

Problems and Perspectives of Stock Market Formation in Georgia

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Stock market, or securities market, and its organizational form – a stock exchange is an integral part of capital market and a necessary condition for efficient operation of modern economy. It plays an important role in advanced market economies as well as emerging economies of post-communist countries. In Georgia this system, unfortunately, falls short of proper operational standards. Stock market in Georgia began to form in parallel to a process of corporatization and privatization of state-owned enterprises and continued in a complex environment. Numerous objective and subjective factors impeded – and still impede – the development of stock market. The process was especially hindered by so-called bank-centric economic system, adopted by Georgia in the transitional period, which brought the entire financial market under the control of commercial banks. At the current stage of privatization, when the reformation of state-owned enterprises is on the agenda, a comprehensive and efficiently operating stock market is a must and support to this end needs to become a priority of state economic policy. The foregoing echoes a conclusion drawn from the study: there is a need to establish a stock exchange as an independent, strong and effective body; to actively employ competitive stock market mechanisms in the process of privatization; and to intensively place secondary securities on the stock exchange. © 2021 Bull. Georg. Natl. Acad. Sci.

Stock market, stock exchange, state and corporate securities, bank-centric system, commercial banks, privatization

Stock market, i.e., securities market is an integral part of capital market and a crucial condition for the operation of market economy. Advanced market economies can hardly be imagined without well-organized, institutionally developed stock markets [1:28]. However, the role of stock market is especially important in post-communist transitional countries [2:298], including in Georgia in the process of transformation into market economy;

however, this mechanism has not been used properly [3:85; 4, 5].

The role of stock exchange is manifested in its functions through which savings of companies and households are converted into investments. Investment is something that both private sector (business) and government need. Investors are those segments of population and private sector that have savings. Population mainly invests in housing

while entrepreneurs use their savings to start and develop small and medium businesses. When population buys shares, it gets benefit from its savings without taking risks related to the management of investments. Price of savings converted into investments is determined by demand and supply on the capital market.

Other functions of stock market (stock exchange) are to distribute financial resources rationally among various sectors of economy and to ensure an efficient process of attracting strategic investors. Stock exchanges also play an extremely important role in financing priority projects of governments.

Metamorphosis of Stock Market

With the start of the transition to the market economy after regaining the independence, Georgia faced a need to establish a securities market. This need arose for two reasons: first, it was impossible to properly develop market economy without securities market and, second, a quasi-securities market existing in the Soviet administrative-command economy was totally inappropriate in new conditions. At the initial stage, however, Georgian population lacked trust towards the elements of stock market.

The issue gained more attention after the start of mass privatization which was preceded by corporatization of large enterprises, sale of shares on the open market, establishment of investment companies, etc., but that was not suffice.

As experience has proved, a successful entry of stock markets by enterprises is possible in the conditions of normal capitalization which can only be determined on a stock market. We believe that, first, a problem of capitalization of enterprises needs to be solved and then, the formation of stock exchanges ensured. In this regard we share the opinion that: "It is unjustifiable to establish a stock exchange, first, and then, start thinking how to attract real buyers and sellers. This may discredit the very idea of stock exchange" [6:61].

Despite numerous irregularities and shortcomings in the process of corporatization, the issuance and placement of corporate securities on stock markets was still a progressive phenomenon that put an end to the monopoly of government securities on the stock market. Mid-1990s saw a fast development of bank stock market, facilitated by the transformation of former state-commercial banks into joint stock companies and issuance of shares in large numbers. Operation of Georgia's stock exchanges of those times starkly differed from the practice across the world. In advanced economies, shares of stock exchange are neither public nor sold outside stock exchange. They are distributed among members of stock exchange alone.

The establishment of stock exchange began in Georgia in 1997, however, in 1998, the issuance of treasury obligations was suspended due to budget and foreign currency crises and the stock exchange stopped functioning. It resumed in 1999, based on the Law of Georgia on Securities Market which was adopted by the parliament on 24 December 1998.

The year 1999 also saw the establishment of the National Securities Commission, a central body of the state system of regulation and supervision of securities market. That body existed until July 2007. The mentioned organizational change entailed other transformations too. In particular, the right to trade in securities was granted to licensed companies alone and only on stock exchange. Amendments introduced at that time to the law on stock exchange prohibited investors to execute any transaction in securities without brokers or/and brokerage companies. After the amendment, investors were allowed to decide themselves on issues concerning the need of a brokerage company and transactions executed on or off the stock exchange. This resulted in market participants giving preference to off-exchange transactions in securities. The main goal of introduced amendments was to liberalize exchange activity.

The Georgian stock exchange now trades in the following securities: government treasury obligations or treasury bonds, corporate shares and certificates of deposit. All of them are traded in auctions and only commercial banks have the right to participate in them. Certificates of deposit are denominated in the national currency Lari.

Nevertheless, a secondary segment of securities in Georgia is extremely limited, while derivative financial instruments are not common.

Circulation of promissory notes represents a promising segment of the securities market. Circulation of promissory notes, as a rule, serves certain economic processes. The aim of promissory notes issued by corporate enterprises is to fill and expand working capital. Promissory notes of local financial bodies fill resources of these structures while bank promissory notes are, in fact, banks' banknotes which are freely used to pay taxes, pension provisions and other needs. As regards promissory notes of the Finance Ministry, they are mainly used by commercial banks to pay borrowings from the central bank. The sphere of circulation of promissory notes is extremely limited in Georgia whereas in many countries it comprises around 25%-28% of money supply [7:77].

From the very start, the formation of stock market in Georgia faced numerous problems due to objective and subjective factors. One of serious problems was that the securities market was not involved in privatization due to several reasons. First, absolute majority of joint stock companies, that were established as a result of corporatization, was unprofitable. Hence, shares issued by them were quoted at a very low price; often, it was even totally impossible to quote them. Naturally, there was no demand for those shares. Second, the activity of joint stock companies often lacked, and still lack, transparency, there is no effective market information system, which diminishes trust and interest of investors towards them. Third, insider groups, that have formed over the years, are not interested in broadening a circle of shareholders.

Fourth, volume of internal savings was, and still is, extremely limited. Much of the volume that exists flows out of the country, does not circulate on the internal stock market and does not serve the economic development of the country. Fifth, a reluctance to invest in a joint venture with "strangers" because of distrust can be considered a subjective impeding factor which, it would be fair to say, has objective grounds. During the post-communist economic transformation, especially in its initial phase, there mushroomed various surrogate "funds," "banks," "investment companies," "stock exchanges" and whatnot which, promising superhigh gains, attracted rather substantial amounts from population and soon thereafter disappeared with those amounts.

Naturally, a stock market could not operate efficiently in the conditions where "there is no supply driven by demand and demand driven by supply on that market" [6:65]. All this led to the situation when large portion of state property was privatized not by using market mechanisms but through other methods.

Experience of advanced market economies shows a close link between privatization and formation of securities market. On the one hand, a fast and democratic way of privatization is sale of shares on a stock exchange. On the other hand, privatization is a necessary condition for the formation of securities market. This means that an objective outcome of privatization must be the formation and efficient operation of securities market in order to achieve desired results. Unfortunately, this was not the case in Georgia. Our negative experience shows that change in ownership relationship without a real, not surrogate, stock market (stock exchange) does not lead to desired result.

Most serious problems to the development of a financial stock market were posed by the banking system. Experience of advanced market economies shows that securities market and bank loan market are not sharply separated from each other but

complement each other. Stock markets play important role even when a country has a rather well-developed banking sector. Stock markets provide economic entities with high liquidity and diversified portfolios. Economic entities have freedom of choice between these two bodies, depending on various factors: a general level of financial market development, macroeconomic environment, taxation of income obtained from financial instruments, etc. The economic literature emphasizes that “stock markets tend to complement—not replace—bank lending” [1:30].

Unfortunately, in Georgia the process took a course opposite to the abovementioned civilized practice. Cooperation between banks and the stock exchange was excluded from the very beginning and an unhealthy competition was formed which manifested in commercial banks establishing a total control over the stock market through various means and ways. In pursue of that aim, they got hold of majority shares – 58% of the stock exchange. Consequently, they got majority of votes in the supervisory board and board of directors of the exchange [8:32].

Monopoly of commercial banks on the capital market was largely supported by amendments to the law adopted in 2008, whereby the regulation of both segments of the capital market – bank loan market and securities market (stock exchange), was entrusted to the National Bank of Georgia. Before that, in 2007, the Georgian government abolished the National Securities Commission which represented a necessary element of the stock exchange. After the mentioned amendment, it became crystal clear whose interest would be considered and protected.

In parallel to that, a strictest constraint policy was implemented against participants of the stock exchange – brokerage companies, that led to virtual disappearance of brokerage companies that were independent of commercial banks and all of them were transformed into commercial bank branches [8:35]. At the same time, the number of brokerage

companies was maximally decreased. Such restriction occurred not as a result of fair competition but artificially, with administratively introduced methods. In particular, the National Bank sharply increased charter capital requirements for brokerage companies, abolished three types of licenses and left only one – a general license which brokerage companies could obtain upon meeting a required charter capital of GEL 500000. Moreover, the required charter capital was calculated only based on cash resources. Naturally, all that did not enable independent brokerage companies to compete with commercial banks. In fact, the stock exchange as an alternative source to bank loans was destroyed.

With the change in power, came the expectation that fair competition would be established on the capital market, but, unfortunately, it did not prove true. Attitude to the formation of stock exchange remained negative. None of the initiatives and proposals submitted to the parliament to regulate this issue has been given the go-ahead. The stock exchange management, staffed by representatives of commercial banks, withdrew legislative or any other initiative that would contribute to forming a proper securities market. In May-June 2015, the stock exchange, which was subordinated to commercial banks, established another stock exchange – Tbilisi Stock Exchange and thus, completely “cleaned” the space from non-banking institutions.

Leaving the economy, especially its real sector, to the mercy of bank loans (which is also proved by the fact that 93% of loan market accounts for bank loans while the remaining 7% for stock market) caused shortage of investment in the economy, resulting in decreased output, bankruptcy of many enterprises and further deterioration of crisis processes. To break this vicious circle, it is necessary to set up securities market and put it into operation.

A substantial constructive potential which the stock exchange has in various areas in current

conditions needs to be taken into account. First, a pension reform in Georgia resulted in setting up a common pension fund which has already accumulated more than GEL 1 billion. It is quite a substantial amount for us, which is “entrusted” to commercial banks. To speed up economic development and raise wellbeing of population, we believe that it will be more efficient to place these financial resources on the stock market, thereby hugely contributing to the development of this body.

Second, Georgia now faces a new stage of privatization. The government has decided to reform state-owned enterprises, which will be implemented in two ways: a) corporatization of enterprises of special strategical importance, which implies turning them into profitable entities; and b) privatization of state-owned enterprises. It is intended to sell around 50 enterprises. These processes can only be carried out successfully in the conditions of properly functioning stock market; this adds extraordinary urgency to the mentioned problem.

There are also several flaws and shortcomings characteristic for the securities market in current conditions. The ratio between government securities and corporate securities on the Georgian stock market is extremely unfavorable and starkly differs from advanced international practice. For example, in Georgia the ratio comprises 21:1 whereas in the USA it stands at 1:2 [7:79]. such a ratio cannot be considered normal. One should also take into account that interest rate on government securities is too high in our country and raises suspicions about corrupt deals. On the other hand, such high interest rates cause a shift of bank assets from the real sector of economy to financial and trade operations, financing of state expenditures and impedes the economic growth.

Georgian securities market actually lacks secondary securities, i.e., derivatives – futures, options, warrants, conversion obligations, etc. Consequently, capital does not flow into the

economy through these instruments. In developed countries the volume of secondary market exceeds the primary market by 10-20 times, which, we think, is a noteworthy fact.

Stock market with all the instruments at its disposal must be linked to the real economy and serve, primarily, its interests. Otherwise, the stock market will be limited to only a mechanism of distribution of incomes and concentration of capital of large actors of the financial sphere.

Conclusion

Unless a securities market is really formed and developed in accordance with modern requirements, it is impossible for the country to achieve a successful economic growth and this is one of most important lessons which we must learn from almost 30-year-long history of market formation. The formation of truly efficient securities market can be facilitated by the following:

First, it is necessary to restore the stock exchange as an independent, strong and efficient body of market economy. To this end:

- All types of securities must be issued publicly, through stock exchange;
- The procedure of access of intermediaries to primary auction must be necessarily simplified and elements of competition enhanced;
- Minimum investment amount on the stock exchange must be decreased and thereby facilitate free access of small and medium sized investors;
- Institutional arrangement of securities must be improved – the National Securities Commission must be reinstated as an independent body to replace the National Bank of Georgia as a regulator;

Second, privatization must be primarily carried out through the stock market; this will help it fully realize its constructive potential and develop fast;

Third, transition from primary placement to secondary placement of securities must be accelerated;

Fourth, it is necessary to increase the share of corporate securities on the stock exchange in the amount that will enable them to play a leading role in the operation of stock exchange.

ეკონომიკა

საფონდო ბაზრის ფორმირების პრობლემები და პერსპექტივები საქართველოში

მ. ლომინაძე

ივანე ჯავახიშვილის თბილისის სახელმწიფო უნივერსიტეტი, ეკონომიკისა და ბიზნესის ფაკულტეტი, თბილისი, საქართველო

(წარმოდგენილია აკადემიის წევრის ა. სილაგაძის მიერ)

საფონდო, ანუ ფასიანი ქაღალდების ბაზარი და მისი ორგანიზაციული ფორმა – საფონდო ბირჟა კაპიტალის ბაზრის ორგანული შემადგენელი ნაწილი და თანამედროვე ეკონომიკის ეფექტიანი ფუნქციონირების აუცილებელი პირობაა. ის მნიშვნელოვან როლს ასრულებს როგორც ჩამოყალიბებულ საბაზრო ეკონომიკაში, ისე პოსტკომუნისტური გარდამავალი ქვეყნების ეკონომიკებში. სამწუხაროდ, საქართველოში ეს სისტემა სათანადო მოთხოვნების დონეზე ვერ ფუნქციონირებს. საქართველოში საფონდო ბაზრის ჩამოყალიბება სახელმწიფო საწარმოთა აქციონირება-პრივატიზების პროცესთან ერთად დაიწყო და რთულ გარემოში წარიმართა. არსებობდა და დღესაც სახეზეა ბევრი ობიექტური და სუბიექტური ფაქტორი, რომელიც საფონდო ბაზრის ფორმირების ხელშემშლელ ფაქტორებად გვევლინება. პროცესი განსაკუთრებით დააბრკოლა გარდამავალ პერიოდში საქართველოში ე.წ. „ბანკოცენტრული“ ეკონომიკური წესრიგის ჩამოყალიბებამ და მთელ ფინანსურ ბაზარზე კომერციული ბანკების კონტროლის დამყარებამ. პრივატიზების თანამედროვე ეტაპზე, როდესაც დღის წესრიგში დგას სახელმწიფო საკუთრებაში არსებული საწარმოების რეფორმირების საკითხი, აუცილებელია სრულფასოვანი და ეფექტიანად ფუნქციონირებადი საფონდო ბაზრის არსებობა, რომლის ფორმირებისთვის ხელშეწყობა სახელმწიფოს ეკონომიკური პოლიტიკის პრიორიტეტი უნდა გახდეს. აღნიშნულთან შესაბამისობაშია კვლევის შედეგად მიღებული დასკვნა, რომლის მიხედვითაც საჭიროა: საფონდო ბირჟის, როგორც საბაზრო ეკონომიკის დამოუკიდებელი,

ძლიერი და ეფექტიანი სტრუქტურის დამკვიდრება, პრივატიზების პროცესში საფონდო ბაზრის კონკურენციული მექანიზმების აქტიურად გამოყენება და საფონდო ბირჟაზე მეორეული ფასიანი ქაღალდების ინტენსიური განთავსება.

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Received February, 2021