NEWSLETTER

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Georgia's financial system on a more stable footing

Over the past year excessively rapid growth of household lending has been successfully reined in, and aggressive lending practices of micro-finance institutions have been banned. The high level of dollarisation and excessive debt of households remain vulnerabilities of the financial system and constrain monetary and exchange rate policy. The National Bank has made good progress in developing a regulatory framework for capital markets. The pensions fund became operational in 2019 and may support liquidity in local markets.

The banking sector is well developed

On the back of strong economic growth (estimated by the IMF at 4.6% in 2019) the Georgian banking sector has continued to expand. In September 2019, the banks' corporate sector assets were about 14.6% higher than a year earlier, retail assets about 7% (valued at constant exchange rates). Overall, credit to the real sector amounted to 65% of GDP, which is among the highest in Emerging Europe. Indicators measuring access to finance from banks also show that Georgia is level with, or even above, EU countries in Central Europe, underlining the advanced development of the country's banking sector.

Credit to real sector to GDP: Regional comparison

Source: World Bank, data for 2018

Emerging risks of overheating have been checked

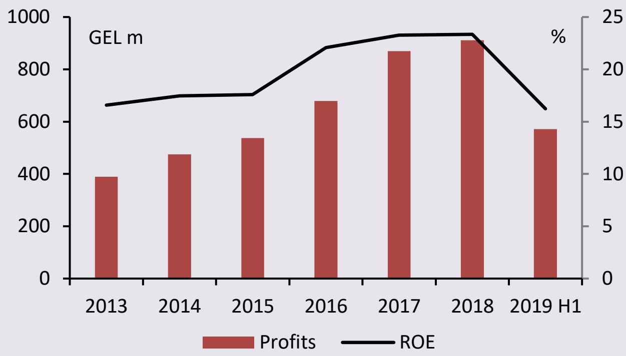
This recent expansion of bank credit at a rate above trend growth has been a concern for the National Bank (NBG). In January 2019, the so-called 'responsible lending regulation' came into effect which restricted lending to households with either insufficient collateral or income. Earlier regulations had already brought the micro-finance sector under the remit of the NBG, and reduced further the maximum interest rate that could be charged on small loans. Many of the smaller lenders, which often followed overly aggressive business models, have since left the industry.

Georgian banks are well capitalised

As should be expected in a period of strong growth, profitability of Georgian banks remains very high. This can be explained by low costs from loan defaults, and also by the high efficiency of the banks.

The low share of non-performing loans is typical of a rapidly expanding banking sector. Yet, vulnerabilities clearly lie in the already high household debt (at 37% of GDP). A large number of very small defaulted individual loans were transferred from the banks to a private foundation, allowing these households fresh borrowing. Corporate leverage has also increased. 56% of enterprise loans are denominated in foreign currency, and clearly vulnerable to a further depreciation of the Lari. The insolvency law that has been introduced in parliament would allow a more orderly restructuring of overly indebted firms.

Banking sector profit



Source: National Bank of Georgia

The very high concentration of the banking sector remains a concern (two banks control 73% of sector assets). Investors and bank managers may consider these banks as too big to fail and such banks may therefore benefit from an implicit state guarantee. This would undermine incentives for sound risk management. A new framework for bank resolution is designed to address this problem.

The NBG requirements for bank capital are based on the Basel III framework, and closely resemble those in effect in the EU. Bank-specific risks, due for instance to unhedged currency exposures, result in additional buffers. At end-2019, all key banks exceeded minimum requirements. Such buffers are appropriate as asset quality would likely deteriorate once the present strong growth falters.

Capital market development

The NBG has also put in place a stronger framework for capital markets. An investment funds law was close to parliamentary approval in December, and a law on derivatives (which is crucial for hedging) has also been tabled in parliament. Bond and equity markets are underdeveloped, even compared to other countries in Eastern Europe. The local bond market amounts to only about 7.7% of GDP, and is largely comprised of government debt. A repo facility has encouraged corporate bond issues, though securities denominated in Lari are mainly held by the banks with little turnover. In its first year of operation, inflows into the Georgian pension fund have already been substantial. Even though the fund will only be able to invest in a limited share of any single issuer or instrument this could help expand liquidity in local markets.

Challenges in financial sector policy

Over the coming years three key policy initiatives are likely to strengthen the resilience of Georgia's financial sector.

First, in December 2019, legal amendments were close to approval which would strengthen the powers of the NBG to conduct bank resolutions. Banks will be required to draft plans for recovery from a crisis and for their orderly restructuring or closure ahead of a potential decision that they have failed. Such regimes for the orderly wind-down of failed banks are increasingly common in emerging markets. Given that at least two banks in Georgia control significant market shares and may be deemed 'too-big-to-fail' this regime should ultimately strengthen incentives for sound risk management, and will limit risks to the financial system arising from stress in an individual bank.

Secondly, the NBG continues with its policy of de-dollarisation. A credible inflation targeting regime is essential in dislodging expectations that the exchange rate may be stable. Various prudential measures adopted since 2016 should also be effective. Foremost among them are the differential reserve requirements on deposits in foreign currency, and the ban on foreign currency loans to households in amounts below GEL 200,000. The limitations on household credit in effect since early 2019 were also more restrictive for foreign-currency denominated loans.

Finally, capital market development will expand the options for funding in local currency of the banks. The government is in the process of adopting an explicit target for funding in Lari in local markets in its debt management strategy, and also seeks to make the process for debt auctions more efficient. Greater liquidity in benchmark issues of certain maturities would allow investors to price securities on the basis of a yield curve for a risk-free local asset.

Author

Alexander Lehmann, lehmann@berlin.economics.com

Editor

Dr Ricardo Giucci

A more comprehensive analysis is provided by the Policy Study "Financial Sector Monitor Georgia 2019"

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The German Economic Team advises the Government of Georgia on economic policy issues since 2014. It is funded by the German Federal Ministry for Economic Affairs and Energy and implemented by the consulting firm Berlin Economics.

Berlin Economics

BE Berlin Economics GmbH | Schillerstraße 59 | 10627 Berlin
+49 30 / 20 61 34 64 - 0 | info@berlin-economics.com | Impressum