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Stock Market Development In Georgia

The goal of this paper is to review the development prospects of stock market in Georgia. The change of economic system in Central and Eastern Europe in 1990s resulted in rapid economic growth. This led to the rise of various financial institutions, especially the development of stock markets. The existence of stock markets in the developing countries is associated with the establishment of free market system and democracy. Therefore, developed countries attach significant importance to the development of stock markets in third countries.

Influence of internal and external factors on Stock market development in third countries is reviewed in this paper. External factors include the establishment of successful economic models through international financial institutions, financial aid, and sharing of best practices in the field. Internal factors include the impacts of sustainable banking systems, pension funds, and insurance companies on stock market operation in developing countries

Keywords: Georgian Stock Market; Coercion, Emulation; learning; Emerging market.

Economic globalization creates opportunities and challenges for developing countries. The main problem for policy makers is which type of economic structure they should adopt to promote economic prosperity.

Empirical knowledge shows the existence of a strong correlation between stock market development and economic growth, since well-developed stock markets can significantly increase a company's capital and ability to implement their future projects (Guglielmo Maria Caplare, Peter G. A. Howells, and Alaa M. Soliman, 2004, pp. 34-36). If we go through the literature, a considerable amount of research suggests that the relationship between stock markets and economic growth is positive and that stock markets often work as a barometer of business direction (Gerald, Weber, & Lounsbury, pp. 1323-1324). There are some economists who are critical of stock markets, though. Many times stock markets have been blamed for economic crises, like the Great Depression in 1929 and Credit Crunch in 2008. The main attack against the stock market came from John Maynard Keynes; he termed the stock market as a gambling casino where players are coming to place bets, and called for fundamental reforms. Despite Keynes's theory about stock markets, a growing literature argues that stock markets provide financial and economic growth. Research shows stock market development can facilitate investment in different sectors of economy (Smith & Greenwood, 1996, pp. 146-148).

Role of Economic Policy in Local Market Development

For past decade, emerging markets have surged not only in Eastern Europe and Asia, but in Africa too. According to the IMF, stock market development is a core component of most domestic financial liberalization programs. In other words, without the development of stock markets, any financial liberalization program is incomplete. (Simmons, Dobbin, & Garrett, pp. 781-787). Research shows that countries with well-developed stock markets have strong banking systems, strong property policies, and low political risk. This last factor is

especially important in investment decisions as it has strong effects on the cost of equity.

At the end of 70's commercial banks played an important role, because only they had the resources to finance companies' growth. At the same time, a huge amount of money was lent, long term, to the governments of developed countries. This bank lending process ended in 1982 when the Mexican government stopped paying debts. This was a signal of the beginning of the debt crises throughout the developing world. The rest of 80's was called the "failure decade" in development world (Manzocchi, 1999, pp. 52-65).

In response to these failures, the "Globalization Project" encouraged market-based economic development (McMichael, 1996, pp. 61-65). This model was based on using private investment funds for developing economies. Therefore, in 1990s, there was a stream of market liberalization. This gave opportunities to the foreign investors to buy domestic equity. The stocks of emerging markets became attractive to institutional investors from the countries with advanced economies (Bekaert, Harvey, & Lundblad, 2005, pp. 21-30). As a result, stock exchanges spread around the world. According to the World Bank in 1986 there were 19 emerging market country funds and 9 global market funds. Even investors were aware of emerging market funds because of the high level of risk and price volatility and by 1995 this number increased and there were over 500 country funds and 800 regional or global funds.

Some markets had significant growth while others were not so successful. For example in 2000 the trading at the Swaziland stock exchange was limited to a total of 50 transactions for the five listed equities. At the same time, the Shanghai stock exchange had rapid growth with 100 million transactions as China became of the world's largest development economies. Creating a new stock exchange requires attention to detail as well as internal and external factors. Internal factors are: economic development, political

system, ideology and prior institutional endowment. These ideas are based on several hypotheses proposed by Weber:

“1. The more financially dependent country is, on its aid from the IMF and the World Bank, the more, likely it is to create stock exchange, and this stock exchange is smaller, then those which was created without such aid. 2. Stock exchanges in the countries favoring investor based systems (characterized by Protestantism, British colonial influence, political democracy, and non socialist ideology) increase the likelihood of stock exchange adoption. 3. The more a country’s regional neighbors and partners have adopted stock exchanges, more likely the county is to create a stock exchange.” (Gerald, Weber, & Lounsbury, pp. 1323-1324) .

External Factors that Affect Development of Financial Markets

In his their review Simmons, Dobbin and Garrett analyzed external attributes and described four mechanisms of international diffusion: coercion, competition, learning and emulation (Simmons, Dobbin, & Garrett, 2009, pp. 790-798) . **Coercion** occurs when states with strong economy impose their models on countries with weaker economy. In this case motivation, experience and sometimes financial assistance come from outside of the country. These factors impact diffusion either directly or through the nongovernmental organizations. **Competition** occurs when state adopts a policy thought to provide advantages relative to competitors. It’s a more decentralized strategy for policy diffusion. In this case policy helps governments to compete with each other for foreign capital and export market share. To achieve this goal, governments should simplify regulatory requirements, reduce tax and improve the investment environment. Sometimes to attract foreign investment they slash social spending and environmental and labor regulations. **Learning** is a third mechanism diffusion. The idea is that the experience of others provides information on

the effectiveness of policies. The rationality for this action rests on exploring effective solutions to given problems. Learning mechanisms are frequently used by governments to build new effective domestic policy. Organizations like the IMF, and the Organization for Economic Cooperation and Development analyzed different reports, reviews, and identify best practices which then became then powerful policy instruments for countries with developing economies. Usually learning takes place when successful policy changes in one country stimulates similar changes in other countries. **Emulation** is a forth mechanism for diffusion. The basic idea behind emulation is: “the desire of actors to conform of widespread norms and socially valued policies” (Torben, 2011, pp. 7-9). In other words, developing countries may adopt policies and create new institutions just for global legitimacy, and in this case the technical functionality of policies is unimportant or they just have symbolic purpose. (Polillo & Guille’n, pp. 1766-1768). Western countries’ economy models served as templates for how developing countries should manage their economies. Most of western countries created their stock exchanges in the 19th century and they are considered to be core institutions. The expansion of core institutions in the 1990s stimulated the huge spread of exchanges in developing countries. Often famous economic experts, policy makers, NGO-s could influence developing countries governments by just making arguments for stock exchanges.

The United States played a main role in the economic liberalization of Latin American countries, but their influence operated through the preference of government leaders who sent financial ministers to train in the United States, rather than through young economists educated at the best U.S. universities. Whereas the logic of development suggests that countries should adopt certain programs when they are ready for them, word polity theorists have found that countries adopt policies that they cannot carry out in reality.

Emerging Stock Markets and Economic Growth

Above we discussed the impact of external factors on stock market development, but internal factors also play a huge role in stock market growth in developing countries. A strong banking sector, well-developed pension funds, insurance companies and other financial institutes play a significant role in stock market development.

The process of stock market development has been quite different in developing countries. Over the past few decades, the world stock market have surged, and emerging market have huge stake in this process. New markets have been established in Eastern European, Asian and African countries (Charles Amo Yartey, 2007, pp. 13-16). Some of those countries have made great progress in developing their stock markets. Financial markets of advanced economies for past 30 decades have become increasingly integrated due to a number of internal factors: 1.deregulation and internationalization of financial markets in well-developed countries; 2. Introduction new financial instruments allowing more risky and bigger financial investments, (like stock options, futures) 3. The increasing role of institutional investors on the stock market.

Later we will discuss stock market development in Eastern European countries using market indicators and theories of stock market development (Butsa, 2008, pp. 15-20). In order to measure the development of stock markets, Butsa used some market indicators like the **market capitalization** ratio-the value of listed stock exchange shares to the GDP of the country. This ratio shows the relative weight of the stock market in the country's economy. **Total value traded/ GDP** – calculated by dividing the total shares traded by GDP. **Turnover ratio** - calculated by dividing total shares traded by market capitalization. This measures trading relative to the size of stock market and it helps to identify small stock market with high growth potential. **Volatility** –statistical measure of the dispersion of returns for the stock market index. **Institutional and regulatory indicators** shows the level of development of

regulatory and market institutions, which is crucial factor for successful stock market development. Now we will take a look at how stock markets in developing countries are organized and explore some of the differences between them.

Polish Stock Exchange

The first stock exchange in Poland opened in Warsaw on May 12, 1817. The exchange traded primarily in bills of exchange and bonds. The exchange started full-scale trading in the second half of the 19th century. After the Germany- Russian invasion of 1939, the stock exchange in Poland was closed. In 1991 after the fall communism, the Warsaw Stock Exchange was founded again. In the early 1990's the privatization process used in Poland did not require mandatory listing of companies on the stock exchange. The Warsaw Stock Exchange had only nine listed companies its first year of operation. After five years this number increased to 83, by the end of 2007 there were 351. Now there are more than 400 listed firms including Italian bank Unicredit. Another 220 smaller companies are listed on New Connect, Warsaw's equivalent of London's Alternative investment market. The advantage to being listed on this market is better visibility if they are not also listed among thousands of others on the NYSE or LSE. This stock market has grown rapidly benefiting from Poland's privatization program. As a result, hundreds of state owned businesses have been auctioned on the stock market including big energy companies which have sold for \$2 billion (Kollewe, 2011).

In 2013 at the Warsaw IPO summit, Georgian companies made a request to be listed on the Warsaw Stock Exchange. They represented several sectors of Georgian economy. They expected to raise their capital and extend businesses. The Georgian companies major problems included that Georgia is not a member of European Union, which meant that there was a more complicate process for listing their securities on the WSE. Before 2012, the strategy of WSE was concentrated on domestic market. The new CEO Pawel Tamborski designed a new strategy oriented on rapid grow. He prefers

foreign listings and this gave Georgian companies a good opportunity to reach foreign investors. It was not easy to execute this plan. Both countries need to create an operational link for a Central Security Depository (CSD), but Georgia at this moment does not have technical capabilities to do so. Georgia could only build a CSD link indirectly.

The Warsaw Stock exchange uses the WIG20 index to measure market performance, which is a capitalization-weighted index. It contains the 20 biggest and most traded companies. To be included in the WIG20 basket, companies have to meet several requirements including that the number of shares in the free float should exceed 10% and that the value of the shares that free float should be larger than €1,000,000. The first value of the index was 1000. The highest level 4000 was reached on October 9 2007. (Figure 1) This index was used until the end of 2015 after which the WIG30 will take its place (Warsaw Stock Exchange, 2014) .

Index calculation

$$WIG20 = \frac{P(i) * S(i)}{(P(0) * S(0))} * 1000,00$$

S(i) – Weighting of an index ‘i’ participant during a certain session

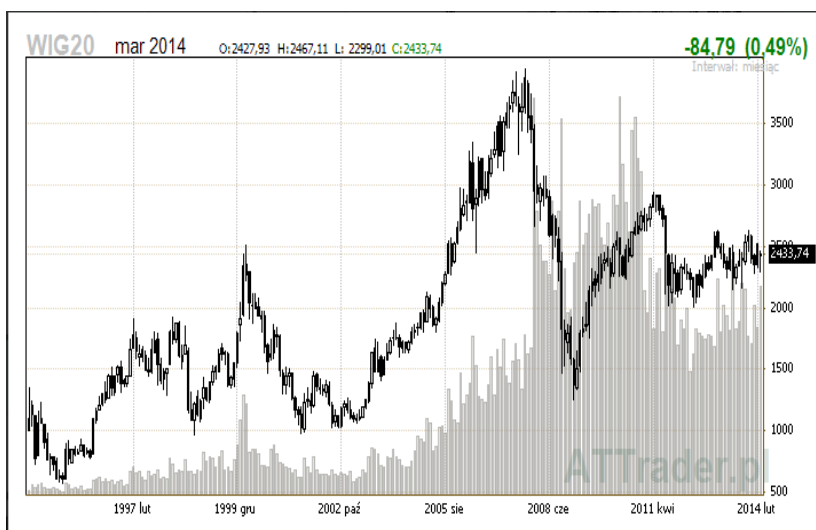
P(i) – Price of an index ‘i’ participant during a certain session

S(0) – Weighting of an index ‘i’ participant during a session at baseline date

P(0) – Price of an index ‘i’ participant during a session at baseline date

K(t) - Index adjustment factor during a certain session

Figure 1



One of the reasons behind the Warsaw Stock Market's performance was the pension reform made in the country (Butsa, 2008, pp. 21-24) As a result, pension funds became big institutional investors, as they were investing 95% of their funds into domestic securities.

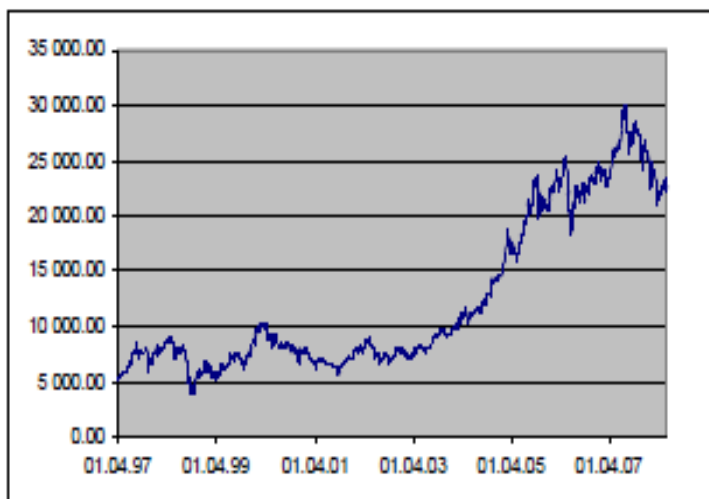
Today the exchange has a market value of €142bn which is bigger than the much older Viennese stock exchange, as well as stock markets in Prague and Budapest. High shares of foreign investors are trading on the Warsaw Stock Exchange and this gives it its international status. The stock exchange is close to achieving its ambition of becoming a regional hub in Eastern Europe.

Hungarian Stock Exchange

The predecessor of today's Budapest Stock Exchange started on January 18, 1864 in Pest. Starting in 1889 BSE became international stock exchange and stock prices of the companies listed on the BSE were also published in Vienna, Frankfurt, London and Paris. After World War II, the Hungarian government nationalized most companies and closed the Budapest Stock Exchange. On June 21 1990 the Budapest Stock Exchange was reopened with 41 founding members and just single equity trade.

In April 2000, the BSE Council decided to convert into a business association. In 2004 major changes happened in the ownership structure of the BSE. A majority stake in the BSE was purchased by Austrian Banks and Vienna Borse. Since 2010, the BSE has been a subsidiary of the CEESEG AG holding company, which owns 50.45 % of the BSE. This has given them an opportunity to integrate into larger European family.

The BSE index is a capitalization-weighted index adjusted for free float. This index tracks the daily price performance of only large, actively traded shares on the BSE. The shares account for 58% of the domestic equity market capitalization. The index has a base value 1000. (<http://www.loomberg.com/quote/BUX:IND>) (Budapest Stock Exchange Budapest Stock Index, 2014)



Source: Homepage of the Budapest Stock Exchange.

Georgian Stock Market

The Georgian Stock Exchange is the only organized security market in Georgia. The Georgian Stock Exchange (GSE) was established in 1999, by a group of security market professionals, leading banks investment, and insurance companies with the assistance of the USAID. Official trading at the GSE began in March 2000. In 1999, through the EU-Georgia Association Agreement, the Law on Securities Market of Georgia (LSM) was adopted. LSM provides investors with proper and accurate information. (The Capital Markets Working Group, 2015, pp. 9-11).

The number of companies trading increased significantly and at the end 2004 reached 277. In 2006, Bank of Georgia (GSE:BOG), listed at the GSE since 2001, issued an IPO at the London Stock Exchange and raised \$160 million. In 2007 a remote system was implemented at the GSE. In 2010 the stock exchange indicator G&T Index was introduced. This is a price-weighted index which includes 8 listed companies. Even though there are more than 2000 companies listed on stock exchange, just some of them regularly trade on the stock exchange. This means that GSE is an undeveloped stock market. The total market capitalization is almost \$1 billion and the daily turnover is \$2,000 (Loladze, 2012). GSE operates on two levels A and B. GSE had significant growth through 2007 with trade sessions increasing and the number of successful IPOs hit the market. The situation changed in 2008 when an amendment to the Law on the Security Market legalized over-the-counter trading. This gave companies listed on the GSE the chance to trade outside of exchange.

Table №1. represents companies' performance listed on GSE. (The Capital Markets Working Group, 2015, pp. 45-54)

LISTED COMPANIES - LIST A

Code	Title	Number of Issued Securities	Nominal Value	Charter Capital	ISIN	Comment
#EBR03L	European Bank for Reconstruction and Development	107 GEL	1000000.000	0	GE8790603384	
GEB	Bank of Georgia	27,821,150 GEL	1.000	43,308,125	GE1100000276	

LISTED COMPANIES - LIST B

Code	Title	Number of Issued Securities	Nominal Value	Charter Capital	ISIN	Comment
#GWP01H	Georgian Water And Power	2,600 GEL	1000.000	208,469,000	GE2700603329	
\$GLC01H	Georgian Leasing Company	10,000 USD	1000.000	10,000,000	GE2700603246	
\$m203H	m2 Real Estate	20,000 USD	1000.000	3,524,058	GE2700603295	
\$M204J	m2 Real Estate	25,000 USD	1000.000	4,179,947	GE2700603436	
\$MCE01H	JSC "Medical Corporation EVEX"	15,000 USD	1000.000	24,165,000	GE2700603303	
\$NKR01I	LTD Nikora Trade	5,000 USD	1000.000	11,175,000	GE2700603360	
BANK	Liberty Bank	5,502,254,354 GEL	0.010	75,000,000	GE1100000300	
WINE	Teliani Valley	369,404,255 GEL	0.010	4,000,000	GE1100003130	

There are some serious reasons for the low level of development of the stock market in Georgia. First of all, high interest rates force investors to deposit money in banks (some commercial banks have 8% return on long-term deposits). The Georgian banking sector is distinguished from the European banking system firstly, by the small role of its banking activities, like deposit, loans and payments. Secondly, the government's economic policy actively interferes in the existing financial relationships instead of strengthening regulatory institutions. As a result, companies protected by the government have no desire to be listed on a stock market. Moreover they use their connections with the government and banking sector against the stock exchange.

Some essential steps should be taken to build a well-developed financial market in Georgia: 1. To improve the reputation of GSE, the government should increase EU regulation on LMS. 2. For companies listed on GSE, the dividend and capital gains tax should be eliminated. 3. There needs to be a significant increase in state owned companies shares traded on GSE. (Georgian Railway; Georgian Oil and Gas Corporation; Telasi; TBIL-AVIAMSHENI; Electricity System Commercial Operation). 4. Reporting requirements should be improved. (The Capital Markets Working Group, 2015, pp. 72-73)

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