Waiting for a push:
A quick overview of Georgia's capital markets

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The purposes of this study

Eighteen years after the collapse of the Soviet Union's planned economy, Georgia's financial markets still remain severely underdeveloped. While in many other developing economies the markets gradually took off, this, for a variety of reasons, was not the case in Georgia. Drawing on the available literature, expert opinions, and original research, this study aims to see what hindered the early development of Georgia's financial markets and what the government and the private sector alike could do to put them back on track.

Where do companies get financing?

To start, let us present a snapshot of how Georgian companies obtain financing for their operations and expansion and then move on to explaining the (small) role that capital markets play in these processes. In decreasing order of importance, the three main sources of financing are banks, foreign investors, and local capital markets – we deal with each below.

Banks: Local banks are by far the most significant source of capital for Georgian businesses. With 22 banks in the market, there is serious competition in the sector, and banks are willing to lend to their customers on fairly attractive terms. In this situation, large businesses do not have much of a problem securing lines of credit, even notwithstanding the recent turmoil in the global capital markets (although it yet remains to be seen how the August war with Russia will affect the lending landscape).

Foreign investors: Several companies, mostly in the financial sector, have sought financing abroad, whether directly from foreign financial institutions (including the likes of the IFC) of from strategic investors interested in buying their equity and/or debt. Some of the recent examples of such transactions include:

- Bank of Georgia's London IPO;
- Bank of Georgia's London debt issue;
- Debt tranches from the EBRD to finance the lending operations of TBC and Bank Republic, two major Georgian commercial banks.

Local capital markets: Only a select few companies have tried to look for financing in the local capital markets – it seems that most would rather deal with banks of foreign investors instead of submitting themselves to the uncertainties of capital market financing. To date, Bank of Georgia remains the country's single best example of a large company going public; others are yet to follow suit.

Capital markets: an overview

To a large extent, the businesses' lack of interest in the markets is due to these markets' somewhat sorry state. Although Georgia has a functioning stock exchange (Georgian Stock Exchange, commonly referred to as GSE), the levels of activity in that exchange are low even by emerging market standards.

Around 250 companies are listed on the exchange, but most of them have done so only to comply with regulatory requirements (listing is legally required of companies with more than 100 shareholders). The stocks of only a few of them are actually traded with any regularity (Bank of Georgia, Teliani, and United Georgian Telecom are among the more popular ones).

To give a better idea of the volume of trading on the GSE, consider that the exchange only recorded GEL 38m ($23.9m) in turnover in all of 2007 – a far cry from what is traded in countries of similar size. In only one example, Croatia's stock exchange logged $13 billion in turnover in the same year.[2]

The capitalization of the market remains low as well: GSE's total market cap hovers around $1.5 billion, 70% of which is due to one stock – Bank of Georgia. To give a sense of perspective, Croatia's stock exchange had a capitalization of $79 billion at the end of 2007, and even in Macedonia, population 2 million, the total market cap has recently touched $3.5bn.

In the case of the GSE, the lack of liquidity and low levels of capitalization are creating a vicious circle: companies will not see a reason to go public unless there is active trading going on, but then, of course, there will be no active trading if companies choose not to go public to begin with. In this situation, the stock exchange does not play the role of a place where prices are determined – instead, it just serves as a clearing house for deals that the market players strike in advance.[3]

Not that there are too many players: although GSE reports the existence of 17 different brokerage houses, a single brokerage company – Galt and Taggart Securities, owned by the Bank of Georgia – is responsible for 64% of trading on the GSE.[4] G&T is also the only major player in the (rather small) Georgian market for investment banking services. Although TBC, the country's second largest bank, has recently created an IBD division, its footprint so far has remained limited. For both G&T and TBC IBD, much business comes from their respective parent banks and not local companies; other banks have shown even less interest in capital market development.

In the more exotic sectors, the level of activity is lower yet – leveraged buy-outs, for example, are yet to come to Georgia, even though another division of Bank of Georgia called Galt and Taggart Capital is trying to make inroads in the sector. The only instances of buyouts have so far occurred when banks snapped up their heavily indebted clients. The situation is similar for other financial instruments: Georgia has neither derivatives nor variable-rate bonds and mortgages.

All of the above would not be particularly troubling if the markets were developing. But they are not: what emerges instead is a picture of a market that is for the most part quite content with the status quo, at least over the short term.

Businesses think of it as a question of habit and convenience: they prefer loan financing because it is cheaper and, in their perception, easier than dealing with the markets. It also requires less effort of them as far as getting their own house in order is concerned.

Banks, in their turn, do not particularly mind: they are happy to continue handing out loans to clients at interest rates around 18-20%.[5] The only two banks that have put some effort into developing their investment banking divisions are facing an internal conflict of interest: while their IBD arms would like to promote the development of local markets, their commercial lending divisions would be quite content to keep things as they are.

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[2] Data from the Zagreb Stock Exchange's annual report, using USD/HRK exchange rate on 31/12/2007

[3] That also makes it much more difficult to deal with insider trading issues – because the market is so inefficient, prices fluctuate wildly, and it is impossible to say whether or not someone acted on insider information when conducting a trade.

[4] Source: Bank of Georgia's 2007 report at
http://www.bog.ge/bogir_files/uploads/BoG_2007_Annual_Report_FINAL.pdf

[5] Source: National Bank of Georgia, 2007

Even the activity of international financial institutions creates unintended obstacles to market development: by giving loans to Georgian companies, the likes of IFC and EBRD take away whatever remaining incentives these companies could have to seek financing in the capital markets.

The very structure of Georgian business supports the logic of the current state of affairs: most companies in the country are very closely held and see no need to go public. TBC Bank, already mentioned above, is a good example: although it is Georgia's second largest bank by volume of assets, it only has six shareholders. Of those, two are minor, two are Georgian physical persons, and two are foreign investment funds. Reportedly, only one of the key shareholders has an interest in going public – everyone else is either ambivalent or disinterested.

One could try to argue that financial innovation could drive down the cost of capital throughout the economy, but some industries are not even that concerned. In capital intensive sectors like real estate, profit margins have been so high that trying to get the best possible deal might not be worth the effort. As one real estate developer put it, "If it costs me $400 to build a square meter of real estate and I can sell it for $2000, what do I care about a couple of extra percent on my loans?"

Then, what is necessary for the development of Georgian capital markets is not so much good laws or good infrastructure – those are largely in place (USAID helped draft the capital market regulations a few years ago, and the trading system at GSE is working well based on Russia's RTS software). Instead, local business has to develop in an interest in moving away from the status quo – but so far, they have not had any reasons to do so.

There are a few historical explanations: in the last fifteen years, the government has not done all that much to promote market development. It never really used the markets to privatize state-owned companies (preferring to dispose of them through direct auctions instead), and it drained a lot of liquidity from the debt markets when it abruptly stopped to issue T-bills a few years ago (**Appendix 1** gives a fuller account of these two stories).

But the far bigger problem for market development is the lack of awareness among the Georgian businessmen: far too many are still in the dark about how capital markets operate. When local businesses need money, they would much rather call up their banker than issue corporate bonds.

Bucking the trend, Bank of Georgia has been trying to promote market development and to get businesses interested in going public. They have had limited success: a few companies like Populi (which BoG partly owns) and Teliani Valley went on IPOs, but so far they have remained exceptions that only prove the general rule.

To be sure, not all is doom and gloom: slowly, the example of Bank of Georgia and others is pushing others to think that they could do the same. But the effect is limited to a few major players such as TBC; smaller companies see the challenge of going public as being beyond their reach – at least over the next few years.

The entrance of foreign players into the Georgian market could be a sign of impending changes as well. The Georgian Stock Exchange is in talks with Nasdaq OMX, a large global stock exchange operator; the talks are likely to end up in GSE's acquisition by the latter. The company already owns stock exchanges in Northern Europe and the Baltics and has also purchased the Armenian stock exchange in a recent transaction. Nasdaq OMX says it has no plans – as of yet – to create a unified trading platform in the Caucasus, but its technology and expertise would still be helpful.

In general, Georgia has all the preconditions for successful capital market development. All that is needed is a critical mass of publicly traded companies that would stimulate trading on the GSE and convince others to follow suit.

The situation could resolve itself as more and more Georgians with experience in London and New York come back to work in the financial sector. A libertarian could argue that the markets should just be given time to organize themselves in the hopes that at the end of the day all would work out well. However, just letting the markets take care of themselves would mean losing a few crucial years of development and growth. On top of that, given the growing strength of the country's banking system, taking such a stance would be essentially tantamount to consigning Georgia to an altogether different path of financial development. Once the banks grow beyond a certain point, challenging their dominance in the economy would not be worth the effort.

To offer a simplifying generalization, Georgia has two possible scenarios in front of it: it could either follow the path of Germany and develop a **bank-driven** system or choose the path of Britain and the United States and develop a **market-driven** one. If it is the former, then Georgia need not do much: banks are already quite strong compared to the rest of the economy, and they will only get stronger so long as the political environment in the country remains stable. If, however, it is the latter, then the government and major market players would need to show rather more initiative.

What are the pluses and minuses of each scenario?

Markets

Pluses:
Lower cost of capital, higher transparency, more accountability, higher involvement of the population, international involvement/activist investors can push management towards changes
Minuses:
Higher volatility, subject to investor psychology, attacks by speculative investors (especially dangerous for a small country like Georgia)

Banks

Pluses:
Higher stability, banks scrutinizing financial statements more closely, less need for governmental oversight, less prone to speculative attacks
Minuses:
Higher cost of capital, less transparency, population largely indifferent, less open to direct international investment

To be fair, one should not overstate the differences between the two scenarios. As Pohl (1995) notes, both systems fulfill the same function – collecting information about investment opportunities, monitoring performance, and taking action on this information.[6] But in the longer term, the difference in potential outcomes is large enough that there is a choice to be made.

International experience

Other transitional countries have been facing similar choices before – and in many cases, they have been able to develop functioning financial markets that, for the most part, have served their economies well. Of course, transitional countries in Central and Eastern Europe have benefited from their proximity to Europe: Austria, Germany and the Nordic countries got involved early on in developments in the Czech Republic, Poland, the Baltics, and some of the Balkan nations, providing them with capital and expertise in the first stages of the transition process. Georgia had no such advantage: its immediate neighbors Armenia and Azerbaijan were having similar troubles, while Turkey was not yet in a position to offer significant technical and material assistance. Then, it is reasonable to see what CEE countries have done with the assistance of their more developed neighbors.

[6] Pohl, Jedrzejczak, & Anderson, p. 12

The Balkans
In the Balkans, Slovenia and Croatia have had the most success in creating functioning financial markets; in both, Austrian involvement played an important role. In Croatia, market capitalization of the Zagreb Stock Exchange reached $79 billion at the end of 2007, as was already mentioned above. In the earlier years, the so-called privatization investment funds played a significant role in market development, while lately, the importance of pension funds has been growing.[7]

Czech Republic[8]
In the Czech Republic, the development of capital markets largely progressed thanks to the government's privatization efforts. Because speed was of primary importance, the government decided to take a lighter approach to regulation and disclosure and quickly put the shares of 1500 companies on the stock market. Then, citizens were able to use vouchers to buy shares in these companies – and although the vouchers were not free (as they were in some other transitional countries), they were cheap enough that most citizens could afford to take part in the privatization process if they so desired.

Not all citizens took part in trading directly: many of them relied on investment funds which cropped up immediately, hoping to cater to the unsophisticated investors. Again, as with privatization, the government did not regulate the activities of the funds too extensively. In the end, this allowed 75% of the adult population to become investors either directly or through these funds (although some funds did go bust after having promised absolutely unrealistic terms to their investors). The government also took the step (eventually) of forcing the large funds trading outside of exchanges to disclose the prices of their transactions to that the smaller investors have an idea of the value of the traded shares.

The government did play a significant role though in the establishment of the market infrastructure: it helped set up a centralized share registry, where all transactions were recorded electronically.

Poland[9]
Unlike Czech Republic, Poland paid much more attention to regulation and focused on the offerings of large and medium-sized companies. Initially, enterprises were sold directly to workers and managers. That resulted in the fact that only fifty companies were trading on the Warsaw Stock Exchange three years after it started working. The government later changed its strategy, creating instead 15 national investment funds which were to offer unsophisticated investors a way to deal in the market (before that, most of the activity was due to short-term speculation) and which would boost the volume of market trading.

Poland's example shows that overregulation of the market in its early stages can stifle its development – although it is fair to say that practically unregulated privatization programs like those in Czech Republic could pose threats to financial stability in the country in the event of a financial crisis. Governments, of course, would do best by trying to strike a balance between the two opposing approaches – but finding that balance is easier said than done.

The Baltics
In Latvia, Lithuania, and Estonia, stock exchange buyouts by foreigners have brought in the much-needed expertise and technology and also raised the profile of the exchanges. In all three countries, OMX, a Scandinavian stock exchange operator, emerged as the leading player. At present, OMX is

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[7] Cingula, Recep, & Klacmer

[8] Pohl, Jedrzejczak, & Anderson, p. 40

[9] *ibid*

trying to facilitate cross-border trading and minimize to the greatest possible extent the differences between the three Baltic markets without actually merging them into one. Given that OMX has already acquired the Armenian Stock Exchange and is showing considerable interest in acquiring the Georgian Stock Exchange, this is a scenario that could potentially play out in the Caucasus as well, albeit in the more distant future.

Lessons for Georgia?

In many a country in transition, capital markets have become a lively feature of economic landscape, attracting capital and foreign investment and fostering financial innovation where none would otherwise have taken place. Georgia, so far, has been lagging behind – but there is no reason it should continue to be that way.

> One could, of course, say that a greater role for capital markets would open Georgia's liberalized economy to **greater risks**, especially given the general population's low levels of financial literacy. And indeed, it would be folly to allow the repetition of the Czech scenario, when dishonest investment funds were easily able to cheat unsophisticated investors.
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> One could also add that banks could – at least in the short term – do a better job of **monitoring the companies to which they lend**, making sure that they remain healthy and stable. Again, given the local investors' lack of sophistication, it is probably true.

Indeed, there are risks inherent to encouraging the development of capital markets – but for a country like Georgia, which is trying to make up for almost two decades of stagnation, the rewards of markets could well outweigh the potential dangers.

> First and foremost, the switch to capital markets would force **transparency and accountability** upon the country's businesses – and given the environment in which they currently operate, that would be rather welcome.
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> On top of that, capital markets could do a better job of **stimulating economic growth** than would a system centered around banks. In the bank-driven model, banks are only interested in getting back the money they loaned to their clients, whereas in the market-driven model, shareholders have a direct interest in seeing their company grow. In the latter case, there will be more pressure on the companies to perform, which could not but reflect on the country's overall economic health.
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> Finally, besides the benefits of supporting capital markets, there also are the dangers of *not* supporting them. In case of Georgia, one would think, in particular, of the real estate sector: in the absence of viable investment opportunities that capital markets would provide, local and foreign investors deal heavily in real estate, pushing up the prices to what some believe could be dangerous levels. Functioning bond and equity markets would **take some steam out of real estate,** contributing to overall economic stability (Appendix 2 describes the situation in the real estate sector in greater detail).

The government seems to know all that, even if it has not always done its utmost to promote market development. In the early nineties, some dreamt of turning Georgia into a regional Singapore – a liberal haven that would attract capital from the neighboring countries. Back then, the plan never really took off because of corruption, incompetence, and instability – but the present government seems intent on giving it another shot.

It is important to realize the conditions under which Georgia could turn into a regional financial hub. Peace, good laws and good courts are necessary, but not sufficient. It is extremely important to ensure that Georgia has a functioning local market, on top of which any regional expansion would have to be based.

Armenia and Azerbaijan are trying to develop their own capital markets as well, but they have had little success so far. In Armenia, despite involvement by Nasdaq OMX, there is even less activity than in Georgia, and in Azerbaijan, businesses are so corrupt and non-transparent (thanks to the influx of oil money) that getting them to go public would be a major challenge. In both Georgia's neighbors, there is talk of readiness for a capital market takeoff, but just like in Georgia, nobody actually seems prepared to act and make that happen.

If Georgia wants to take advantage of its neighbors' passivity and claim for itself the leading role in regional finance, there is not that much time available for a strong local market to be created – as we already mentioned above, the stronger Georgia's banking system gets, the more entrenched will be its relationships with its customers, and the less interest there will be in capital markets. This is particularly true because of Georgia's economic openness: over time, more and more foreign players – and by that, we mean foreign banks – will be coming to the market, and those, given the small size of the country's economy, will have even less of an interest in developing markets for capital than do the local financial institutions.

A counterargument to that would be that the banking system cannot expand endlessly and would likely want to outsource some of its financing decisions to the markets as its deal volume grows. Perhaps so – but if one agrees with that statement, there is little reason to wait for that to happen instead of trying to give the markets a necessary push right now.

What has been done?

A recent package of laws, called Global Financial Services Competitiveness Act, which the Gurgenidze cabinet passed at the beginning of 2008 shows that the government understands the important role that capital markets could play in the country's development. The measures are mostly technical, and they would not solve the deadlock in the markets in and of themselves, but they still are a step forward. To be more specific,[10]

- The government has created the Financial Supervising Agency, which will function as the sole regulator of the financial sector. Financial regulation in Georgia was previously quite weak.
- New anti-money laundering regulations will enhance the transparency of the banking sector.
- There will be changes in the taxation regime: starting in 2009, the government will stop taxing income received from bank deposits and publicly traded fixed income securities. There will be no more capital gains tax on securities with a free float in excess of 25%, and dividend income from such securities will not be taxed either.
- The government has allowed the creation of International Financial Institutions to let local and international investors take advantage of a more favorable tax regime.
- The government has introduced the concept of Experienced Investor Funds to make Georgia more attractive for wealth and asset management.
- Local stock exchanges are now allowed to quote securities in the currency of their choice (settlement will still take place in Georgian lari).

[10] Source: The Georgian Times at http://www.geotimes.ge/index.php?m=home&newsid=8758

- The securities law now allows for the demutualization[11] of local stock exchanges. Remote foreign membership of stock exchanges will also be permitted so long as foreign brokers do not solicit business from the Georgian residents.[12]

- The new law introduces the concept of experienced investors, clarifies and simplifies IPO procedures, and streamlines the operations of registrars.

In May 2008, the Georgian Stock Exchange took advantage of the law's new provisions and demutualized, which in time will hopefully lead to broader involvement by foreign investors in its governance.[13]

In another useful step (though unrelated to the new legislation), the National Bank of Georgia introduced TIBR, Tbilisi Interbank Rate, which measures the cost of funds in the interbank sector and could, with time, become the benchmark against which the market could value variable rate securities.

What else should be done?

The measures above are a good first step, but it's important to ensure that the government follow a cohesive market development strategy rather than deal with local problems as they arise. Del Valle (2005) provides a rough outline of a possible development path:

1. Develop the money markets to inject liquidity into the system and establish a short term yield curve;

2. Develop the public debt market, first focusing on short term issuances;

3. Develop the private debt market, creating a broader set of options for institutional investors;

4. Develop the derivatives market to decrease the interest rates.

At present, it appears that Georgia is more or less dealing with (1), skipping (2) and starting to develop (3), while (4) remains too arcane for the majority of local players.

It seems fairly clear that the markets could easily remain in limbo for a few more years if left to their own devices – although the preconditions for their development are in place, the lack of interest from the local business community ensures that things never really get off the ground.

In this situation, several important players need to take the longer term view and work to explain the advantages of markets to Georgian businesses. Words will not be enough: someone needs to lead by example. Bank of Georgia has been doing some work on that front, but in rather spectacular

[11] As defined in Aggarwal (2000), "*demutualization* is the process of converting a non-profit, mutually owned organization to a for-profit, investor-owned corporation. The members of mutually owned exchanges—that is, broker-dealers with "seats" on the exchange—are also its owners, with all the voting rights conferred by ownership. In contrast, a demutualized exchange is a limited liability company owned by its shareholders. Trading rights and ownership can be separated; shareholders provide capital to the exchange and receive profits, but they need not conduct trading on the exchange… [A]lthough demutualized exchanges will continue to provide many if not most of the same services, they will have different governance structures in which outside shareholders are represented by boards of directors."

[12] The above-mentioned buyout of the GSE by OMX could not happen without a law on demutualization

[13] Source: http://www.gse.ge/downloads/PressRelease_AGM_ENG.pdf

isolation. TBC has made some moves signaling its interest, but has not yet achieved anything significant.

Instead, the government needs to step in, with its sheer size as its main advantage. And although playing too big of a role in the markets would run counter to the authorities' present-day economic philosophy, there are at least two things that the government could do for the markets without appearing heavy-handedly interventionist.

> **First**, it could consider issuing new debt – not just abroad, as it has recently done with its $500 million London offering, but also at home, where such measures would help to inject liquidity in the market. Some government officials are averse to domestic debt: why issue it, they say, when borrowing abroad is so much cheaper? Yet, they need to realize that even if the government can find other ways of financing its activities, issuing domestic debt has the positive externality of giving an extra jolt to capital markets.

> **Second**, and more importantly, the authorities could try to atone for the way they have conducted privatizations in the past and sell some of the state's remaining properties through the capital markets. Georgian Railway and a few regional water supply systems could be potential candidates. Putting up large, important companies for domestic IPOs, would increase the profile of the GSE and lend the offerings credibility in a country where most people still know little to nothing about the way markets work.

Implementing both of the above would be complicated – but not unreasonably so. The main challenge for the government would be to see the role that capital markets can play and sacrifice short-term efficiency and convenience for the country's longer-term economic development.

On a more technical and less grand-sounding note, there are a few other things the government could consider.

- Georgia lacks functioning rating agencies. The government has decided to leave that matter completely up to the market, but it could consider speeding up the process to increase the volume of local bond issuance.
- Some in the government seem to believe that the less regulation there is, the better, but that is not necessarily the case. Market players are frequently glad to see rules being enforced – which was not something that previous regulatory agencies seemed to be good at. The newly created FSA should play an active role in regulating the markets.
- The government could grant local companies tax incentives to list their shares on the stock market (although merely listing a company does not do much for market development, as the current situation in Georgia clearly shows)
- The Ministry of Finance could speed up the securitization of the government's debt to the NBG (although the MoF has indicated it does not intend to do so; see **Appendix 1** for more details).
- The government needs to encourage the development of pension and mutual funds through appropriate legislation.[14]

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[14] Although Vittas (2000) argues that pension funds are neither necessary nor sufficient for capital market development, they can nevertheless contribute greatly to the creation of a stronger financial landscape. As the original paper puts it, "if [pension funds] are subject to conducive regulations, adopt optimizing policies, and operate in a pluralistic structure, they can have a large impact on capital market development and modernization once they reach a critical mass."

Conclusion: Taking the broader view

To bring together the disparate strands of this paper's arguments, let us conclude by pointing out – again – that Georgia's economy is ready to assign capital markets a greater role than they currently play. Very importantly, the infrastructure and laws are almost all in place in the country today, and all that is necessary is a push by the government and a few large players that would convince everyone else to use the opportunities that capital markets have to offer. Without such a push, capital markets might still arise organically – but given the positive impact that they could have on the country's economic development, waiting for that to happen does not make much sense.

Annex 1: A bit of history

While it is true that the business community has not shown much interest in the functioning of capital markets, some of the blame lies with the government as well: over the last fifteen years, it has not done all that it could have done to promote market development. Two of its failures were most notable: the way privatization was (and is) organized and the way government debt was (and no longer is) traded.

The story of privatization

First, there is the way in which Georgia managed – and still manages – the privatization of its state-run enterprises. In many transitional countries, governments stimulated the development of capital markets by relying on them in the process of privatization: often, the government would briefly take over the management of a state-owned enterprise, implement minimal changes, and list it on domestic stock markets, where its shares would be purchased by individual investors.

The Georgian government chose a different path. Here, the government sought to auction off the state enterprises, transferring control to the highest bidder. On the one hand, this served the interests of simplicity and efficiency – the government did not have to deal with the need to "patch up" the enterprises before taking them public. Instead, it outsourced the task to private investors. Moreover, it could reasonably hope that private investors would be able to turn the stagnating enterprises around in the fastest way possible, thus creating workspaces and boosting the government's tax revenues. However, this did have one distinct disadvantage: the government forewent – and is still forgoing – the chance to stimulate the development of Georgia's capital markets by using them to privatize its properties.

The story of Georgia's T-bills

But it's not just privatization that the government got wrong: the story of government debt was another factor that hindered the proper development of capital markets.[15]

Originally, Georgia introduced T-bills in 1999. Back then, the rates on them were sky-high – often in excess of 100% – which reflected the market's poor opinion of the government's reliability. Eventually, they started to go down, reaching 11% around 2005. Although still high (a similar number in a developed economy would be around 5%),[16] this rate was already manageable. For a while, it seemed that Georgia would have a functioning market for government debt.

Then, something changed. Later in 2005, the interest rates started climbing up and went as high as 20%. Compared to the previous fluctuations, the increase was not too significant. It could be due to the market's changing risk perception, or it could have been a result of speculation. After all, the market for government debt was still small, and anyone with the right amount of money could theoretically corner it. Yet, the jump in rates got the government worried. Soon thereafter, it decided to stop issuing T-bills altogether.

The Georgian T-bill market ceased to exist. The government lost its ability to borrow money locally in order to fund its deficits, but the Ministry of Finance did not seem too concerned. Thanks to improved fiscal administration after the Rose Revolution, the state's budget deficit was not nearly as large as it used to be. And if the government still needed to borrow, it could rely on the international financial institutions.

[15] Parts of this subchapter appear verbatim in a story by the author published in *Georgia Today* in October 2007

[16] Source: personal interviews with market players

Essentially, the government would now borrow abroad, for it was cheaper and easier than dealing with the messy domestic market. From the government's self-interested point of view, such a move might have made sense – but it also delivered a blow to the development of Georgia's financial markets. Once the most liquid and reliable security was no longer in circulation, private borrowers' offerings did not fill the niche. The market might have been reluctant to deal in government securities (for which the reputation of the pre-Rose Revolution authorities provided some justification) – but the risk of dealing with debt obligations of unrated, non-transparent private Georgian companies it simply deemed unacceptable.

With no new T-bills issued, the only type of operations that the government is undertaking with its debt obligations is securitization: it is converting 833 million lari of its debt to the National Bank of Georgia into marketable securities. However, the conversion is proceeding at a fairly slow pace – to the tune of 48 million lari a year – and the government has indicated it will not speed up the process, as the Ministry of Finance would then have to deal with increased interest payments on its debt obligations.

Annex 2: Taking the heat out of real estate

Georgia's real estate sector is a good example of the potential dangers that the state of Georgia's capital markets poses to the economy and of the opportunities that their development could create.

On the demand side, many investors see real estate as the only viable investment opportunity, which leads to speculation in the real estate segment, pushing prices to what might be unsustainable levels. Now that an external shock of the Russian invasion has hit the Georgian economy, the real estate sector could go down first, taking the rest of the economy with it.

On the supply side, investors' ever increasing appetite for real estate strains the resources of developers, causing them to look for new ways to finance their operations. Functioning financial markets and prudent regulation could allow them to expand safely, while discouraging excessive risk-taking.

Currently, when starting a new project, a developer companies could seek to attract bank financing to purchase land on which construction takes place. In this case, the company would normally contribute around 30% of the total cost of the land plot, while the bank would provide the remaining 70%. The money usually comes as a medium-term loan (up to six years). Loan rates are typically around 14-15% (in USD, although the continuing slide of the dollar forces some companies to start operating in Euros).

Only a few banks are large enough to provide loans to the developers: Cartu, Bank of Georgia, Bank Republic, VTB, and TBC. The developer will typically talk to several banks to negotiate the most attractive financing terms. Normally, one bank would finance one project in it entirety, although there have been some recent attempts to attract investments from IFIs (IFC, for example).

For now, the financing situation seems to be working out reasonably well. However, as the scale of projects grows (AXIS, a large developer company, needed $60 million for its most recent construction initiative, which none of the banks could provide on its own), the companies will need to look beyond banks to find new sources of financing.

In this situation, functioning capital markets would offer three advantages:

1. They would prevent the real estate sector from overheating by creating alternative investment opportunities;
2. They would give companies new financing sources;
3. They would limit excessive risk taking because of the greater transparency that seeking financing through them requires.

Between equity and bond markets, the latter have a readier appeal for local developers: most are closely held, and there is no reason for them to relinquish even some control over the company's course by selling their equity. Issuing bonds though would allow them to diversify their capital base, obtain longer term loans, and finance projects that some banks might be uninterested in.

Still, equity markets would fill a niche as well: developers could create wholly owned subsidiaries for the construction of a particular project and then take them public. The more open companies could consider going on IPOs in their entirety, as a major local developer appears to be planning to do.

Yet, for many, wading in the markets today is a no-go: few developers in Georgia are large enough that they would be willing to take the risk of dealing with capital markets as they are. As one of them put it, "If we issue bonds, who is going to buy them?" But if the markets get a boost from the government and large local players, more than a few developers would be glad to join in, giving the markets yet more liquidity and bringing more accountability into a seemingly overheating sector.

Interviews

This paper is partially based on a series of interviews conducted in November-December 2007, mostly in Tbilisi. The list of respondents and interview dates is below; positions occupied are as of the interview date.

Merab Akubardia, Finance Manager, AXIS Development Company.
November 15, 2007.

Giga Bedineishvili, Head of Investment Banking, TBC Bank.
November 13, 2007.

Henri Bergstrom, Senior Vice President, Corporate Development Unit, OMX Group.
November 23, 2007 (by phone from Stockholm).

Macca Ekizashvili, Head of Investor Relations, Bank of Georgia.
November 30, 2007.

Eli Enoch, Chief Executive Officer, Galt and Taggart Capital.
December 7, 2007.

Merab Kakulia, Senior Expert, Georgian-European Policy and Legal Advice Centre (GEPLAC).
October 12, 2007.

Nikoloz Kavelashvili, Project Director, Georgia Regional Development Fund.
November 7, 2007.

George Loladze, Chairman of the Supervisory Board, Georgian Stock Exchange.
November 20, 2007.

Lia Mamniashvili, Acting Chief Executive Officer, Millennium Challenge Georgia Fund.
November 7, 2007.

Revaz Ormotsadze, Project Manager, Office of Economic Growth, USAID.
November 14, 2007.

Giorgi Paresishvili, Global Co-Head of Sales, Galt and Taggart Securities.
November 21, 2007.

Lasha Tsagareishvili, Director, AWORD Management.
November 19, 2007.

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