Institute for Development of Freedom of Information (IDFI)

Capital Market in Georgia and its Enemies

By

Khishtovani[1] Giorgi

Working Paper

2012

[1] Department of Accounting and Control, University of Bremen, Germany, khishtovani@uni-bremen.de; Expert of the Institute for Development of Freedom of Information (IDFI)

For the last 20 years, two parallel processes necessary for the long-term development of the Georgian economy have been in progress: on the one hand, the model of Georgian capitalism is forming (Christophe, 2006) and on the other hand, a functional Georgian financial market is in the process of development. Unfortunately, these two interrelated phenomena are distinguished by their inconsistency and obvious mutual contradiction, which calls the economic development of the country into question.

The goal of this article is to analyze the Georgian financial market, theoretically explain the reasons for its low level of development, and predict long-term results.

When talking about the low development level of the financial markets in Georgia, the low development level of one of its main components, the capital market, is implied. This circumstance, as is generally known, makes doubtful the final goal of the financial development of every transitional economy (Papava, 2005) and full integration of the economy of the country into the world financial market. This is because it calls into question such an important (financial) instrument of the world economy as, for example, the concepts of the valuation of specific assets or whole enterprises and capital market-oriented financial reporting. At the same time, in the circumstance of an undeveloped capital market, the fulfillment of the necessary condition of the country's economic liberalization is threatened. These threats include, for example, the prospect of raising capital by market players in equal conditions and later using it for their own rational reasons in a free competitive environment with the other players; or the possibility for the local physical or legal entities to invest their capital in the country's economy as potential investors, instead of the conventional method of investing in Georgia – placing funds on deposit in the banking sector. In the end, in the conditions of a weak capital market, the probability of the existence of international capital in the national economy decreases significantly on the one hand, and on the other hand, the possibility of effectively distributing local financial resources in different sectors of the economy is limited. This generally calls into question the perspective of long-term development of the national economy.

By way of background, the positive changes made after 2003 in Georgia should be noted. For example, the degree of enforcement of Georgian tax laws increased sharply after this time, which, as a rule, is empirically followed by a growth in enterprises' value and an improvement in the quality of corporate governance (Desai et al., 2007). We also know that corruption, which has a negative effect on the growth of the economy, capital costs, and the quality of corporate governance (Lee/Dg, 2009; Dg, 2006), has significantly decreased in Georgia since 2003 ("Global Competitiveness Report 2012-2013", 2012). At the same time, the opening of financial markets and their liberalization are the official policy of the Georgian government. The working tools of this policy (Djankov et al., 2002), which were successfully integrated in Georgia („Doing Business 2012", 2011), positively correlate with foreign direct investments in emerging markets (Agosin/Machado, 2007) and also cause the growth of value of local enterprises (Chua et al. 2007).

The growth of the Georgian economy in recent decades should also be discussed as a prerequisite for the development of a Georgian financial market (especially capital market) and should be supported by evidence from case studies of other transitional economies (Barna/Mura, 2010). Unfortunately, in spite of the factors mentioned above, the absence of a functional capital market in Georgia is still very obvious, a strong indicator of which is a very low (insignificant) rate of the trade of its main instruments on the stock exchange, such as shares, corporate bonds and other securities. For instance, according to the World Economic Forum, the underdevelopment of the financial sector is named as the main deterrent of the competitiveness of the Georgian economy (World Economic Forum, "Global Competitiveness Report 2012-2013", 2012). To develop this issue further, I would like to formulate several hypotheses, and with the help of these and several other factors it will become possible to theoretically explain this low level of development[2].

The first potentially hindering factor is the Georgian banking system and its monopoly on the Georgian financial market. It should be noted that the banking sector is one of the rare Georgian institutions that gradually developed after the collapse of the 1990s and strengthened its positions on the market. As a result, by following the rules of "influential group theory" (Olson, 1965), a strong homogenous group of financial actors appeared in

[2]It will be necessary to confirm this hypothesis empirically in future research.

Georgia,[3] which subsequently hinders the development of the financial system for fear of the expected competition (Rajan/Zingales, 2003; Murgulia, 2012). Empirically, the best solution to the problem (slowing down the development of financial markets) is the strengthening of the cross-border flow of goods and capital (Baltagi et al., 2009). On paper, Georgia enjoys an exemplary fulfillment of these conditions, yet in spite of this the country has failed to overcome the aforementioned obstacles. This is the result of a relatively weak institutional organization within the government (e.g., nonexistent transparency and weak legal protection of investors[4]) (Haber/North/Weingast, 2008; Daude/Fratzscher, 2008). These circumstances can lead to underdevelopment of the capital market in Georgia in two ways. First, in institutionally weak countries, priority is given to financing existing credit institutions and foreign direct investments, rather than portfolio investments (Daude/Fratzscher, 2008), which in turn causes further strengthening of the banking sector[5]. Second, data confirms that the rate of the development of financial markets declines especially when the existence of strong interest groups is accompanied by a weak and unstable government (Beccera et al., 2012; Levitsky/Way, 2010).

The actions of the Georgian government and its unintended disruption of financial markets is another factor hindering the development of a capital market in Georgia. In this context it is necessary to explain the two main paradigms of Georgia's economic policy of the last decade. First, the government focused on foreign direct investment. Second, the government attempted to support the strengthening of the financial standing of state companies and their market positions for future privatization projects. In the end, this disrupted the already weak balance in the Georgian markets and rendered impossible the creation of a competitive environment. Despite the fact that the Georgian government has made at least two serious attempts during the last twenty years to

[3]It should be taken into consideration that the whole Georgian banking sector, in contrast with, for example, European one, is distinguished by its primitive model and encompasses only a small part of banking activities (deposits, loans, payments).

[4]It is empirically confirmed that in the conditions of weak legal protection of minority shareholders the process of developing the capital market becomes more difficult (Modigliani/Perotti, 1997) and the interest groups give preference to the form of bank lending.

[5]A similar doubt can be expressed concerning a sharp growth in the amount of the so called *remittances*, which as a rule causes the development of the financial markets along with the growth of the number of credits given in regards to the deposits in the bank institutions and gross domestic product (Aggarwal et al., 2010); but at the same time a doubt that this type of development unilaterally strengthens the banking sector and therefore disrupts the development of capital markets may arise.

strengthen the capital market and today the political elite officially supports this process, for the above mentioned reasons this goal is impossible to realize[6]. Foreign direct investments hinder the development of the capital market, since with their help it becomes possible to ignore the development of the necessary functional mechanisms of the capital market (such as, for example, communication with the capital market, transparent and high quality financial reporting, listing on the stock market and trading with different king of securities) and necessary prerequisites like a strong institution for defending the rights of minority shareholders (Daude/Fratzscher, 2008). Concerning the unilateral privileges of governmental enterprises, Than and Freeman (2009) offer an interesting insight into what type of negative macro- and microeconomic results follow the domination of local markets by government companies in developing countries.

The promotion of individual enterprises by the government brings us close to the third important factor which potentially hinders the development of the Georgian capital market: the so-called politically connected enterprises (Fisman, 2001; Faccio, 2006). In the case of these kinds of companies, one should note that these connections render unnecessary the usage of such market mechanisms as listing on the stock market and trade with securities, which resembles the strategy of attracting foreign direct investments by the government (Chaney et al., 2011; Leuz/Oberholzer-Gee, 2006; Faccio, 2006). Data confirm that these types of political connections reduce the costs of capital (Boubakri, 2012), increase its profits and therefore cause an increase in the value of the enterprise (Leuz/Oberholzer-Gee, 2006; Faccio, 2006). As a result of the latter, the owners of such enterprises in transitional economies prioritize increasing the performance of enterprises result from such connections (in contrast to the strategy which is based on the success of market connections), which is subsequently harmful for the national economy (Papava, 2002). Their long-term goal is probably a profitable sale of such enterprises to foreign investors (Faccio, 2006; Baum et al., 2008)[7].

[6] It is noteworthy that in 2008, when the Georgian government introduced the „the Bill of Global Competitiveness of the Financial Sector“ and other related bills, it did not mention the development of the capital stock (capital) market at all. In other words, under the competitiveness of the financial sector the government implied only the strengthening of the supervision of the banking sector and nothing else. In the end the bill was canceled in two years after being canceled because it did not work in practice (Narmania, 2008).

[7] It should also be noted that, according to the Global Competitiveness Report published in 2012, Georgia occupies the 131 place out of 142 countries in regards to protection of property rights. (World Economic

A no less important reason for the low level of development of the Georgian capital market is its social perception. As mentioned above, in the 1990s there were at least two serious attempts to establish a strong capital market in Georgia. In essence, the first attempt implied the so-called "voucher privatization process" and it is of relevance to take into consideration the impact of the failure of this process on the failed results of the process launched after the Rose Revolution. This was the first real experience of the young Georgian state and its population with real property. This was expressed in owning the shares of nearly bankrupt Georgian enterprises, the shareholders of which were at the same time the workers in these enterprises (Papava, 2010). In this context it is necessary to mention the concept of the "Washington Consensus", which, since the 1990s, promoted opening markets across the world and a maximum liberalization of the world economy. The Washington Consensus took hold in Georgia with the help of world financial institutions. At the same time, the derivative "Gaidar Reforms" in Russia were mirrored in nearly all transitional economies, and, except for a couple of cases (as a rule, these exceptions were the enterprises that produced gas and oil and recycled metal on the territory of the former Soviet Union) ended in the bankruptcy of privatized enterprises and the waste of existing property as assets (Christophe, 2006; Papava, 2002). In Georgia, like in many other transitional economies, this process was accompanied by the primitive copying of the continental European legal system, which in this period offered very little legal protection to first-generation Georgian minority shareholders (Christophe, 2006; La Porta et al., 1997). This and many other reasons enable us to assume that the second attempt to establish a strong capital market was accompanied by the still vivid memory of the collective collapse of the "voucherization process" of the 1990s. This factor continues to play a role in the establishment of capital markets in the country.

At this stage, we can assume that the circle is complete. The Georgian banking sector is closely related to the Georgian government and it is propelled by an inner motivation, defined by corporate interests, to prevent the establishment of a functional capital market in Georgia. The Georgian government, in turn, supports the privatization process and the inflow of foreign direct investments. This complicates the formation of the capital market

Forum, "Global Competitiveness Report 2012-2013", 2012). This fact partially explains why it is possible because of different interests for a Georgian company, connected or not, not to be interested in making the information about its owner's public, which in turn is an important prerequisite for the development of a capital market.

in Georgia, when on the one hand, the balance in the local markets is disrupted and, on the other hand, it disturbs the establishment of real institutions in the country with this policy. At the same time, the existing interest groups on the level of enterprises are still closely connected to the government actors and/or the banking sector[8] and are obviously not interested in the existence of real competition in financial markets and therefore try to prevent it by all means. In the end, the Georgian population, which has accumulated only negative experience concerning financial operations over the last 20 years, lacks the decisiveness and necessary confidence to independently direct the clearly beneficial process of the development of the capital market in Georgia.

Conclusion

- As a result, as this short theoretical review has demonstrated, in Georgia one observes an unbalanced financial development process, with a single dominant actor (the Georgian banking sector); as well as a government which, within the framework of its economic policy, actively interferes in the existing financial relationships instead of strengthening the regulatory institutions. Furthermore, the government limits itself to ensuring the enforcement of agreements between private subjects in the market.
- Simultaneously, politically connected companies still exist in Georgia, the majority of which, for obvious reasons, do not wish to operate on a competitive market and use their connections with the government and the banking sector against such a competitive environment.
- As a result of the existing (seemingly accidental, though quite logical) strategic union between the three main actors (the government, the banking sector, and politically connected companies), a modified model of capitalism emerges in Georgia in which the flow of capital is strictly regulated and is dependent first of all on the non-market relations of its main actors.

[8] At the same time it is empirically confirmed that in the so-called emerging market the enterprises in bank possession show a relatively weak performance as opposed to other market actors (Lin et al., 2009).

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