PMCG Research

Change in the Borrowing Patterns of Private Sector in Georgia

Economic Outlook and Indicators

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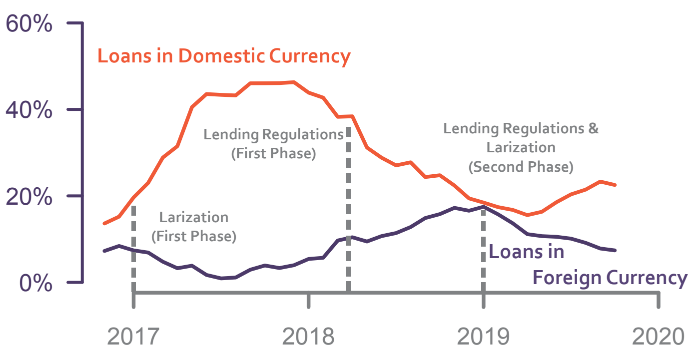
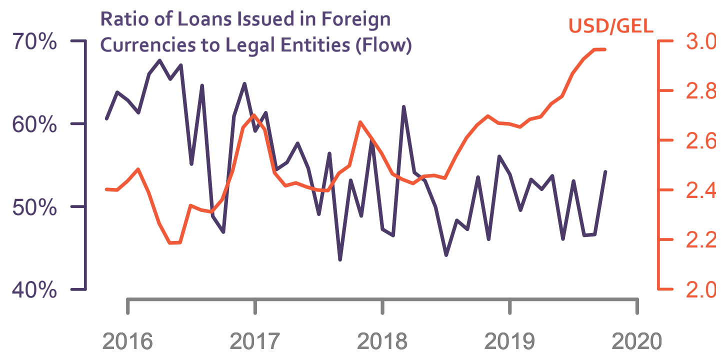
In the past few years several major regulations were implemented both by the government and the National Bank of Georgia. Including but not limited to, a bill passed in January 2017 outlawing the issuing of loans below (the equivalent of) 100 thousand GEL in foreign currencies to individuals (the first phase of Larization), stricter collateral requirements in May 2018 (first phase of lending regulations), borrower's income analysis requirement (second phase of lending regulations) and increase in the minimum threshold of lending in foreign currencies to 200 thousand GEL, this time including both individuals and legal entities. The latter has been recently criticized and seen as an obstacle by the private sector. Thus, authorities have been considering loosening some of the abovementioned requirements[1]. Until the suggested easing takes effect, it is important to determine the implications that the regulations might have had on private sector borrowing patterns. In this newsletter, possible implications of imposed lending constraints on the private sector are presented.

YoY Growth of Total Loans (Nov 2016 - Oct 2019) Graph 1

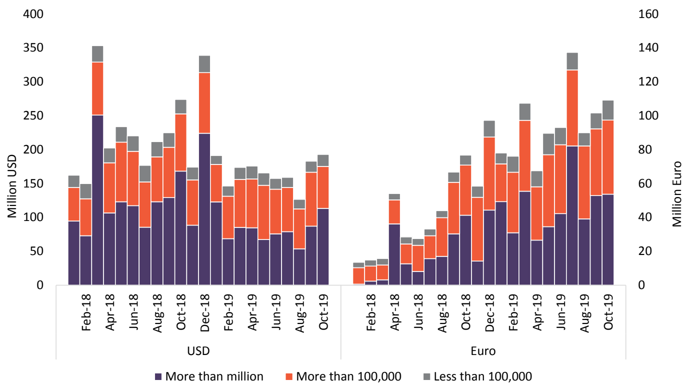


Ratio of Loans issued in Foreign Currencies to Legal Entities (Nov 2015 - Oct 2019) Graph 2

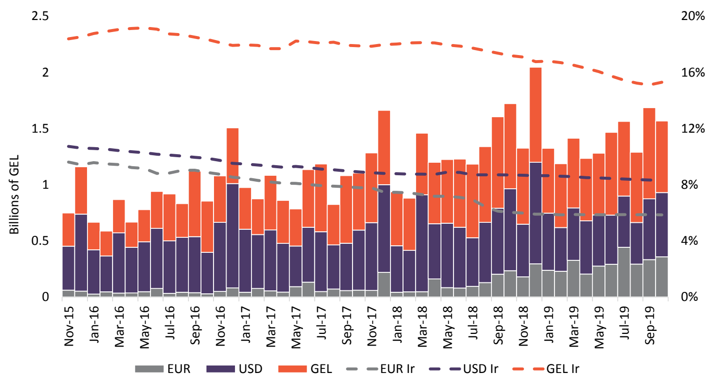


The steady growth of loans issued in foreign currency (i.e. increasing dollarization) has been an acute issue in the past few years. In spite of a lari-denominated debt growing significantly faster as a result of the first phase of larization, the granting of dollar- and euro- denominated foreign loans have accelerated since the third quarter of 2017, especially in the last quarter of 2018. (See graph 1, where currency exchange effect is excluded) The main driver of the above mentioned loans, issued in non-domestic currencies are legal entities as they hold approximately 86.5% of debt denominated in foreign currencies. As depicted in the second graph, contrary to the expectations that the limit of 200 000 GEL issued in foreign currencies was going to hinder private sector borrowing, the percentage of loans issued in foreign currencies (both USD and EUR) by legal entities (with fixed USD/GEL value) has been relatively stable since 2019. Possible explanation could be the volume of issued loans: only 12.6% of large corporate loans were under 100 000 USD (297.5 thousand Lari)[3], while for SMEs, it was 29% (see graph 3).

Monthly Flow of Business Loans by Volume for Different Currencies (Graph 3)



Monthly Flow of Business Loans for Different Currencies with Respective Interest Rates (Graph 4)



Far more interesting is the fact that since the implementation of the aforementioned regulations in January 2019, the flow of loans in US dollars issued to private sector has abruptly dropped without affecting the rate of loans in foreign currencies. Instead of borrowing more in lari, companies resorted to the euro as an alternative. Since 2017, both SMEs and large corporations have increased borrowing in euros fivefold. Interestingly, on average, interest rates on loans in euros have been 2% lower compared to those in USD. Simultaneously, since February 2018 the euro has depreciated by 12% against the US dollar (but still managed to appreciate 7.6% against the lari). The relatively low real interest rate of the euro makes it especially lucrative for Georgian businesses, who are trapped between the high interest rate of the lari and the constantly appreciating US dollar. The advent of the euro as a transitional currency (see graph 4) explains why companies have not decreased borrowing in foreign currencies since January 2019 (see graph 2). The same graph also indicates why borrowing in foreign currencies decreased before the limitations were set in place. The expectation of further depreciation couldh have discouraged companies from taking risky (USD- and EUR- denominated) loans.

1 The Government Considers Reducing The Lending Threshold Of GEL 200,000 In National Currency (BMG);
2 Please note: although the regulation forbids issuing less than 200 000 GEL (67 thousand USD), 100 000 USD is the only available data that is relevant.

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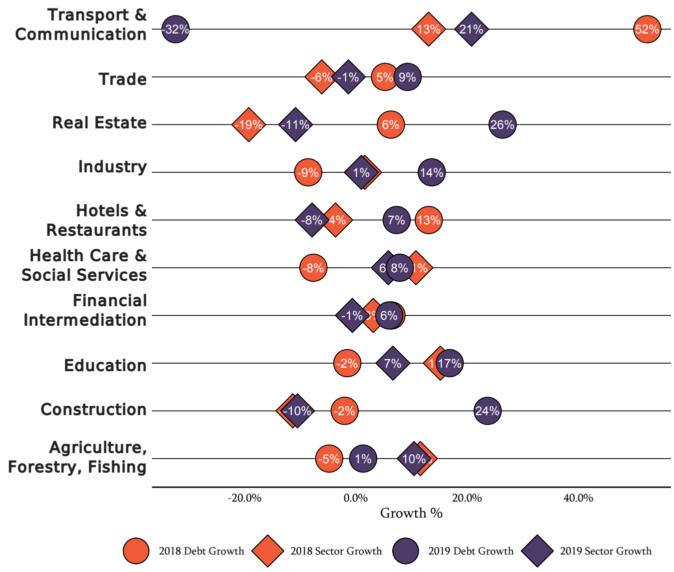
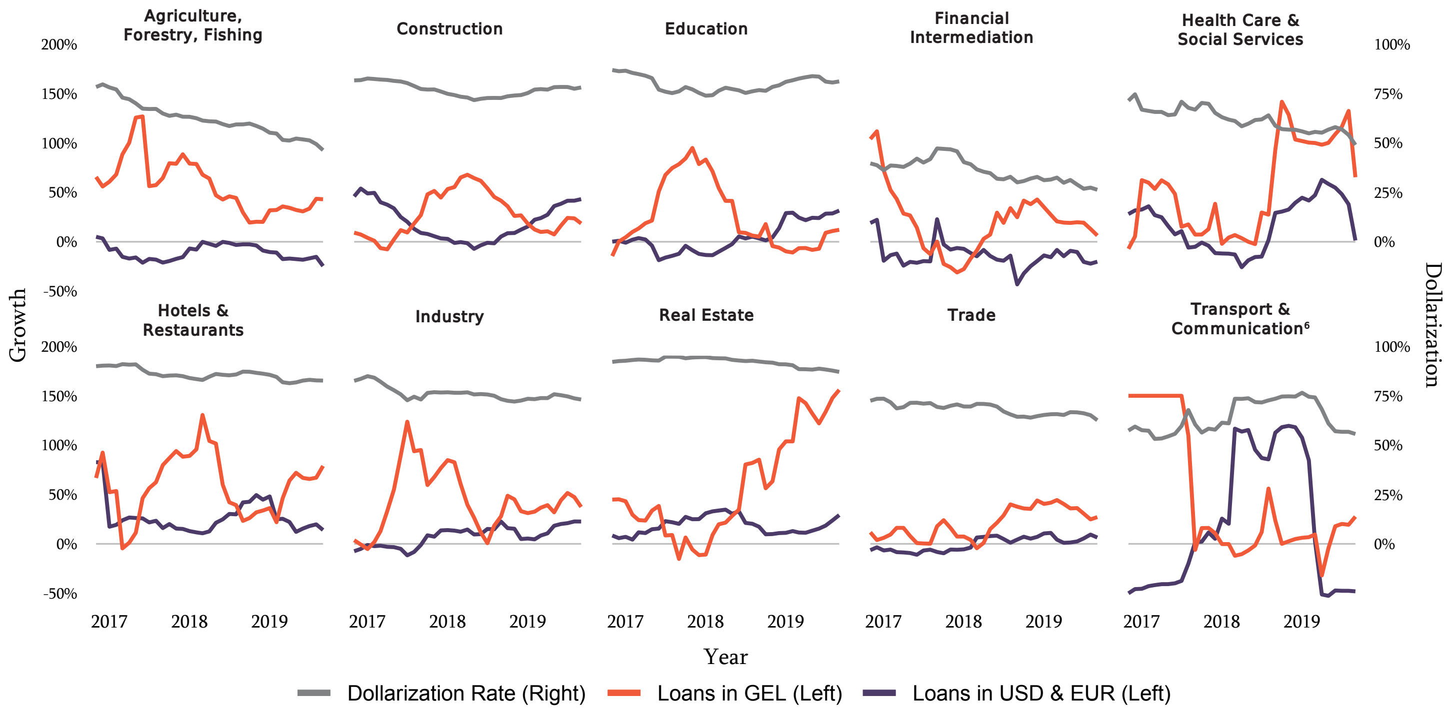
The possibility of a regulation reversal has been met positively by the private sector. Some have even stated that the reversal is necessary to “avoid having a negative impact on economic growth”[3]. Imposing thresholds on individual borrowing had a profound effect on household borrowing patterns[4]. However, no similar effects can be observed in the fifth graph, where the change in sector output and debt levels for the first half of 2018 and 2019 is presented. In fact, in the first two quarters of 2019 the growth of sector output was similar to the growth in the previous year. In fact, change in the debt levels is slightly more noticeable, especially in sectors such as *Transport & Communication*, *Education* and *Construction*. Additionally, on average, companies are borrowing more compared to last year, the cause of which has probably little or no connection to the regulations. The threshold for companies borrowing in USD has probably acted, not as an effective prevention mechanism against private sector dollarization, but as a tool mitigating exchange rate shocks on relatively small scale SMEs - loans which make up a minute percentage of the total loans issued to legal entities (0.3%)[5].

Growth of Sector Output and Loans in the First Half of 2018 and 2019 (Graph 5)



Year-over-year Growth of Debt and Dollarization by Sectors (Dec 2016 - Oct 2019) Graph 6



The dollarization rate in the private sector is at 70%. Compared to the households’ 41% this number is abnormally high. Sectors like *Real Estate*, *Construction* and *Education* are especially vulnerable to exchange rate shocks. It has not abated (nor have the authorities taken measures to tackle it) as in the two of the abovementioned sectors loans in foreign currencies are growing considerably faster than in laris, whilst only a handful of sectors seem to be decreasing demand for loans in USD and EUR. Furthermore, each sector has its own borrowing characteristics: more than 90% of the construction sector debt is in foreign currencies, while for financial intermediation the same number is 41%. This variety further complicates the already challenging intent to decrease dollarization.

In conclusion, the private sector seems to have easily avoided the 200 000 GEL threshold and in times of high depreciation resorted to the euro as an alternative. If the high dollarization in the private sector is a matter of concern it should be adressed with an effective response from the authorities. If it is not, the implementation of such regulations is made redundant.

3 President of Association of Banks of Georgia - Alexander Dzneladze; 4 PMC Research - Analysis of Tighter Lending Regulations in Georgia. 5 Approximate share of SME loans that were susceptible to the 200 000 GEL regulation in December 2018; 6 Domestic Loan debt growth for Transport and communication sector before August 2017 exceeds graph limits therefore is not included.

Basic Economic Indicators	2014	2015	2016	2017	2018
Nominal GDP (mln USD)	17625.5	14948.2	15141.7	16248.5	17596.6
GDP per Capita (USD)	5015.0	4012.6	4062.1	4358.5	4772.0
GDP Real Growth (%)	4.6%	3.0%	2.9%	4.8%	4.8%
Inflation	3.1%	4.0%	2.1%	6.0%	2.6%
FDI (mln USD)	1,817.7	1,665.6	1,565.8	1,894.5	1,265.2
Unemployment Rate (%)	14.6%	14.1%	14.0%	13.9%	12.7%
External Debt (mln USD)	4,199.8	4,314.9	4,515.7	5,177.4	5,434
Poverty Rate (relative)	21.4%	20.2%	21.0%	22.3%	20.1%