i, j, l) to accurately reflect expected impact of prior actions included in the PDMF. Additional indicators reflect commitments made by the authorities under the Medium-term Debt Strategy 2021-2025 and the Capital Market Development Strategy 2022-2028.
[c] Government decrees require cabinet approval.
[d] The Decree of the Government of Georgia #1012 of 10 June 2022 "*On Financial Oversight of the SOEs*," applies to: (a) JSC Georgia State Electrosystem; (b) LLC Enguri HES; (c) JSC Georgia Oil and Gas Corporation; (d) JSC Georgia Railways; (e) LLC Georgia Gas and Transportation Company; (f) LLC Georgia Airport Union; (g) LLC Georgian United Water Company. Together, these SOEs represent roughly 90% of annual turnover in the SOE sector.
[e] SCI is a document that states the financial and nonfinancial goals of the enterprise that need to be achieved within limited risks in a 4-year period, updated annually.
[f] Quasi-fiscal activities are any activities undertaken by state-owned banks and enterprises, and some- times by private sector companies at the direction of the government, where the prices charged are less than usual or less than the "market rate."
[g] A primary dealer is a bank or other financial institution that has been approved to trade securities with a national government.
[h] Implementation of the Capital Market Development Strategy commences in 2022, with approval of the Covered Bonds Law and Securitization Law as first achievements of implementation.
[i] The target has been revised downwards from 40% to 35% on account of good progress made against this outcome indicator. The 2020 baseline was updated to reflect actual external debt ratio as of December 2020.
[j] The target has been revised upwards from 80% to 95% to reflect better-than-expected progress made against this outcome indicator.

Contribution to Strategy 2030 Operational Priorities: Operational priority indicators to which this operation will contribute results are detailed in Contribution to Strategy 2030 Operational Priorities (accessible from the list of linked documents in Appendix 2).

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

http://www.adb.org/Documents/RRPs/?id=54271-002-3

1. Loan Agreement
2. Sector Assessment (Summary): Public Expenditure and Fiscal Management
3. Contribution to Strategy 2030 Operational Priorities
4. Development Coordination
5. International Monetary Fund Assessment Letter[1]
6. Summary Poverty Reduction and Social Strategy
7. Program Impact Assessment
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items
10. Management-Approved Concept Paper: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 for the Second Domestic Resource Mobilization Program
11. Matrix of Potential Environmental and Social Impacts and Measures
12. Approved Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 for the Fiscal Resilience and Social Protection Support Program

Supplementary Documents

13. Supplementary Note on Capital Market Development
14. Supplementary Note on Pension Reform
15. Supplementary Note on Compliance with the Fiscal Rule
16. Climate Change Assessment
17. Supplementary Note: Key Revisions in the Policy Matrix

[1] The International Monetary Fund confirmed on 15 September 2020 that the attached Press Release No. 20/202 may serve as the International Monetary Fund Assessment Letter.

DEVELOPMENT POLICY LETTER

საქართველოს
ფინანსთა მინისტრი
Minister of Finance
of Georgia

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DEVELOPMENT POLICY LETTER

Dear Mr. President

I thank the Asian Development Bank (ADB) for its support to Georgia to overcome the challenges posed by the COVID-19 pandemic, which helped pave the way for robust economic growth in 2021. Despite strong economic growth, regional and global downside risks remain. Russia's invasion of Ukraine and related sanctions could worsen Georgia's external position, leading to further energy and food inflationary pressures. Rising geopolitical tensions would not only dampen external demand—including tourism—it could also harm investment for longer. At the same time, we recognize that the ongoing pandemic may still threaten our recovery as a resurgence of COVID-9 cases could strain the economy. Moreover, unexpected rate hikes by systemically important central banks could trigger capital flight, currency depreciation pressures, and result in higher debt-servicing costs and higher inflation. Amid mounting downside risks, Georgia is committed to addressing longstanding institutional vulnerabilities that expose our economy to external shocks and threaten the macroeconomic stability upon which Georgia's recovery rests. To this end, we have undertaken several significant institutional reforms which strengthen resilience of our fiscal position, ensuring continued economic recovery without compromising critical social spending.

As part of our efforts to strengthen the resilience of our public finances, we have undertaken a number of significant and structural reforms to the way we manage our exposure to fiscal risks. While these reforms have been in preparation for a number of years now, partly thanks to the support of ADB and the IMF, we have taken concrete steps to ensure that public exposure to fiscal risks stemming from climate change are adequately quantified. In addition to this, we have undertaken significant reforms to strengthen financial oversight of SOEs by MOF and improved corporate governance standards for SOEs. This helps minimize unplanned fiscal pressures stemming from the materialization of fiscal risks by undercapitalized SOEs which can significantly disrupt macroeconomic stability. In light of the current economic outlook in Georgia and globally, the government expedited these reforms to help maintain strong economic recovery, unhindered by unplanned fiscal pressures.

Another key reform area which we consider critical to address to effects of the COVID-19 crisis in the medium term pertains to the development of capital markets, with particular focus on the market of government securities. This implies increasing liquidity, transparency,

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and predictability of the market. A more developed domestic market should decrease the budget expenses on debt service and reduce risks in the medium and long-term, freeing up fiscal space for key social spending and economic recovery efforts. Developed government securities market will support the development of domestic capital market, which in turn will create additional GEL denominated financial resources available for the market participants. It will also help reduce Georgia's reliance on external debt to finance countercyclical expenditure programs should the current crisis be prolonged.

Finally, and parallel to our institutional reforms to fiscal risk management and public debt management, Georgia has also accelerated key institutional reforms to the pension system in order to ensure adequate financial support to older adults in a fiscally responsible way. ADB has been an important partner of Georgia in the reform of its pension system, the largest social protection program in Georgia, providing significant TA resources to help implement and operationalize a new supplementary contributory pension scheme, to be administered on a fully funded basis, to complement the existing universal pension scheme. With ADB's support, the Government of Georgia developed a legal framework for the new supplementary voluntary pension scheme (i.e. a Pillar III pension scheme). The introduction of a multi-pillar pension framework will help enhancing adequacy of old age income of citizens by accumulating additional savings to generate old age income. ADB has a significant role to play in these reforms given its proven familiarity with the country context. We would appreciate continued policy dialogue on these specific reform areas within the coming years.

Once again, I express my sincere gratitude to ADB for the support it has extended to the Government of Georgia. We are committed to working closely with you and other development partners under a strong and coordinated approach to ensure that all our interventions are complementary and help us overcome the critical challenges we face.

Sincerely,

Lasha Khutsishvili