Financing Economic Growth in Georgia

Georgia is witnessing a credit boom, which could bring about sustained financial deepening

Andreas Billmeier and Shuang Ding

Georgia's output contracted sharply at the beginning of the transition period. Since 2001, however, economic development has accelerated and policies aimed at macroeconomic stability have allowed the economy to grow at almost 7% per year in an environment of modest inflation. After the Rose Revolution in 2003, economic reform gained fresh momentum, focusing on strengthening the country's fiscal position, addressing constraints in infrastructure, and improving the business climate.

However, until recently the economic expansion has not been accompanied by significant financial sector deepening. Monetization remains below 20% of GDP, and the financial sector remains small in comparison with more advanced transition economies (see Table).

The sector is dominated by the banking system, while the stock market remains small. There are currently 18 banks — all private, of which two are wholly foreign-owned banks. Despite the sharp decrease in the number of banks from the peak of 229 in 1994 — partly due to the new minimum capital requirement — the country is still considered to to have too many banks relative to the size of the population and the economy.

The banking system is generally sound, but the interest rate spread remains high (at about 10% in 2005), which is mainly due to high operating costs, high reserve requirements, and perceived credit risk.

Why Lagging Behind?

Our analysis concludes that financial intermediation in recent years has been impeded by:

- A difficult macroeconomic environment during the 1990s — characterized by periods of economic contraction, hyperinflation, and sharp exchange rate movements — has damaged public trust in the *lari* and retarded the pace of remonetization of the economy, limiting the size of commercial banks' balance sheets.
- The lack of loanable funds, as a large portion of the money is held in cash outside the banking system. Besides, the high reserve requirement implies that only 90% of the funds attracted by the banks are available for extending loans;
- Low demand for credit, until recently, owing mainly to the lack of profitable investment opportunities and high interest rates;
- Weak institutions, e.g. weak creditor rights, an inefficient judicial system, limited information about firms' performance, and lack of expertise in evaluating risk, which limits bank lending;
- Certain financial regulations, such as the ceiling on equity stakes in domestic banks by non-industry investors, and the current capital adequacy requirements;
- Market structure with many small and financially weak banks.

Prepared to Catch Up?

Georgia has started to witness a credit boom — albeit from a very low level. During 2005, private sector credit increased to 15% of GDP from about 10% in 2004. The credit boom — accompanied by longer loan maturities, lower lending rates, de-dollarization, and simplification of loan applications — could bring about a period of sustained financial deepening, crucial for financing economic development.

The main contributors to the credit boom are the favorable economic conditions, an improved business environment, the awakening of an "entrepreneurial spirit", and — from the consumer side — an increased demand for durables and real estate following the increase in income levels.

Financial Sector Development, 1996 & 2005 (% of GDP)

	Banking system credit to economy		Monetization	
	1996	2005	1996	2005
Georgia	**3.3**	**15.0**	**6.7**	**16.5**
Kazakhstan	5.1	38.6	9.5	30.3
Poland, Czech Rep., Hungary (average)	36.5	39.0	49.7	55.4
Baltic states (average)	11.8	54.1	21.6	47.6

To promote sound financial intermediation over time, the authorities have already set in motion some of the required processes, such as:

- Setting up the credit information bureau;
- Seeking sovereign credit ratings from renowned rating agencies to improve access to external financing;
- Introducing a deposit insurance scheme to increase public trust in banks;
- Introducing legislation to eliminate the restrictions on bank ownership;
- Introducing new capital requirements to further reduce the number of small banks with weaker ratings.

However, more needs to be done to address the fundamental issues. The following measures are worth considering:

- Strengthening institutions and infrastructure, such as better protecting creditor rights, expediting court procedures and promoting international accounting and auditing standards and disclosure requirements;
- Consolidating further the banking sector to achieve economies of scale;
- Encouraging foreign entry, which can bring in much-needed capital, financial know-how, sound corporate governance practices, more competition;
- Streamlining regulations, while striking a delicate balance between safeguarding the integrity of the financial system and avoiding over-regulation.

In the meantime, the authorities need to be wary of the risks associated with rapid financial expansion and be prepared to deal with the fallout of the credit boom. Supervisory capacity should be strengthened to deal with a much larger and more complicated loan portfolio.

Andreas Billmeier and Shuang Ding are economists at the IMF, Washington, DC. The views expressed here are those of the authors at the time of writing (March 2006) and should not be attributed to the IMF, its Executive Board, or its management. The full text of the paper can be accessed at: http://www.imf.org/external/pubs/cat/longres.cfm?sk=19216.0 **BT**