Banking Reform in Georgia

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Abstract

Georgia's banking system restructure began in 1991 when Soviet Union collopsed.This paper tries to compare and constract the performance of banks and banking system between 1999 and 2004 with banks in other transition countries.Although Georgia banking system showed a long processing in banking sector, it is still lags behind other transition countries Central and Eastern Europe. Neverthless.An efficient financial institution and performance will not come without further economic development and reform of regulation and increase in people's confidence in the financial system as a whole.

Key words: Transition economies, Banking,Financial reform

Introduction

A successful implementation of an overall reform program will enable Georgian banks to provide intermediation and assist in the country's development from a weak market economy to a mature financial system. The changes for reform are better now than at any time during the last decade. Favorable economic and political conditions and changes in attitude among bank management have created an usual opportunities for development and growth. The situation in Georgian banks was improved markedly since 1994, so EBRD increased the banking reform marks from +2 points to +3 points. The banks has grown in terms of assets, equity, deposit, loans and profit. The positive development in banking sector have taken place with general economic recovery. Table 1 shows the general size and development of banking sector, measured as a percentage gross domestic product(GDP).Figure1 shows the general transition and banking reform scores for Georgia and some other transition countries as measured by the European Bank for Reconstruction and Development(EBRD,Transition report 2003)

In general, the banking and economic systems changed in parallel with economic development. Little happened before mid-decade, but Georgia's overall transition (measured as the simple average of the EBRD's eight components of reform) converged to the group average for all 25 transition economies by 1997, while Georgian bank reform converged to near the group average by the same year.

There are different variety of factors distinguish the transition economies in structuring the financial sector development. Although the variety of structuring challenges, all transition countries faced the same problems of transforming a few state-owned banks into a western-style banking system (Amaghlobeli, Farrell, Nielsen).

An efficient banks and financial institution in transition economies is crucial for conversion from plan to market and overall economic growth and technological advancement. Financial institution perfor unique task in the economy by providing liquidity to business and households by linking surplus holding with deposit spending units.Success of financial institutions perform

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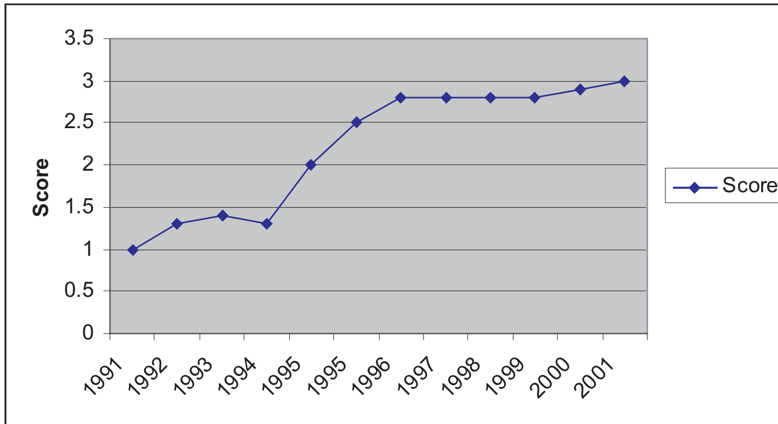
these task will largerly depend on the environment in which they operate the policies the regulatory authorities follow and the ability of management to efficiently utilize available resourses. (Jaffee, Levian, 2001)



Source: EBRD, *Transition Report,* various years.

Figure 1. Overall transition and bank reform (BR) scores, all countries and Georgia ,1991-2001.

The article is organized as follow: First, It examines current performance in Georgia, following which market structure and concentration are analysed.Next section , compare major development of Georgia with other transition countries, then conclusion. Banking sector in Georgia is in need of reform.Why№Reason first, the ability to sustain the positive economic gains made in the last few years depend , to a large extent on a well functioning banking sector.The current system cannot adeguately support economic growth as very little to its activity consists of financial intermediation.The role of banking sector can be identified(Jaffee,Levian ,2001) :

- Payment system
- Intermadiation
- Investment

In an efficient banking system, each of these services will be supplied up to the level at which the marginal benefit to banks customers equals the marginal cost to the bank of providing the services.

Second ,sharp increase in foreign direct investment inflow ($315 million), being incapable of facilitating an efficient allocation of these capital inflows, the banking sector will try to cope with this liquidity influse by building up assets through increased lending an investment porfolio and of building up asset prices. The biggest protection against such a scenorio would be a strong competant and efficient banking sector.

General Overview of Georgia

After declaring independence in 1991 Georgia experienced a particulary deep recession.From 1991 to 1994 GDP dropped by more than 70% (45 % in 1992 alone) while annual inflation raged at 7,487 and 6,473% in 1993 and 1994

respectively(Wang 1999). Transformation of recession is common to all transition economies.Output decreased, inflation increased and unemployment increased.There were two secessionist wars, including political turmoil retared the economic recovery with getting political stabilization by mid-1994, counrty begin to implement the program of comprehensive reform with external assistant from IMF, the World Bank, Technical Aid for CIS(TACIS) and others.GDP increased by 11% in 1997, 10 % in 1998 inflation was only 7% in 1997, GDP 11,1 % recently ($ 3,73 billion)GDP growth moderated to around 3 % in 1998 , partly as a result of the Asian and Russisan financial system.(EBRD, Transition report)

Structure Stratage of Banking System

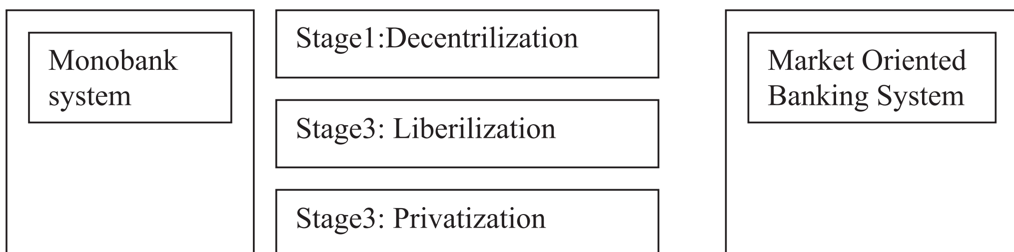
Banking reform in georgia started in the late 1980s when the country was still a part of the soviet union, but substantive changes accored only after the country gained independence.In 1991 a two-tier banking system was introduced when the Gosbank branch in Georgia became the national bank of Georgia(NBG) and five state-owned specialized bank (Eximbank, Sberbenk, Agropnombank, Promstoibank and Zhilsotsbank) were privatized.Altough new legislation established the NBG as an independent supervisory, regulatory and monetary body, most of its practices inherited from soviet planning program.NBG was obliged to autometically finance government deficit and administer direct credits and ,until december 1992, the NBG continue to provide loans to state-owned enterprises. . (Gurgenidze, 1995)

Banking issues have usually dominated the reform agenda in transition economies because banks tend to be largest part of financial system in most transition economies and because banks were only financial institution in the past. Building a banking system or creation of a new banking system, Georgia choiced the second route, most of Central Europe have mostly pursued the first route. The main two approaches to banking reform can consequently be characterize as rehabilization and new entry approaches. The rehabilitation is best illustrated by Hungary and Poland, transforming of existing state bank eventually privatize them. (Alimkulov, 1999)

The main sequence of the new entry approach to banking generally consist of following stages: the split-up of the mono-bank into a number of state-owned commercial banks, but then follows with the liberal entry of new banks and privatization of state banks (Chart 1).

Chart1

NEW ENTRY APPROACH TO THE BANKING REFORM

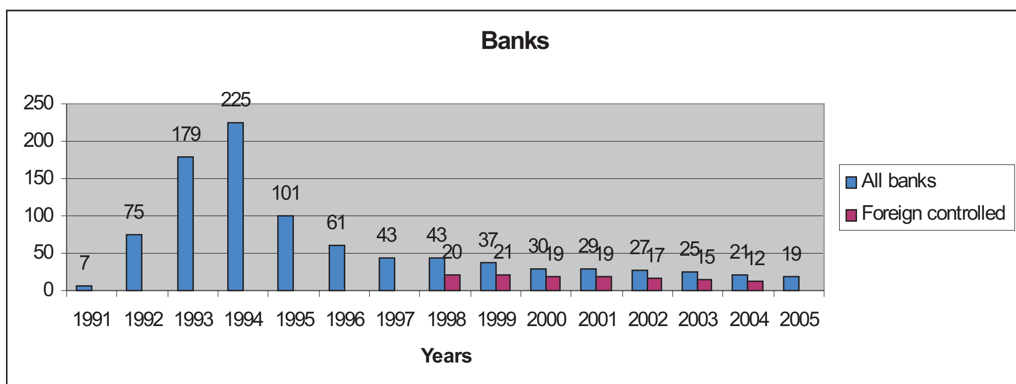


Although Claessens (1996) argues that the institutional development of banking systems may be faster under the new entry approach than under the rehabilitation approach FSU countries still have the banking systems with a lower level of financial intermediation than CEE countries.[9] This may explain by weaker initial conditions, macroeconomic instability and inconsistent reform measures in FSU countries. The high spreads between loan and deposit rates, especially in FSU countries, show again that the activity of banks in FSU countries is extremely inefficient in comparison with CEE countries.

Banking stage after 1997

NBG certified the United Georgian Bank and the Bank of Georgia in mid-1997. Reserve requirements were lowered and the capital adequacy standard was raised from 8 to 10% of total assets. As a result of the BCP and stricter regulations, 173 commercial banks (of 226) had vanished in less than 3 years. As noted by Kloc (1999), this was an unprecedented outcome among the nations of the former Soviet Union.As it is illustrated in figure2 , number of banks decreased as more strong bank regulation implemented.

Late 1997 brought the next stage of reform when the NBG announced a plan to gradually increase the minimum capital requirement for commercial banks to GEL 5,000,000 (approximately $3,846,000) by the end of 2000. This measure aimed to further consolidate the industry by eliminating the smaller and weaker banks. Throughout 1998 the NBG was involved in revoking licenses of banks not meeting the new minimum capital requirements and other prudential regulations. Although initially stymied by a court challenge, the issue was resolved in favor of the NBG and de-licensing resumed. By the end of the year a total of 10 banks had lost their licenses.(Amaghlobeli, Farrell, Nielsen,2003



Source: EBRD (2001) and National Bank of Georgia (2001).

Figure 2. Commercial banks in Georgia, 1991-2001.

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Table 1. Commercial banks grouped by paid-up authorised capital (GEL and %)

	<1 mln	2-3 mln	3-4 mln	4-5 mln	er5 mln	Over 5 mln	Over 10 mln	Total
1998	40	6	5	1	0	1	0	53
1999	1	10	12	4	5	5	0	37
2000	0	0	0	5	20	7	0	32
2001	0	0	0	0	6	24	0	30
2005	0	0	0	0	0	13	6	19
2006-January	0	0	0	0	0	13	6	19

Source: National Bank of Georgia data (2001)

The Russian financial crisis of 1998 adversely affected commercial banking in Georgia. The GEL was devalued by about 40% from November to December, bank deposits dropped and GDP growth slowed from 6% in the first half of 1998 to between 1 and 2% in the second half. Nonetheless, the nation's banking system managed to maintain an adequate financial position and even though the NBG prepared a plan to assist banks, only two banks asked for short-term liquidity loans in the total amount of GEL 4 million.

By 2000 the NBG had achieved total compliance with the new minimum capital requirements in step with the established timetable. As a result, the number of commercial banks had dropped to 26 by the end of 2001 and the size structure of the banking system had radically changed (see Figure 2 and Table 1).

Asset and liability of banks

As shown in Table 2, between 1995 and 2000 the percentage of total bank assets held in loans decreased by almost 10%, while the percentage held in accounts with correspondent banks increased almost six-fold. As interest rate spreads were decreasing sharply during this period, commercial banks sought to secure non-loan sources of revenue involving currency conversion and especially money transfers (both domestic and international). Banks started maintaining multiple correspondent accounts with other banks in the country and abroad, which came at the expense of lending. On the liability side, a substantial increase in capital can be observed as well as a corresponding decrease in the percentage of demand deposits. As public confidence in the banks increased, both time deposits and household deposits increased more than six-fold. .(Amaghlobeli, Farrell, Nielsen,2003)

Table 2. Asset and liability composition of the banking sector, 1995-2000 (%)

	1995	1996	1997	1998	1999	2000
Vault cash	2.9	3.7	4.3	2	2.1	1.8
Required reserves	7.1	5.7	4.9	3.7	**5.5**	5
Foreign currency accounts	5	4.8	5.7	4.5	3.7	4.7
Accountswith correspondent	2.6	10	10.8	18.3	13.8	13.4
Debtors	2.5	3.5	2.9	3.1	2.6	2.3
Loans	64.2	50.6	50.7	48	50.7	55
Claims on banks	1.7	3.6	2.4	1	0.9	0.8
Securities	0.2	1.2	2.3	2.1	3.3	2.1
Fixed assets and premises	12.4	14.5	14.5	15.8	13	12.2
Other assets	1.4	2.4	1.5	1.4	4.4	2.7
Total Assets	**100**	**100**	**100**	**100**	**100**	**100**
Authorised capital	15.1	25	28.1	24.4	22.5	24.4
Other funds	6.7	6.8	7.6	10.2	10.4	13.1
Foreign currency accounts	16.4	20.8	23	12.7	13.7	14.8
Other bank accounts	0.7	1.6	3.6	1.4	1.7	1
Transaction deposits	17.1	18.1	12.4	8.9	6.6	7.4
Term deposits	0.1	0.5	2	4.2	4.8	4
Other banks' loans	28.1	19.3	15.8	21.8	21.2	18.8
Other creditors	9	2.8	2.4	2 2	1.9	1.2
Deposits of households	2.2	2.9	3	8.9	10.5	13.9
Retained earnings	-0.9	-0.3	-0.1	0.9	3.1	0.5
Other liabilities	**5.5**	2.4	2.1	4.1	2.9	2.1
Budgetary resources	0	0	0.1	0.3	0.6	0.5
Total Liabilities	**100**	**100**	**100**	**100**	**100**	**100**

Source: National Bank of Georgia (2000).

Growth in commercial bank lending in Georgia was primarily due to trade (see Figure 3). In 2000 this sector accounted for close to 70% of total loans (see Table 3), followed by manufacturing (19%), construction (6%) and agriculture (5%). Almost all banks in the country provide financing for retail and wholesale merchants because such loans are short-term and carry higher than average interest rates. The share of manufacturing and construction doubled between 1996 and 2000, while the share of agriculture, transport and other services (which includes services of caterers, hotels, petrol stations, barbers' shops etc.) dropped sharply.

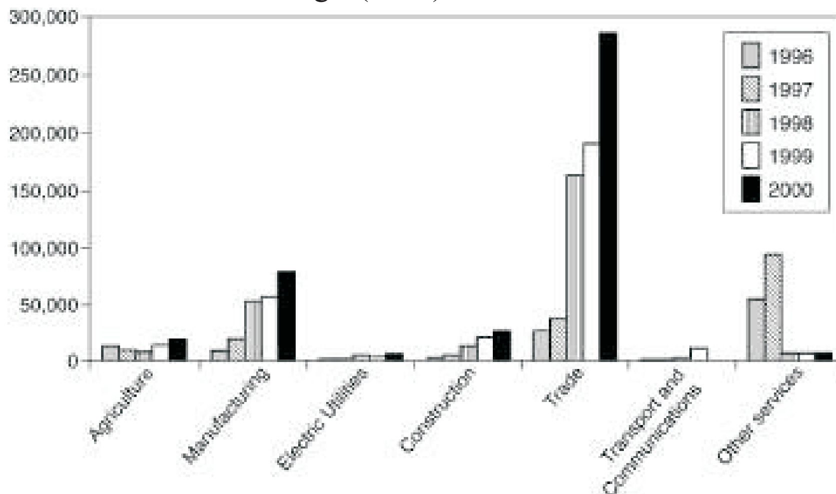
The growth in manufacturing lending was mostly driven by agricultural processing and light industry traditional sectors in the Georgian economy. These industries required relatively small-scale and short-term loans that banks were ready to provide. Heavy industry, however, remained substantially deprived of borrowing opportunities since it requires investments with long maturities and

high risk.

Table 3. Sector shares in total bank loan portfolio, 1996-2000 (%)

	1996	1997	1998	1999	2000
Agriculture	13.5	6.9	4.2	5.3	4.7
Manufacturing	9.9	12.9	21.0	18.7	18.6
Electric utilities	1.8	1.5	2.2	1.1	1.8
Construction	3.4	3.4	**5.5**	6.9	6.2
Trade	23.3	20.8	64.0	62.5	67.4
Transport and communications	1.0	0.8	1.0	3.6	0.0
Other services	47.1	53.7	2.1	2.0	1.4
Total	100.0	100.0	100.0	100.0	100.0

Source: National Bank of Georgia (2000)



Source: National Bank of Georgia (2000).

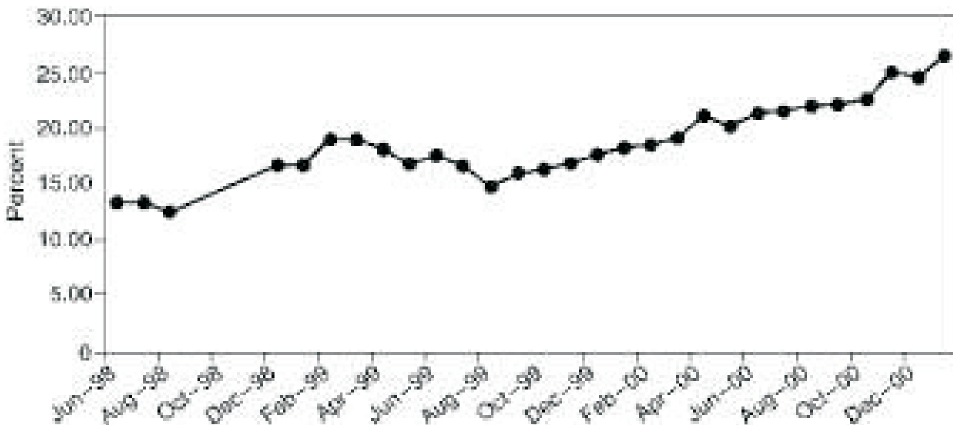
Figure 3. Bank loans by industrial sector, 1996-2000 (000 GEL).

Quality of Loan

The prevalence of bad loans and the term structure of loans are general indicators of lending quality. As for bad loans, their share in the total bank loan portfolio was about 6.9% in 2000, down from over 40% just 5 years earlier. The high percentage of the middle 1990s reflects output collapse, a deteriorating payments system, bad loans inherited from both the communist past and the early transition years, a lack of credit risk assessment skills and, first and foremost, allocation of credit according to non-commercial considerations (Gurgenidze, 1995). The economic recovery, the full write-off of old bad loans, the privatization of state-owned banks and the improvement in the payments discipline and credit assessment skills of loan officers evidently helped bring down the share of non-performing loans

Turning to the term structure of loans, it is common knowledge that in the

early transition years most lending was short-term. Georgia is no exception to the rule. However, over time the share of long-term loans in the total loan portfolio increased considerably: in mid-1998 about 13% of loans were long-term, but by the end of 2000 this share had increased to 26% (see Figure 5). Dollarisation inhibited faster growth of long-term loans. Borrowers with loans denominated in US dollars prefer to keep them short-term for fear that the depreciation of the lari will induce exchange rate losses. On the other hand, lenders are also unwilling to take excessive exchange rate risk by supplying longer-term credits in lari. .(Amaghlobeli, Farrell, Nielsen,2003)



Source: National Bank of Georgia (2000) and authors' calculations.
Figure 4. Long-term loan share of total loans, 1998-2000 (%).

Evolution of state ownership

Among CIS countries only Armenia and Georgia have been able to fully eliminate state ownership in the banking sector, while the Kyrgyz Republic has only three state banks accounting for about 10% of the system's assets (Table 4). Kazakhstan has been able to substantially reduce the share of state bank assets since 1998, and Moldova's banking sector will be fully privatized as soon as the state shares in the former savings bank are sold. Tajikistan privatized four of its five state banks by 1998, accompanied with the government program prohibiting further direct lending

Ukraine at the end of 2004 had two state banks, whose assets accounted for about 14% of the sectoral total. Although the huge state agricultural bank "Ukrayina" underwent liquidation in 2001, the share of state banks has not dropped since, and has even slightly increased. This is somewhat surprising, since one of the two state banks is the loss-making Oschadny (savings) bank. Experts question whether Oschadny can become competitive without significant assistance from the government. Preliminary estimates in early 2001 indicated that Oschadny would need to reduce its costs by about 40% in order to be profitable (Sherif *et al.,* 2001).

Table 4. Asset share of state owned banks for selected transition economies. 1995 - 2002, end of a year, % of total banking sector assets

	1995	1996	1997	1998	1999	2000	2001
Armenia	2.4	3.2	3.4	5.7	3.5	3.8	0.0
Azerbaijan	80.5	77.6	80.9	65.5	82.5	60.4	62.0
Belarus	62.3	54.1	55.2	59.5	66.6	66.0	53.2
Georgia	48.6	0.0	0.0	0.0	0.0	0.0	0.0
Kazakhstan	24.3	28.4	44.8	23.0	19.9	1.9	3.5
Kyrgyz	69.7	5.0	10.3	10.4	25.8	15.8	16.6
Moldova				0.3	7.9	9.8	10.2
Tajikistan		5.3	30.3	29.2	6.9	6.8	4.8
Turkmenistan	26.1	64.1	68.3	77.8	96.9	97.1	96.5
Russia			37.0	41.9		44.1	
Ukraine			13.5	13.7	12.5	11.9	11.8
Uzbekistan	38.4	75.5	70.6	67.3	65.8	77.5	96.0
Latvia	9.9	6.9	6.8	8.5	2.6	2.9	3.2
Poland	71.7	69.8	51.6	48.0	24.9	23.9	24.4
Hungary	49.0	15.3	3.5	9.8	7.8	7.7	9.1

Source: EBRD Transition Report

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Banking sectors in Azerbaijan, Belarus, Russia, Uzbekistan and Turkmenistan remain dominated by large state banks (Table 1). Still, on average, assets of state banks have been declining since the mid-1990s, thanks mainly to the large scale privatization or liquidation of state banks in countries like Georgia, Kazakhstan, and Kyrgyzstan. The introduction and better enforcement of prudential standards is combining with competition to favor more efficient private banks.

Bank dominance and development of stock markets

Non-banking financial institutions are in a rudimentary state in the CIS, dwarfed in importance by commercial banks. Only in Russia, Kazakhstan, and the Kyrgyz Republic has stock market size remained comparable to banks' size. In developed countries both bank and non-bank financial institutions play more

significant roles. Market capitalization of listed companies (commonly used as a proxy for stock market size) is comparable to the size of total deposits with banking financial institutions.(Golodniuk,2005)
Figure 1 illustrates also the small size of financial intermediation in the CIS compared to advanced transition economies.

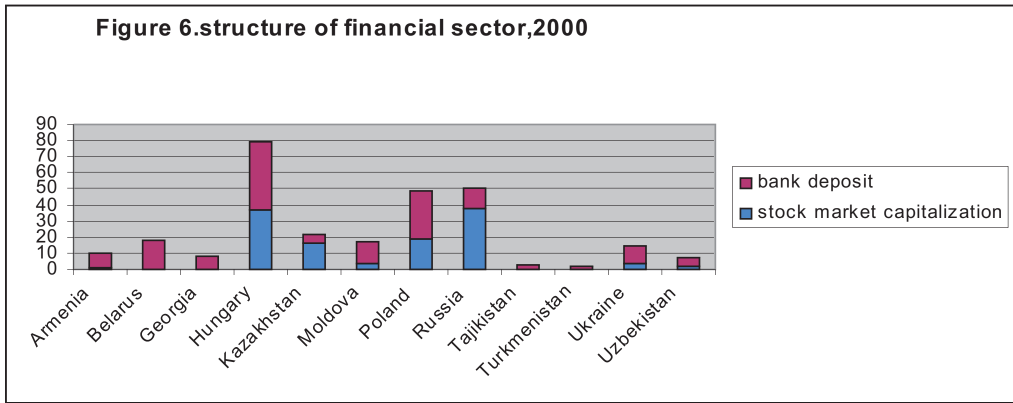


Figure 6.structure of financial sector,2000

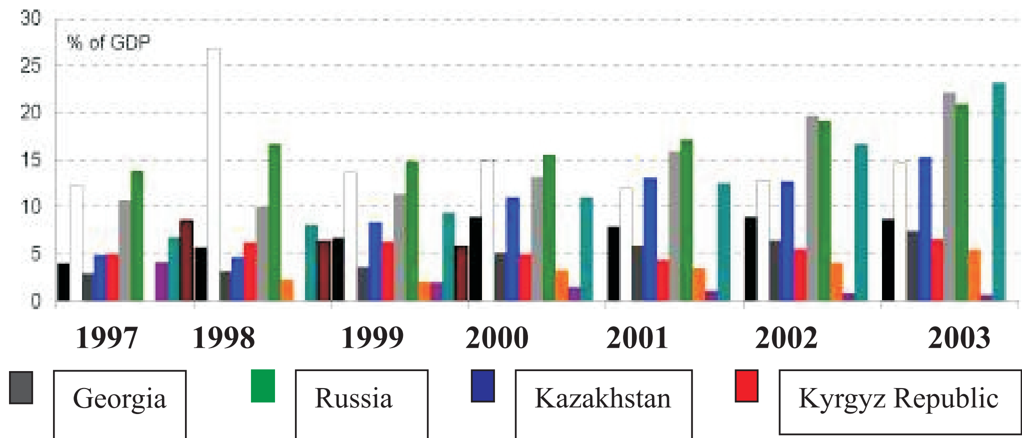
World Bank, IMF International Financial Statistics.

Bank Credit and Deposits

Banks' abilities to attract deposits are improving and bank deposits are steadily growing in all countries, except Turkmenistan and Belarus (Figure 7). This growth is most remarkable in Ukraine, Kazakhstan and Moldova. Deposit trends indicate that public trust in the banks is recovering after Russian financial crisis events and the trend persists.

Figure7. Dynamics of bank deposits, CIS, 1997- 2003, end year

Source: WDI World Bank.



The literature finds a positive relationship between credits to the private sector and economic growth, because decisions about crediting the private sector are generally made on the basis of economic rather than political considerations. With the exception of Turkmenistan, Belarus, and the Kyrgyz Republic, shares of credits allocated to the private sector have been steadily increasing (Figure 8).

Interest rate spread

The difference between interest rates earned on credits and offered on deposits shows a bank's efficiency as a financial intermediary. This spread measures the proportion of funds raised from crediting that is absorbed by the banking system, rather than acquired by the investor (owner of a deposit). The interest rate spread has been persistently diminishing since 1997 in all countries of the region. The only exception is Turkmenistan, where the interest rate is not meaningful as such since banks operate as payment agents to subsidize the economy from the Central Bank of Turkmenistan.

Table 5. Spread between lending and deposit rate 1997-2003, %

	199	1998	1999	2000	2001	2002	2003
Armenia	28.2	23.5	11.5	13.5	11.8	11.5	14.0
Azerbaijan			7.4	6.8	11.2	8.7	5.9
Belarus	16.2	12.7	27.2	30.1	12.8	10.0	6.5
Georgia	36.9	29.0	18.8	22.6	19.5	22.0	23.0
Hungary	4.8	4.9	4.4	3.1	3.7	2.8	-1.4
Kyrgyz	9.8	37.7	25.3	33.5	24.8	18.9	16.8
Latvia	9.4	9.0	9.2	7.5	5.9	4.7	2.4
Moldova	9.9	9.2	8.0	8.9	7.8	9.3	6.7
Poland	5.6	6.3	5.8	5.8	6.6	5.8	3.6
Russia	15.3	24.7	26.0	17.9	13.1	10.8	8.5
Tajikistan	51.6	41.1	21.0	24.3	15.9	5.0	6.9
Ukraine	30.9	32.2	34.3	27.8	21.3	17.4	10.9

Source: World development indicators, World Bank

The declining spread is an extremely positive development. First, high spreads usually imply high lending rates, which can have substantial adverse economic implications, especially for small and medium sized enterprises (SMEs). Second, declining spreads are most likely associated with the increasing competition in the sector. These trends suggest that financial systems in CIS economies are moving toward the successful frameworks put in place in the new EU member states. Financial sectors are improving their services to enterprises, lending has been growing as a percentage of GDP, and economic growth rates are solid. Public trust in the financial sector is firming. Interest rate spreads are converging toward levels observed in the new EU countries, and such modern financial products as payment cards, microloans, and credit lines are being constantly introduced. Regulatory and supervisory standards are also converging toward best international practices, although their enforcement is still weak. However, because they have not benefited from the extensive foreign direct investment that recapitalised banks in Central Europe, financial stability in many CIS countries remains an open question.(Golodniuk, 2005)

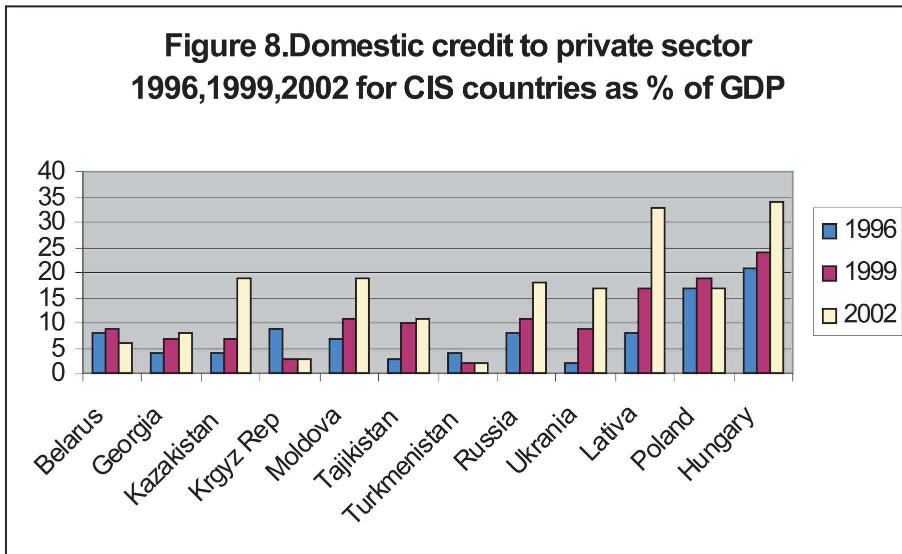


Figure 8.Domestic credit to private sector 1996,1999,2002 for CIS countries as % of GDP

Source: WDI World Bank

Conclusions

The banking system in Georgia was in complete chaos in 1994. Assets were emaciated, bad loans were prominent in bank portfolios, public confidence was devastated and banks were subject to no real supervision. The country experienced full-scale disintermediation that left banks without attractive investment opportunities and little to invest. On top of all this, banks were often poorly managed and corrupt.

With political and economic consolidation, this desperate state of affairs triggered drastic measures from the NBG and the government designed to recreate the banking industry. These measures have born fruit, including healthy profitability based on normal banking activities of transactions mediation and financing, banking consolidation as small and weak banks disappeared and sound banks were strengthened, privatisation and foreign ownership, diminution of interest spreads and lengthening of loan maturities, extension of banking loans to different sectors, development of modern banking by some if not all banks, and dramatically improved transparency (publication of interest rates and bank balance sheets, improved accounting practices and general financial strengthening of banks).

There is also no doubt that macroeconomic stability contributed to the healthy development of commercial banking in Georgia. With a new currency and stable monetary policy, banks were obliged to focus on the business of banking rather than grasping for quick profits afforded by turbulent times Notwithstanding significant progress, Georgia ranks very low compared with leading transition economies and developed market economies in terms of financial development. It ranks about average in terms of financial transition. Dollarisation, reflecting wariness of banking, seems to be adding some security to the activities of commercial banks, but it seriously lessens the powers of the NBG. Lack of public confidence in the national currency and financial institutions also retards financial

development. Banking is still irrelevant and distrusted by the bulk of the population. Limited economic development, specific labour shortages, still primitive accounting and telecommunications systems and the absence of a liquid stock market as well as other financial institutions are all barriers to be overcome.

Banking reform in Georgia is still work in progress. Given Georgia's geographical position aside the Silk Route and its ambitions to pursue a transport-based growth strategy founded on free market institutions, this reform is essential work. The role of trust as well as technology means that banking must be modern to ensure trade and growth. In the best case, the next decade will bring as much change to Georgian banking as the last.

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