Banking System Comparison in Black Sea Region: Turkish and Georgian Example

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In many emerging market economies, the presence of banks has increased, especially during the 1990s. A banking system is very essential for growth of the economy in a country. At the beginning of 1990s, the Soviet successor states started to transform their financial sectors to meet the needs of the emerging market economies. One of many transition countries is Georgia. After 1996, Georgian banking system changed tremendously. The purpose of this paper is to compare two Black Sea Countries' banking systems. Turkey's banking system' adaptation to European banking system's is a good example for Georgia.

Introduction

The objective of this paper is to compare the banking system development between Georgian experiment in transition banking since the country's break from the former Soviet Union in 1991, and Turkey's experience after financial liberalization in the 1980s. Building stable and sustainable financial institutions is crucial for swift conversion from planned to market economies, and for overall economic growth and technological advancement. Financial institutions perform unique tasks in the economy by providing liquidity to businesses and households by linking surplus holdings with deficit spending units. How successfully financial institutions perform these tasks will largely depend on the environment in which they operate, the policies the regulatory authorities follow and the ability of management to efficiently utilize available resources.

The Turkish banking system, like banking in many other countries, experienced legal, structural, and institutional changes as a result of the financial liberalization program in the 1980s. Prior to 1980, the Turkish banking system was a closed system and heavily regulated in terms of market entry and interest rates due to inward oriented economic policies. Furthermore, international capital movement and foreign exchange operations were subject to tight controls.(Kasman,2002)

Georgia was a part of the same state organism, which had a uniform system of economic and political institutions. The economic system of these republics began to change as a result of the reforms carried out at the end of the 1980s and beginning of the 1990s throughout the Soviet Union. All of the countries that emerged after the breakup of the Soviet Union were in similar economic straits; however, Georgia was among the countries that had and continues to have the greatest difficulty getting through the economic crisis connected with the demise of the system. The crisis is characterized by a substantial drop in GDP, high inflation, and a considerable budget deficit. This is illustrated in Table 1.

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Trend of GDP and Inflation in 1991-2000 Table 1

Georgia:	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
GDP growth	-20.6	-44.8	-25.4	-11.4	2.4	10.5	11.0	2.9	3.0	1.9
inflation	175.0	1,340.0	9,340.	8,340.0	157.4	113.8	107.3	110.7	110.9	104.6
Turkey										
change in	-5	7	7	7	8	3	-5	7	8	6

Sources: National Bank of Georgia ,annual report (1999) and (2000) .International Financial Indicator

Georgia is an extreme example of economic collapse in the countries of the Commonwealth of Independent States (CIS), although it was one of the richest republics in Soviet times. The economic collapse after independence was exacerbated by civil war. According to official data, the national income dropped 80 percent in 1990-94. At the same time, the shadow economy grew significantly, alleviating, to a certain extent, the catastrophic drop in production. During the civil war in 1992-93, budget revenues declined to just a few percent of budget expenditures. Inflationary budget financing gave rise to hyperinflation, which exceeded 9,000 percent in 1993 and 8,000 percent in 1994. Inflation was halted in 1995-96; it was 163 percent in 1995 and approximately 25 percent in 1996. The decline in GDP was halted in 1995. In 1996, the national income rose by 10 percent, reaching 22 percent of the level of 1989. In that year, the budget deficit was held to 6 percent. Structural reforms were begun, prices were decontrolled, and privatization was accelerated. In the fall of 1995, a national currency was introduced (the lari), and—with foreign assistance— the exchange rate was kept stable. In 1996-97, Georgia embarked on the path of economic recovery. The economic growth rate was more than 10 percent, and inflation dropped from 14 percent to 7 percent. However, the Russian crisis slowed the pace of positive changes in the economy. Since the crisis, annual GDP growth has not exceeded 2-3 percent. A report prepared for the World Bank in 1996, Stijn Claessens distinguished two models of change in the banking sector of the post-socialist countries.[3] The first was based on the so-called new entry strategy, that is, the complete liberalization of the conditions for creating new banks, with the simultaneous spontaneous fragmentation of the old state banks, which were subsequently privatized or liquidated. The second model, which is called the rehabilitation approach, focused efforts on restructuring the existing state banks, their institutional development, and their subsequent privatization. In this model, the freedom to create new banks and fragmentation of the existing state banks were limited. Hungary and Poland are examples of countries that took this route. Georgia was one of the transition countries which used the new entry strategy. As in Ukraine, by the mid-1990s, 230 commercial banks had appeared in this small country. Large state banks were similarly privatized. In addition, three of the former state industrial banks were permitted to merge into one. As a result, while the banking sector was weakened overall, the role of state banks grew.

A Brief Overview on the Banking System

In Turkey, there were 75 banks, of which 15 were development and investment banks and the rest were commercial banks. 75 banks had 7,370 branches there. That means approximately one branch for each 8,500 inhabitants in 1998. Turkey's financial system is bank-oriented and commercial banks are the dominants institution in the Turkish banking system. Because of less development capital markets, the banks are the main source of funding for the industrial and commercial businesses. Although the newly developing capital markets are able to compete with the banking sector, banks are still dominant in the financial system, as in other developing countries` financial system. Investment banks specialize in underwriting securities. Development banks, on the other hand, obtain funds

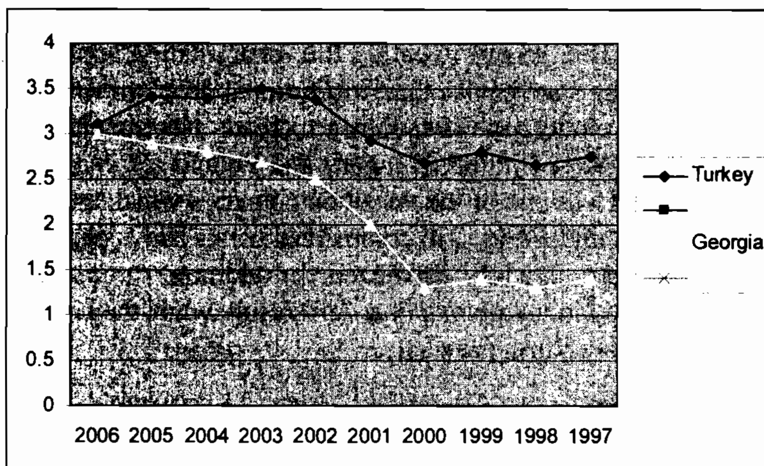
from the government or other international institutions like the World Bank. The acquired funds have traditionally been used to make medium and long-term loans to select industries. Three types of ownership exist in the Turkish banking system; state-owned banks, private national banks, and foreign banks. Four state –owned banks held more than 35% of industry's total assets in 1998 and controlled the bulk of the funds in the banking industry.

The Turkish banking system was a closed system and heavily regulated with respect to market entry and interest rates before 1980. To increase efficiency and create competition in the financial system, the Turkish government announced a liberalization program in January 1980. The main objective of this program was to establish a Western-type free market economy and competition. Most of the 1980s witnessed continues legal and institutional changes in the financial system. The banking system was deregulated and a new banking law was enacted in 1985. Figure1 shows the general transition and banking reform scores for Georgia and Turkey as measured by index of economic freedom.Most restriction concerning market entry and interest were eliminated. Opening the banking system to the foreign banks was intended to be a crucial element of competition. The new banks started to enter the market, and severe competition started in the first part of 1980. The number of banks increased from 43 in 1980 to 75 in 1998.See Figure2.

The number of banks operating in Turkey declined from 50 in 2003 to 48 in 2004. Of the banks operating in Turkey, 35 were commercial bank and 13 were non-depository banks. Of the commercial banks, 3 were state-owned banks, and 18 were privately owned banks.

The number of branches increased by 140 to 6,106 in 2004.By banking groups, the number of branches increased by 139 in commercial banks, and by one depository banks.(Turkey Central Bank Statistic)

Figure 1. Overall transition and bank reform (BR) scores



Source: index of economic freedom (http://www.heritage.org)

After declaring independence in 1991 Georgia experienced a particulary deep recession.From 1991 to 1994 GDP dropped by more than 70% (45 % in 1992 alone) while annual inflation raged at 7,487 and 6,473% in 1993 and 1994 respectively (Wang 1999). Transformation of recession is common to all transition economies. Output decreased, inflation increased and unemployment increased. There were two secessionist wars, including political turmoil retarded the economic recovery,gaining

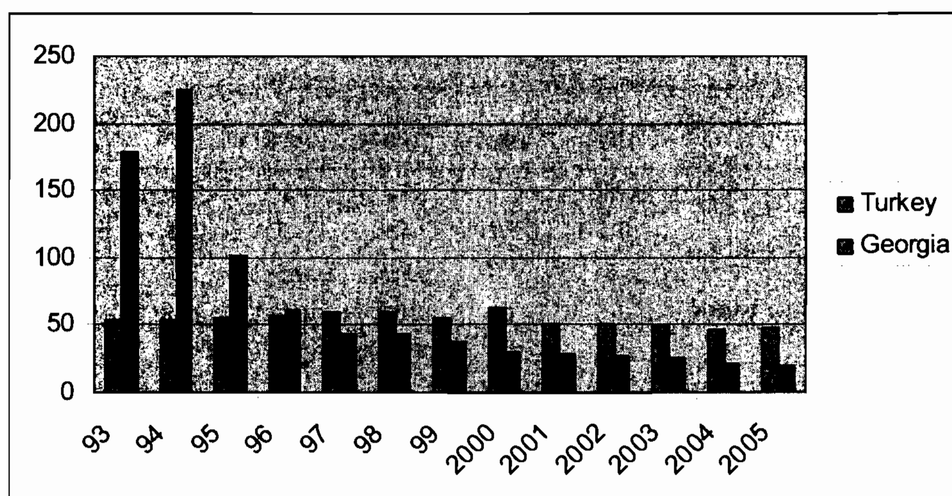
political stabilization by mid-1994, the country began to implement the program of comprehensive reform with external assistance from IMF, the World Bank, Technical Aid for CIS (TACIS) and others. GDP increased by 11% in 1997, 10 % in 1998, Inflation was only 7% in 1997, GDP 11,1 % recently ($ 3,73 billion) GDP growth moderated to around 3 % in 1998 , partly as a result of the Asian and Russian financial system. (EBRD, Transition report)

Banking stage in Georgia after 1997

NBG certified the United Georgian Bank and the Bank of Georgia in mid-1997. Reserve requirements were lowered and the capital adequacy standard was raised from 8 to 10% of total assets. As a result of the BCP and stricter regulations, 173 commercial banks (of 226) had vanished in less than 3 years. As noted by Kloc (1999), this was an unprecedented outcome among the nations of the former Soviet Union. As it is illustrated in figure2, number of banks decreased as stronger bank regulation was implemented.

Late 1997 brought the next stage of reform when the NBG announced a plan to gradually increase the minimum capital requirement for commercial banks to GEL 5,000,000 (approximately $3,846,000) by the end of 2000. This measure aimed to further consolidate the industry by eliminating the smaller and weaker banks. Throughout 1998 the NBG was involved in revoking licenses of banks not meeting the new minimum capital requirements and other prudential regulations. Although initially stymied by a court challenge, the issue was resolved in favor of the NBG and de-licensing resumed. By the end of the year a total of 10 banks had lost their licenses.(Amaghlobeli, Farrell, Nielsen,2003)

Figure 2. Commercial banks in Georgia and Turkey.



Source: National Bank of Georgia (2001), Bank Association of Turkey

As it is illustrated in Table 2 an increase in the number of branches since 1995 in Turkey. This trend continued also between 1998 and 2005 , and the number of branches reached 7,370 by increasing 8 percent (551 branches). Especially, a significant increase is observed in the number of branches of the privately owned banks. Number of branches in Georgia increased steadily although there were dramatically decreasing trend in number of banks. See Table2.

Table2 (Number of Branches in the Banking Sector)

	2000	2001	2002	20003	2004	2005
Of Turkey						
Commercial banks	6,419	6,795	7,340	5,949	6,008	6,228
State-owned	2,875	2,886	2,915	2,832	N/A	N/A
Privately-owned	3,240	3,429	3,764	4,393	N/A	N/A
Foreign banks	104	104	116	115	N/A	N/A
Of Georgia						
Commercial banks	208	206	199	201	162	159

Source: National Bank of Georgia (2001), Bank Association of Turkey

Asset and liability of banks

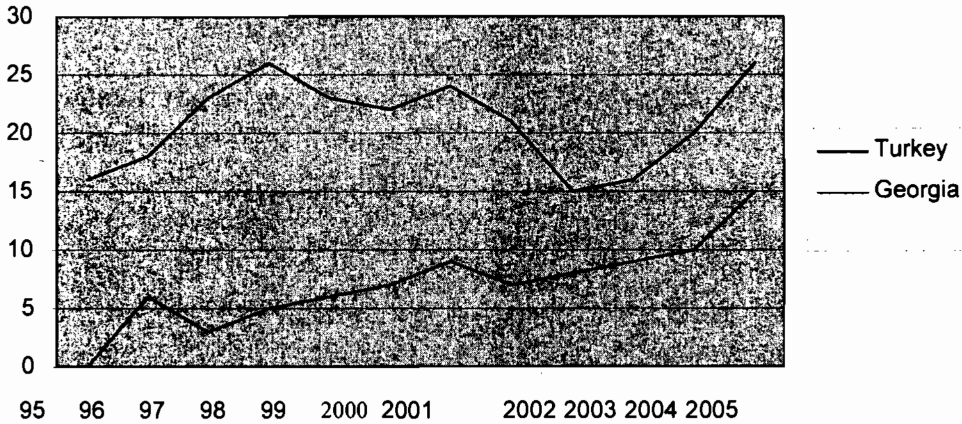
As shown in Table 3 and figure 3, between 1995 and 2000 the percentage of total bank assets held in loans decreased by almost 10%, while the percentage held in accounts with correspondent banks increased almost six-fold. As interest rate spreads were decreasing sharply during this period, commercial banks sought to secure non-loan sources of revenue involving currency conversion and especially money transfers (both domestic and international). Banks started maintaining multiple correspondent accounts with other banks in the country and abroad, which came at the expense of lending. On the liability side, a substantial increase in capital can be observed as well as a corresponding decrease in the percentage of demand deposits. As public confidence in the banks increased, both time deposits and household deposits increased more than six-fold. (Mercan, 2006)

Table 3. Asset and liability composition of the banking sector in Georgia, 1995-2000 (%)

	1995	1996	1997	1998	1999	2000
Vault cash	2.9	3.7	4.3	2	2.1	1.8
Required reserves	7.1	5.7	4.9	3.7	**5.5**	5
Foreign currency accounts	5	4.8	5.7	4.5	3.7	4.7
Accountswith correspondent banks	2.6	10	10.8	18.3	13.8	13.4
Debtors	2.5	3.5	2.9	3.1	2.6	2.3
Loans	64.2	50.6	50.7	48	50.7	55
Claims on banks	1.7	3.6	2.4	1	0.9	0.8
Securities	0.2	1.2	2.3	2.1	3.3	2.1
Fixed assets and premises	12.4	14.5	14.5	15.8	13	12.2
Other assets	1.4	2.4	1.5	1.4	4.4	2.7
Total Assets	**100**	**100**	**100**	**100**	**100**	**100**

Source: National Bank of Georgia (2000).

Figure3.Domestic credit to private sector as % GDP



Sources: International Financial Indicator

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