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## Development of the Banking Sector in Georgia

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Wirtschafts- und Sozialwissenschaftliche Fakultät

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**STATISTISCHE DISKUSSIONSBEITRÄGE**

**Nr. 36**

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# STATISTISCHE DISKUSSIONSBEITRÄGE

Nr. 36

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## Development of the Banking Sector in Georgia

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## Summary

The authors' outline of the evolution of the banking sector development assesses governmental approaches to bank regulation and supervision and is a basic regulatory framework, needed to reduce bank failures; it characterises steps of the evolution of the banking sector and trends of its development.

The discussion focuses on: 1. Initial forming and restructuring of the banks, changes in the commercial banking sector and the reorganising of the banking systems; 2. Change of the role of the national bank and the mode of its intervention; 3. Dynamics of the banking system development in Georgia and the risks of banking activities.

The main findings suggest that 1. The Georgian banks overcame the crisis of the 90's because of having portfolios of assets in foreign currencies and performing of the national banks function in the "lender of last resort"; 2. Regulatory and supervisory practices in Georgia develop from strict regulations to a deregulation that is most effective in promoting good performance and stability in the banking sector; 3. Alongside with the increase of banking concentration and openness the banking competition and financial risks boost too; that could be managed by further development of institutional reforms in the banking sector. There is an assess of the development and weakness of the banking sector.

**Key words:** banking sector, banking supervision, financial risks

## **Structure**

Introduction

1. The Institutional Reforms in the Banking Sector
2. Financial Crises and the Challenges of the Banking Sector before and after the “Revolution of Roses”
3. Breakings and Risks in Banking Sector Development

Conclusion

Literature

## **Introduction**

After the collapse of Soviet Union and the restoring of the independence in 1990 in Georgia the formation and development of the banking sector was going along with resistances and contradictions. Several stages have been past, such as reforming the soviet period system, the banking recession and the concentration.

Despite the fact that Georgia's economy was densely tied with the Economy of Russia, the banking crisis in 1998 in Russia did not provoke the banking crisis in Georgia. Likewise is the bankruptcy of banks in Georgia during the last 15 years less significant, it was typical and mainly caused by the logical processes of transitional reforms of this sector and the typical preconditions of the banking crisis for the whole market economy. The banking system was reforming, starting from mono banking to a two-tier continental system, the creation of unified regulations was caused by the local conditions.

Since 2004 a new period has begun in the banking system development in Georgia. Banking has bloomed (banking foundations and capital accumulation). Bank activities have created strong incentives for the development of the economy, but also new financial risks have arisen.

This paper is an attempt to review the banking sector development challenges in Georgia. Its aim is the highlighting of the banking sector evolution, risks and the nature of bankruptcy of banks after the reforms in the mid 90's. There is an assessment and an answer to the question of to what extent commercial banks are strengthened and competitive.

## 1. The Institutional Reforms in the Banking Sector

Banking sector revival and recession have taken place periodically and were connected to general political and economic processes in the country. Since 1990, after gaining the independence, the country was institutionally badly organized and was regulated by means of old soviet laws. The banking system had a mono organizational form. Until 1995, before the initiation of economic reforms, it was represented by a central bank and state owned branch banks.

During this period Georgia was in a Ruble zone and there was still a surplus of cash money on the Central Bank of Russia, which reduced the money supply in the early 90<sup>th</sup> and stopped the money delivery totally afterwards. This resulted in a “Money deficit” and encouraged barter in trade. The state banking sector was fully destroyed. The National Bank of Georgia started to issue with a national currency (GEL – Georgian Lari) September 1995.

These were the most difficult years. Internal conflicts and the civil war, a demolish of traditional markets and a legislative vacuum aggravated the country’s economic and structural crisis. The reduction of the production had been continued for five years; from 1990 to 1998 the GDP was reduced by 78%. In this period the annual inflation rate reached 55%<sup>1</sup>. While in 1992 the deposits in the state banks were accounted to 350 mln (million) USD, they were reduced to 3,7 mln USD in 1995.

Since 1994 the privatization of the banking system had already begun. State owned banks had transferred into joint stock companies. They changed the profile. The first commercial banks were created on the basis of state banks before special laws on commercial banks were introduced. Other banks were created alike by typical private commercial companies. The liberal licensing policy, the low charter capital requirements, the absence of regulation norms from the national bank and the absence of professional requirements for managers of newly created banks facilitated the process of the creation of new private banks. By the middle of 1995, more than 230 banks had already been formed. To a certain extent, the process was accompanied by a criminalization of the banking business and an accompanying discredit in the eyes of the broad public.

Commercial banks lacked credit resources and they began to compete in attracting money amounts from the population in return for huge interest rates. Interest rates reach 25-30% per month. Unfortunately, such promises were beyond reasonable. After a year, already in 1995, such promises gave deplorable results. These banks became bankrupts.<sup>2</sup>

At the same time, alongside with the speculative behavior of these private banks and financial companies, the National Bank of Georgia provided a “Cheap Money” policy, continued crediting industrial companies of the state by means of clearing in the Russian Rubles. The Russian Ruble was devaluating rapidly. Besides the fact that such a policy boosted the inflation, credit issues by the National Bank of Georgia became un-liquidated.

The practice of opening commercial banks easily and providing credits by the national bank was successfully stopped by the introduction of a new regulation and the introduction of strict requirements for commercial banks. As a result of institutional changes, in 1996 a two-tier

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<sup>1</sup> World Economic Outlook Database. 2007.

<sup>2</sup> According to expert estimation, total amount, accumulated in these companies and banks, fluctuates between 25 million and 50 million USD, composed 20-35% of state budget in 1995.

banking system has been developed. The national bank constituted the upper level of the banking system. All other banks, which were under private ownership, constituted the lower tier. The National Bank of Georgia was formed as a classic central bank. The national bank was forbidden to give credits by the legislation and its function has changed according to the law “On National Bank of Georgia”. Commercial banks were subjected to strict regulation on the basis of the law “On Commercial Banks”.

Regulations from the international practice were adapted to Georgian conditions. The establishing of a stricter national bank reserves requirements, assets, liabilities and a risk management, and precedents of license revocation, bank closing and liquidation urged banks to change their behavior.

There is no doubt that in the economy, with its weak and underdeveloped banking system, the national bank’s interference was necessary as a financial markets’ organizer. Before 1995 there was no Georgian currency. The Russian Ruble and the US Dollar were used for payment transactions. In 1996 the organized interbank currency market was successfully formed. Also in 1996, the bond market for primary and secondary state securities and the interbank money market started to form.

Therefore, in the banking sector of Georgia the Continental model, which is covering the majority of the European countries, has been adopted. It was conditioned by a lack of developed capital markets and the extremely large role of its banks in the transformation process. Moreover, the creation of an effective capital allocation mechanism also supported the choice of the Continental model.

Apart from the Anglo-American model (the US, Great Britain, most Latin American countries, which provide divisions into deposit banks and investment banks and separation of the typical banking activities (deposit-taking and extending commercial credits) from typical capital market operations (security issues, secondary markets, etc.)), Universal banks were formed in Georgia. They engaged in deposit-taking and in the extension of commercial credits. In their activities credit financing prevails. It includes the two-tier corporate governance system (supervisory boards and executive boards) and strong direct control by main shareholders over the banks’ executive boards.

Commercial banks are not strictly restricted in the forming of the financial portfolio and are responsible for their financial risks. Therefore, the system can be characterized as a decentralized approach. The main responsibility for bad loan restructuring is placed with the commercial banks. These banks are responsible for the separation of loans classified as substandard or non-performing, and the managing of the bad loan portfolio.<sup>3</sup> Banks are forced to undertake active measures against bad borrowers; bank staff trains to do credit risk assessment, to deal with bad borrowers, and to be responsible for their own actions.

The national bank supervised commercial banks through regulation norms and intervened on its activities when serious financial risks, inadequate prudent regulations, severe bad loan

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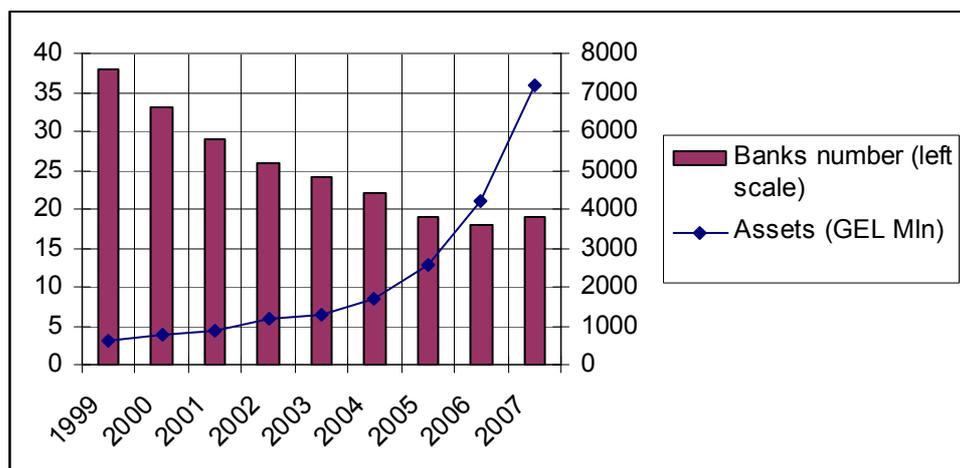
<sup>3</sup> Despite the fact that the World Bank supported the central approach and the creation of a separate financial institution to take a certain portion of the bad credits from the commercial banks and thus help cleaning the bank balance and create acceptable conditions for debtors. The main resources for covering the transferred non-performing loans were long-term facilities from the central bank (bonds and long term loans). (See Jermakowicz / Irishev (1996), p. 21-22).

problems, structural weaknesses in investment performance, have been disclosed. So in this way the National Bank of Georgia has a preventing role aiming at avoiding threats.

The central bank supported the concentration of the Georgian banking system to develop large and secure banks. In 1998, in order to improve the banks' equity liquidity, the requirements for the charter capital structure banks were made stricter. The national bank introduced a minimal charter capital at the amount of 5 mln GEL and in next the period gradually increased up to 12 mln GEL. This policy conditioned a decrease of number of commercial banks. Only in 1998 115 commercial banks lost their license. Further they decreased more. Weak and unstable banks were taken out of financial spheres (See Figure 1).

In 2007 only 19 commercial banks were functioning. 58% of the foundation capital of the banks belongs to foreigners. 13 of 19 commercial banks are functioning with foreign investments in bank capitals. Non-residents control 73,5% of the banking system assets. Their share in total activities of the banking sector in Georgia reaches 90%.

Figure 1: Number of Banks and Assets Dynamics (1999-2007)



Source: Own calculations

Nowadays the Georgian banking system consists of 20 commercial banks (in the year 2005 it had been 19, in 2006 17 and in 2007/2008 19 banks). 18 of the existing commercial banks are national and 2 are branch establishments of Turkish and Azerbaijan banks. All in all 17 of the 20 commercial banks were founded under the participation of foreign financial institutions such as Commerzbank, Societe Generale and HSBS.

Georgian strategy for banking supervision and independence regulator was based on the assumption that it is the same situation as in other transitional countries, where financial markets and instruments were fairly weak. It was a good reason for the national bank to intervene occasionally and strategically in cases that involve the threat of the insolvency of banks. By contrast, in countries that have well-developed financial markets and instruments, the financial sector may benefit more from the absence of such intervention. The presence of a strong infrastructure and a regulatory framework in these countries, including a culture where contractual rights are enforced, meaning that intervention is not necessary for the

market to function efficiently.<sup>4</sup> However, the present Global Financial Crisis shows the opposite. A lack of regulation and supervision led to excessive risk-taking in the banking sector – especially in the United States and in Europe.

As experts assert, in the condition of lacking in security markets the supervision of many central banks are based on the direct control of the banks assets and the composition of liabilities. As practice shows it has an inadequate effect and causes a deterioration of the allocation of resources.<sup>5</sup> The National Bank of Georgia, like other central banks, could not say no to its pro-active role in banking system, because the forming of the banking systems was in the preliminary stage.

From the institutional point of view, until 2008 the national bank has implemented a regulator function, but recently an amendment to the banking legislation, saying that the supervision function goes out of the central bank's duty and to the new independent agency of financial supervision, which is generated to banks, non financial institutes, security markets and insurance companies, was introduced. Moreover, supervised requirements towards the banks were simplified. Since November 2009 the agency of financial supervision is no longer independent.

Furthermore, Georgian banks are allowed to control corporations. During the last years they have begun to amalgamate with insurance and stock companies. This model is prominent for its strong connection between banks and firms, which facilitates banks' control over companies. Banks are in a position, as shareholders and creditors, to monitor a firm's management and they can interfere, when necessary, to prevent failure.

So widening supervisory activities on the banks that are members of the financial groups became necessary. This situation is beyond the rights that the constitution grants to the national bank. New approaches are needed, which will ensure the liberalization of the regulation of the banking and financing system. For 2009 the Georgian banks are less regulated.

Therefore, from the different strategies of regulations of the banking system (strong government regulation, fast deregulation strategy with a limited role for the government etc), Georgia has selected the two stage approach. In the 90's a strict regulated approach was adopted. Recently a slow movement in a direction of a deregulated system was introduced. This was possible because, macroeconomic stability has been achieved, the bank competition is strong enough, barriers on new foreign and domestic bank entry has been lifted. The prudential regulation and the bank supervision were strengthened enough to make banks soundness high.

Despite such reforms the institutionalization of the banking system is not finished yet. An infrastructure that could promote the provision of information and the security of clients is undeveloped. Nonexistence of credit bureaus, a deposit insurance system and the relevant legislation further hinder the banking system development.

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<sup>4</sup> Mwenda (2006), p. 31-32.

<sup>5</sup> Greenspan (1991), p. 97.

## **2. Financial Crises and the Challenges of the Banking Sector before and after the “Revolution of Roses”**

One of the serious challenges of the Georgian banking system soundness was the Financial Crisis in the end of the 90's. Indeed, this crisis, which started in Asia, spread in Russia and covered all the post-communist countries, also affected the financial sector of Georgia.

The crisis in Latin America in 1994-1995, the crises in Indonesia, South Korea, Malaysia, the Philippines and Thailand in 1997-1998, as well as in Russia in 1998, in Turkey in 2000-2001 are known by their typical character. They arise when a bank becomes weaker and appears in a doubtful financial situation, this affects the stability of other banks as well as the population, which lost its confidence to any of banks. Whenever a problem of a bank is publicly discovered, the problem spreads out over the banks in a “chain reaction” and the banking crisis begins.

There are numerous in-depth studies on global financial crises and several identifications of banking crises in the literature: One author stresses the importance of the increase of non-performing loans in the investment portfolios of the banks, another emphasises the action of massive withdrawal of activities by the depositors, a third underlines the deterioration of bank actives caused by the increase of bank risks.

It is commonly acknowledged, that during a bank crisis the banks loose a part of their assets or they go bankrupt, the bank balances get worse and the share of the immovable credits tends to grow in the bank portfolios. In times of a bank crisis mass withdrawal of the bank deposits are traceable. Expectations of instability still worsen the situation, which even under safe conditions creates the possibility to destroy financial systems. Generally speaking the crises have several aspects and factors, though they always begin with a little problem and cause large financial losses. When the expectation of mistrusts arises among the market agents, a financial destabilization occurs and the bankruptcy of one bank would be spread out over others.

In 1998 and 1999 the affect of the currency financial crisis in Georgia was very significant. Among well-known financial crises (banking, debt and exchange rate) only exchange rate crises drastically developed. The Georgian currency was permanently and sharply devaluated. There were signs for the bankruptcy of some small banks, because the exchange rate deterioration and the loss of the value of the national currency provoked consumers to withdraw deposits from the banks. To decrease the broad money the national bank increased the norm of required reserves for commercial banks from 12% to 16%. Consequently the volume of credits and the rate of interest increased.

Commercial banks failed in very difficult financial situations, but it did not effect a rise of the banking crisis, because 80% of the deposits were invested in the US Dollars. So requests of consumers to withdraw deposits touched only the national currency. A speculative rush to exchange the national currency into a foreign currency enlarged and a currency panic increased rapidly. The exchange rate fluctuated swiftly and a currency crisis had developed. Commercial bank assets in the national currency reduced, but the large amount allocated in a foreign currency has been preserved.

In addition to that the national bank supported commercial banks through crediting them with short term loans when financial difficulties were imminent. But the national bank has not enough sources to assist all the banks. Special criteria were made to select those banks whose assets in sum were covering about 80% of the deposits. Afterwards only 13 banks were chosen and have been given credits to avoid bankruptcy.

By that time the large number of small banks collapsed during the financial crisis. Their activity was based on a poor management. Many of them had significant outstanding debts, but this weakness could not touch the whole banking sector. They became a bankrupt. In 1998 more than 150 banks had deprived licensee. But take into account that more than 80% of the clients' deposits were sound and secure, the banking system crisis only spread out over Georgia.

Therefore, during the financial crisis in the end 90's in the post-communist countries, the banking crisis did not strongly develop in Georgia because of the prevailing of actives in a foreign currency (US Dollar) in the structure of the portfolio of commercial banks.

The Russian-Georgian-War in august 2008 and the Global Financial Crisis in 2008/2009 brought new challenges for the Georgian monetary system. The tension with Russia caused that individuals have withdrawn their savings and deposits from the banks. To avoid a crisis and to let the banks satisfy the claims of the customers smoothly, the required reserves of commercial banks were reduced from 13% to 5 % in November 2008. The objective behind was to stimulate the national economy, rather than to implement the strict monetary policy measures.

Despite the heavy consequences of the Global Financial Crisis and the war against Russia, Georgia succeeded in preserving the positive economic growth rate, the low inflation, the stability of the national currency and the fiscal system. It is also noteworthy that none of the existing commercial banks in Georgia applied for insolvency. Reasons for that, among others, might be the adequate policy of the national bank and the strict supervision, the relatively low dependency of the banking sector on foreign capital or the low impact of the financial crisis. Besides the allocation of the internal resources, the financial support from the United States and Europe highly contributed to achieving these positive results.

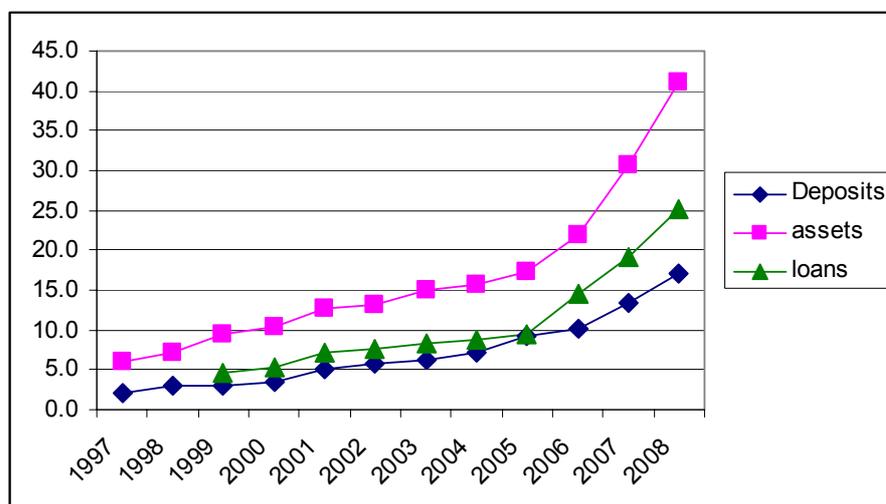
### 3. Breakings and Risks in the Banking Sector Development

The breakthrough in the banking sector happened in 2004, after the “Revolution of Roses”.<sup>6</sup> Since 2004 commercial bank assets, deposits and loans grow up considerably (See figure 2).

Despite the fact that during 1995-2004 banks assets increased periodically, its share in the GDP was less than 15%. There was a comparatively low volume of deposits in the banks, a low level of savings, high interest rates on loans<sup>7</sup>, and a high share of money flow in cash. At the same time the volume of credits in the private sector was about 8-9% of the GDP.

During the years 2004-2006 the bank assets tripled. Meanwhile, the same accomplishment needed almost 6 years to happen in the past years. It is predicted that the assets of commercial banks will reach to 40% of the GDP in 2009.

Figure 2: Share of monetary aggregates of commercial banks in GDP (%)



Source: National Bank of Georgia, 2008

These indicators belong to the important signs of the financial sector development, which is record breaking high for the Georgian economy, but it is low compared to many other countries. Among countries with transition economies, Georgia's loan to the GDP ratio exceeds only that of Armenia, Azerbaijan, Kyrgyzstan and Moldova. In Turkey it exceeds by 20% in 2004 and it reaches 150% in the countries with developed economy.<sup>8</sup> This ratio demonstrates how much the financial and the real sector of economy are integrated.

<sup>6</sup> Economic stagnation was one of the reasons of the “Revolution of Roses” in November 2003. The president Saakashvili's new government started radical changes in the social, political and institutional fields. A corresponding change followed in the country's financial sector, too. Afterwards corruption and the involvement of state institutions in the economy reduced drastically, the investment climate improved and the averaged GDP growth rate reached to 9.3 in the years 2004-2007.

<sup>7</sup> The annually weighted interest rate decreased from 45 % in 1996 to 25 % in 2008.

<sup>8</sup> Kovzanadze (2005).

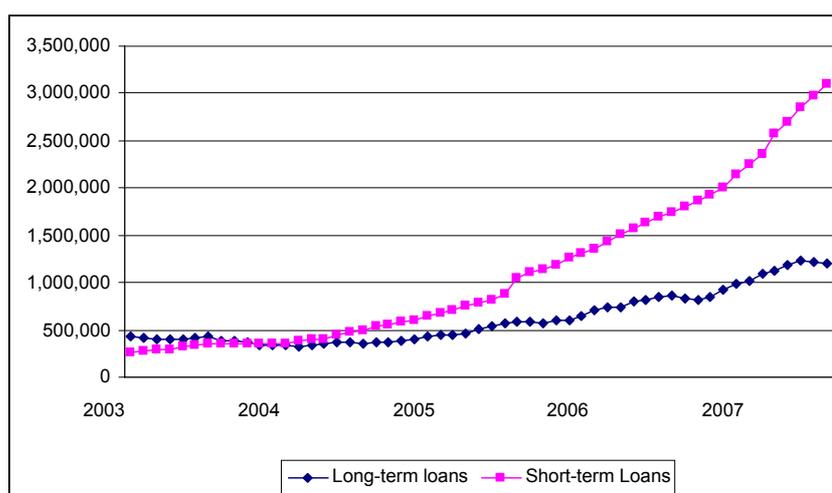
Despite the fact that the rapid growth of the loan level is a positive event, it also bears certain risks. Some authors are convinced that the high inflation and the rapid growth of credits could be considered as the most reliable indicators of the possibly coming bank crisis.<sup>9</sup> A similarly high pace of the loan growth was recorded, e.g. in 1988-1994 in Mexico, when an annual average of the growth of the loans granted by the banks to the private sector exceeded by 25%. Such a rapid growth was one of the reasons for the banking crisis in Mexico in 1994.

However, it should also be mentioned that such a danger is basically awaiting those countries, where the banking regulation and the supervision is very low, whereas the corruption is high and the society is far from being law-abiding. The countries in which the process of financial liberalization is newly launched or is implemented in wrong sequences are also under the threat of a certain risk. The basis for the so called “tequila-crisis” in Mexico, on the whole, was the wrongly exercised policy.

Moreover, the bank credits tended to grow rapidly in the last years in Central and Eastern European countries. One reason for this development is the low initial level of financial intermediation in these countries and the fast development of the sector is simply an attempt to “catch up” with the developed financial system of the Euro-Union and in most cases it is not threatening.<sup>10</sup> Furthermore, Kiss et al. (2006) conclude that the credit growth could be too rapid and bear a certain risk because the country’s economy may fail to adapt to the growth rate of the financial system.

In 2007 60% of the balance sheets of the Georgian banking sector were loans to non-households (government loans, company loans). The volume of the bank loans significantly exceeded the deposit volume, which is demonstrating the fact that a substantive portion of resources attracted by the banks is from relatively low rate credit lines to and from foreign commercial banks and financial institutions.

Figure 3: Monthly Volumes of the Loans of Commercial Banks to National Economy in 1/2003 – 12/2007 (in 1000 GEL)



Source: National Bank of Georgia, 2008

<sup>9</sup> Kovzanadze (2002).

<sup>10</sup> Kiss et al. (2006).

Beforehand, by the end of 2000 banks just issued short-term credits due to the instability of the country. Issuing short term loans was the main strategy of commercial banks. The shorter the period for loans was the higher was the confidence in the return of debts and a minor risk. In 2007 the volume of short-term credits increased and reached 69% in the total volume of the credits in Georgia. (See figure 3).

The increase of the long-term loans' is explained by the policy of active loans of the commercial banks. Banks improve the risk management, which allows them to manage the long-term credit portfolio better. The increase in the loan maturity period lowers banks' costs, which is related to the extension of new loans and permits economic agents to satisfy their demand for long-term loans, is contributing to a better allocation of resources. However, long-term loans (with a maturity period of 10 years and more) with fixed interest rates may bear certain credit risks, since borrowers face interest rate risks. In addition the long-term loans' share in the loan structure declined considerably since 2004. In particular, if interest rates decrease in the future, borrowers will have to cover loans with high interest rates and lose competitiveness, where the latter is affecting the borrowers' solvency.

Long-term credits encourage the development of the economy and their long-term stability as well. The share of credits for trade reduced by one third (1/3) in the total amount of the credits.<sup>11</sup> Credits for construction and service spheres have increased. Real estate credits have especially raised, consumption credits have reached one third (1/3) of the total credit volume. The export industry only accounts for 7% of the total credits. If we take into account that this industry is one of the most important branches of the economy of Georgia, we can draw the conclusion that the credit structure is not sound and steady yet.

Along with the growth of the credit portfolio of the commercial banks, also its quality improved. In particular in the years 2002-2007 the share of non-performing loans decreased from 7,2 to 2%, that indicates reduced risks. An absolute low indicator of non-performing loans, on the one hand, is the result of an improvement of the quality of assets and, on the other hand, the reason for that is the abrupt rapid growth of loans that started a couple of years ago.

It should be noted that overdue liabilities in the national and the foreign currency equaled each other. Historically an undue debt repayment was more peculiar to loans extended in the foreign currency. It was explained by the fact that commercial banks used the foreign currency more actively in the high-risk segment of the credit market. Equalization of overdue liabilities in the national and the foreign currency mainly occurred due to improvements that were related to foreign currency denominated loans.

The circumstance that overdue liabilities dropped in the foreign currency, first of all, confirms the hypothesis that the appreciation of the national currency decreases the risks that are related to foreign currency denominated loans. In a situation where the loan dollarization rate is high, which is not mainly caused by the distrust towards the national currency, but due to the availability of excessive volumes of the foreign currency, this leads to appropriate improvements in the credit portfolio.

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<sup>11</sup> National Bank of Georgia. Database.

There is a sufficient demand for Lari denominated loans in the economy. This is proved by the fact that national currency denominated loans bear higher interest rates than loans extended in the foreign currency. In particular, 2/3 part of the loans extended in Lari were short-term (under 1 year), while more than half of the loans denominated in the foreign currency were long-term (over 1 year).<sup>12</sup> This can be explained by the fact that neither the banks nor the population expect the Lari to depreciate in the short-term period, while banks do not wish to bear exchange rate risks in the long-term, preferring to extend long-term credits in the foreign currency.

In Georgia, compared to other countries, the interest rate spread is very high. The high spread between the interest rates of loans and deposits was encouraging the high return on the assets, but then again it is the result of the grown cost of the loans.

In the recent period credit resources have become more expensive on the international markets. The existence of high interest rates in Georgia is not distinctive, compared to other post-communist countries. Up to the present day Georgian banks could attract cheap credits from the European banks and international organizations, that facilitated to decrease the interest rates, but at present due to the Global Financial Crisis, foreign credits provided to the Georgian banks could be restrictive and deterioration of bank loans and assets on average will be observable. It will create serious risks, but at the same time, domestic competition grew more intensively, forcing the banks to refrain from the increasing interest rates on loans.

In Georgia half of the liquid assets are denominated in a foreign currency demonstrating the fact that the exchange rate (primarily the Lari-US Dollar rate) is a significant factor for managing the bank liquidity. A variation of the exchange rate is one of the essential factors that in addition to the direct impact on the structure of asset-liabilities of the commercial bank also influence the credit quality. Respectively, exchange rate fluctuation could be the cause of the growth of the credit risk. It is likely that along with the decrease of the exchange rate spread, the improvement of the non-interest income and/or the better management of expenditures shall become more urgent for banks and a critical element for profitability.

Overall, in 2007 in comparison to 2003, all financial strength indices<sup>13</sup> except for profitability and liquidity drastically increased. Large banks performed better than small banks and had a higher liquidity. The banking sector's profitability deteriorated, although this fact has a temporary nature and will not outweigh the improvements of other parameters (See figure 4).

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<sup>12</sup> National Bank of Georgia. Database.

<sup>13</sup> The Asset Quality index - total non-performing loans/total loans, not non-performing loans/equity capital, and the residual value of fixed assets/total assets. Each ratio has the weight of 0.33 in the index.

The Liquidity index - liquid assets/total assets, assets with under-1-month maturity/liabilities with under-1-month maturity. The ratios have the weights of 0.4 and 0.6, respectively.

The Currency Risk index - balance sheet currency position/supervisory capital, net currency position/supervisory capital. The ratio's weights equal 0.75 and 0.25, respectively.

Profitability index - return on assets and return on equity. Each ratio has the weight of 0.5 in the index.

The Capital Adequacy index- supervisory capital adequacy index.

The Interest Rate Risk - ratio of the difference between interest-bearing assets and liabilities with under-1-month maturity to the equity capital.

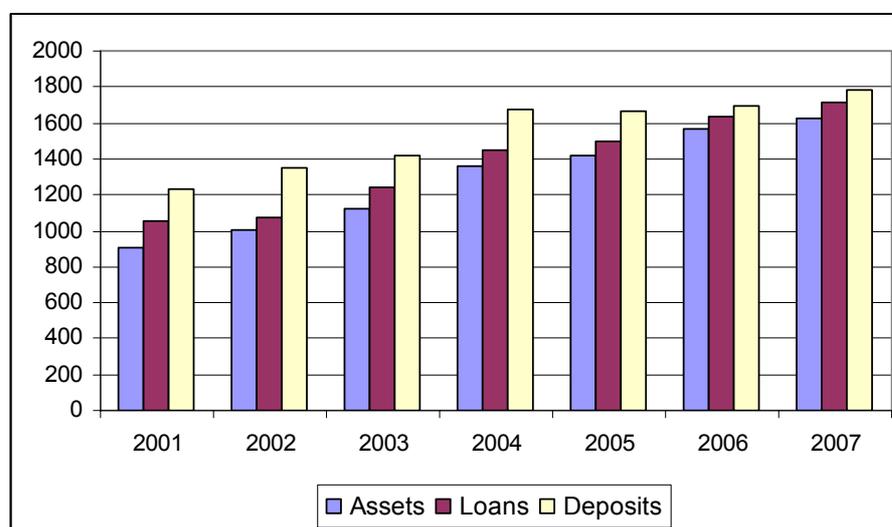
Figure 4: Financial Strength indices

	Asset Quality	Liquidity	Exchange Rate Risk	Profitability	Capital Adequacy	Interest Rate Risk
2003	100	100	100	100	100	100
2004	106.4	67.5	89.4	28.4	98.1	118.3
2005	120.6	82.3	111.8	33.3	88.3	156.4
2006	119.2	97.9	251.2	98.4	96.9	108.7
2007	118.1	100.0	257.5	74.9	110.4	281.8

Source: National Bank of Georgia; Own calculations

In addition the bank market concentration has increased, especially on the deposit market because the deposit policy of large banks has become livelier. The deposit market has always tended to have a higher concentration than the loan market, which at a certain extent reflects inhomogeneous confidence of the economic agents towards the different banks. Despite the fact that the 6 largest banks occupy more than 80% of the bank market revenues, the bank market concentration according to the Herfindahl-Hirschman-Index<sup>14</sup>, which is a worldwide acknowledged measure of market concentration, is within a reasonable competition. The Herfindahl-Hirschman-Index shows that in 2007 the Georgian banking market is moderately concentrated. But with the addition, the HHI for the deposit market is close to 1800 (above 1800 means a highly concentrated market). (See figure 5)

Figure 5: Market concentration by Herfindahl-Hirschman-Index (HHI)



Source: National Bank of Georgia; Own calculations

<sup>14</sup> HHI is calculated as sum of square of market share in per cent of all firms in the market. Its value varies within  $0 < HHI \leq 10000$  and depends both on the number of market participant firms and their relevant shares. By marginal values determined by Trade Federal Commission and Department of Justice of the USA: The Agency divides the spectrum of market concentration as measured by the HHI into three regions that can be broadly characterized as unconcentrated (HHI below 1000), moderately concentrated (HHI between 1000 and 1800), and highly concentrated (HHI above 1800).

Credit market concentration has been steadily increasing during recent years. The concentration of assets also tends to grow. The growth of the market concentration of deposits is primarily due to the decreasing number of banks. The concentration level in this market is high, which indicates that only a few banks succeed in mobilizing large volumes of deposits from the economy.

Partly due to this tendency, several banks have merged and large groups of the banks developed. The six largest banks control 86% of the deposits in Georgia. In fact they determine stability of the banking sector and represent competitors for innovations and introductions of new bank products on the market.

It should be noted that under the conditions of a dynamic growth in the banking sector, a high level of concentration is not worrisome, since banks still face intensive competitions in gaining a share of the growing financial market. In addition, the entry of new banks to the Georgian banking sector essentially contributes to the development of the competitive market.

## **Conclusion**

The transformation of the banking system in Georgia had passed through several stages. At the initial stage of the development industrial-commercial companies were created that served as financial mediators, but as it was expected there were bankrupted. Since 1996, after the creating of the legislation base, the institutional formation of commercial banks had begun, though they had limited financial resources. With the help of foreign capital a lot of banks were founded. The banks were oriented on foreign currency operations.

Despite bank reforms in the middle of the 90's, the population's confidence towards the financial system quite low. The credit resources of the banks had been rather poor for further ten years. Consequently, the economic development passed on a very low rate and the economy was growing slowly.

In 1997-1998 the financial crisis affected the Georgian banking sector weakly. Banks, due to their operations in US dollars, escaped bankruptcy. Till 2004 they developed with a slow rate. Only after 2004 due to an economic liberalization and foreign investments flows, the actives of commercial banks had increased significantly. The role of the banks in the Georgian economy rose. The concentration of the banks boosts the integration of the financial sector into the "open space", but problems of the bank regulations have increased. During the Global Financial Crisis profitability and liquidity as well as the interest rate and the dependence on the foreign loans form new main risks for the banks financial strength.

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