საქართველოს ეროვნული ბანკი
National Bank of Georgia

# Financial Stability Report 2024

# Preface

The Financial Stability Report is an annual publication issued by the National Bank of Georgia (NBG). It presents an assessment of vulnerabilities and risks in the financial system, with a focus on the long-term, structural features of the financial sector and the Georgian economy that are of importance for financial stability. It also analyses the domestic financial system's resilience and conveys the Financial Stability Committee's (FSC) view on the policies and measures necessary to preserve financial stability.

The financial system is considered stable when it can provide crucial services to market participants in both good and bad times. It is a cornerstone for the sustainable development of the economy.

Given its mandate as defined by the Organic Law of Georgia, the National Bank of Georgia continuously aims to ensure that the financial system is safe and sound.

This analysis draws on data available up to 30 June 2024, unless otherwise stated.



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# Financial Stability Report

# 2024

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# Executive Summary

**Due to the macroprudential and microprudential measures adopted by the National Bank of Georgia (NBG), the financial sector remains resilient and continues smooth lending to the economy.** As a result of increased economic activity, the appreciation of the local currency, and measures implemented by the National Bank of Georgia, the financial indicators of commercial banks have improved. Banks have fully recovered the capital buffers that were released at the beginning of the pandemic and the banking sector has sufficient resources to provide credit to the economy. Recently, the growth rate of loans has increased and at the current stage exceeds its long-term sustainable level. However, alongside a normalization of economic growth, it is expected that credit growth will approach its long-term trend. Despite the high growth of credit, against the backdrop of strong economic activity, the credit-to-GDP ratio remains below the trend, and there is therefore no need to change the cyclical component of the countercyclical capital buffer at the current stage. At the same time, the banking system continues gradually accumulating the cycle-neutral countercyclical capital buffer (base rate), which was set last year by the Financial Stability Committee at 1 percent. The abovementioned indicates the healthiness of the country’s financial system. Moreover, the non-banking sector, which must also meet prudential requirements, remains resilient.

**Despite the positive developments observed in recent periods, financial stability risks arising from the external sector remain significant.** Georgia is a small open economy characterized by structural challenges, including a high level of dollarization, a current account deficit, and a significant dependence on international financial inflows. This makes the financial system vulnerable to global economic and financial developments. The weakening of the migration effect caused by the Russia-Ukraine war was followed by a decrease in inflows from the main foreign channels, which in turn reduced the share of foreign demand in economic growth. However, structural changes to the economy, particularly increased exports of information and computer services and a rise in transportation exports via the Middle Corridor, have supported improvement of potential GDP. It should be noted that in 2023, amid the recovery of the global economy and the reduction of inflationary pressure, the financial stability risks arising from Georgia’s foreign sector were revised downward. However, amid continued high uncertainty, the abovementioned risks remain noteworthy. In particular, factors that should be taken into account include the pace of the exit from the globally tight monetary policy; a possible worsening of geopolitical fragmentation and its impact on inflation; and asynchronous changes in monetary policy between developed and developing countries, which would be followed by capital outflow from developing countries and exchange rate fluctuations. A realization of these risks would have a negative impact on Georgia and the countries of the region, which could be reflected in a decrease in foreign demand, an increase in the external debt burden, and a deterioration of the current account.

**The distributions of the payment-to-income (PTI) and loan-to-value (LTV) ratios in households’ credit portfolios remain healthy, while the quality of loans remains good.** High economic growth and ongoing developments with the monetary policy rate have improved the creditworthiness of households, which supports a low share of non-performing loans. Moreover, average wages keep growing, while unemployment is at a historic low, both of which have a positive effect on the economic conditions of households. Household credit growth remains high, particularly for consumer loans. This has been driven by the extension of loan maturities from three to four years and, to some extent, reflects the base effect. Thanks to the macroprudential policy implemented by the NBG, loan dollarization is declining; however, the exchange rate risk of unhedged borrowers remains significant.

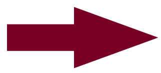
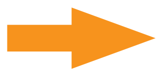
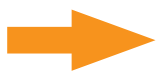
**Despite the increased uncertainty resulting from existing global geopolitical tensions, non-financial companies continue to grow at a stable pace.** Overall, the resilience of non-financial companies has increased, although certain sectors, such as the healthcare and telecom sectors, have seen an increase in the share of non-performing loans. The share of bank loans in the financing structure of companies continues to increase. The volume of bonds issued in the local market is also growing, especially those denominated in foreign currency. At the same time, the pace of de-dollarization of both domestic and total debt of non-financial companies has slowed down significantly. It should be noted that, amid the high economic growth in the last two years, the growth rate of bank loans of non-financial companies accelerated in the first half of 2024 and surpassed those of European countries. Nevertheless, the debt burden of companies, as a ratio of debt to nominal GDP, remains below its long-run level. Considering the setbacks caused by the COVID-19 pandemic, the profitability, liquidity and solvency indicators of non-financial companies improved by 2022. At the same time, the share of short-term debt in the total financing of non-financial companies has also decreased. Amid globally tightened financial conditions, the high dollarization of companies' liabilities indicates the existence of certain risks in this segment. However, according to the sensitivity analysis of non-financial companies, under the moderate-stress scenario, the debt-servicing capacities of companies remain at a healthy level, while risks to their financial stability do not increase substantially.

**With the gradual fading of the migration effect resulting from the Russia-Ukraine war, the rental price of residential real estate has stabilized and a decrease of USD-denominated rent prices has been observed; however, rental prices still exceed their long-term trend.** Following the rise of migration, rental prices increased sharply in 2022-2023. However, since April 2023, the rental price index has had a decreasing trend. This fall has been particularly pronounced in the USD-denominated rental price index. The current dynamics of the rental price reduction are less threatening in terms of financial stability, as the decline is gradual. Moreover, the decrease had been expected following the sharp increase in rent prices caused by the one-time, migration-related shock. The fall in rental prices has caused a decline in the capitalization index, which is the ratio of rental price to sale price that can be used to measure the investment attractiveness of property. Therefore, the long-term maintenance of a similar trend in real estate rental prices might affect the attractiveness of real estate. It should be noted that the housing affordability index increased slightly in the recent period, driven by growth in average wages. Real estate affordability itself is a fundamental factor in the demand for real estate. The rising demand seen in previous periods was partially a reflection of increased migration. However, as of 2024, the effect of migration has basically been exhausted, yet the real estate sector remains resilient. As for the supply side, there has been a significant increase in the number of permits issued for multi-dwelling properties, which could become a source of excess supply. The quality of loans issued by commercial banks to the construction and real estate sectors is good, and the growth rate of mortgage loans is stable. However, the annual growth rate of loans issued to development companies has significantly increased, requiring close attention. Therefore, continued monitoring of the real estate sector is essential.

**As a result of the financial stability policy measures implemented by the NBG, the financial system remains stable and has continued smooth lending to the economy in 2024.** Similar to the previous year, the banking sector's capital adequacy, liquidity and loan quality indicators have continued improving in 2024. Georgia's risk premium and national currency volatility decreased, which contributed to a further reduction of the financial stress index. Amid geopolitical tensions, uncertainty around macroeconomic developments remains high, however the Georgian financial sector remains resilient. With strong economic activity, the credit-to-GDP ratio remains below its trend. However, it should be noted that the negative gap of the credit-to-GDP ratio is closing, and credit growth is expected to be in line with nominal economic growth by the end of the year.

**The NBG's efforts to improve the resilience of the financial system are a continuous work in progress.** The National Bank is constantly monitoring the situation and will use all the tools at its disposal to reduce the impact of potential threats caused by the complex geopolitical situation in the region on the country's economy and to ensure financial stability. In recent years, the banking system has successfully coped with various global and regional challenges. The banking sector's asset quality has improved and banks have healthy capital and liquidity indicators. However, there remains high levels of uncertainty surrounding the ongoing geopolitical situation, including that related to the imposition of additional sanctions against Russia, and the potential economic and financial impact those would have. The National Bank of Georgia continues to actively monitor the country's financial stability, to assess domestic and foreign risks, and to ensure financial stability by employing macroprudential and microprudential instruments.

The following table summarizes the major financial stability risks facing the Georgian economy:

| The Main Risks to Financial Stability | Magnitude/Change |
|---|---|
| **Risks related to a possible prolongation and escalation of geopolitical conflicts**. The geopolitical risks stemming from the Russia-Ukraine war and conflicts in the Middle East remain elevated. This situation contributes to increased macroeconomic vulnerability, both globally and in Georgia's trade partner countries. Prolonged geopolitical tensions in the region could become a source of inflationary pressure, which is further influenced by ongoing developments in the Red Sea region. Additionally, the turbulent geopolitical environment may negatively impact investor sentiment in the region, leading to a revaluation of Georgia's sovereign risk. This could result in capital outflows and put the local currency under pressure of depreciation. Considering the still-high level of dollarization, a materialization of such risk could have a significant impact on both inflation and the quality of the credit portfolio. |  |
| **A slowdown of monetary policy normalization by leading central banks**. The prolonged maintenance of globally tightened monetary policy has led to a gradual decrease in global inflation. However, uncertainty surrounding inflation remains high, compelling leading central banks to adopt a cautious stance and slowing the process of the normalization of monetary policy. An increase in uncertainty regarding price dynamics may result in an additional tightening of monetary policy or a prolonged maintenance of the current tight stance. This will likely slow global economic growth and heighten risks to global financial stability. Consequently, these factors will lead to a revaluation of risks by financial markets and result in a tightening of financial conditions. As a result, developing and emerging market economies will have restricted access to sources of financing and the burden of external debt will increase. |  |
| **Cyclical downturn on the real estate market.** As a result of increased migration resulting from the Russia-Ukraine war, there was a significant increase in demand for real estate. However, as that effect faded, external demand was substituted by local demand, as supported by strong economic growth. Alongside sustained strong demand, supply also increased, as reflected in the rising number of construction permits issued. Since demand is mostly cyclical, in the event of a significant decline in economic activity, the high concentration of the workforce and investments in this sector could result in a drastic increase in unemployment and lead to debt-servicing difficulties, both of which would have negative effects on financial stability and the economy as a whole. |  |

<table>
<tr><th colspan="4">The Main Risks to Financial Stability</th><th colspan="2">Magnitude/Change</th></tr>
<tr><td colspan="4">Worsening of external factors. The effects of the Russia-Ukraine war have been heterogeneous across Georgia's main trade partner countries. While the economic situations of those countries directly involved in the war have worsened significantly, the increase of regional migration resulting from the war led to rising money inflows in a number of other regional countries, positively contributing to their economic growth. A further deterioration of the geopolitical situation in the region could lead to a rapid outflow of capital from the latter countries, which would worsen their economic growth. This would have a negative effect on Georgia's external demand and, therefore, on its economic growth.</td><td colspan="2"></td></tr>
<tr><td colspan="6">1 = minor risk and 6 = major risk. The arrow indicates changes in the risk level from the previous year</td></tr>
<tr><td>≥1</td><td>≥2</td><td>≥3</td><td>≥4</td><td>≥5</td><td>≥6</td></tr>
</table>

# I. Macro-Financial Environment and Outlook

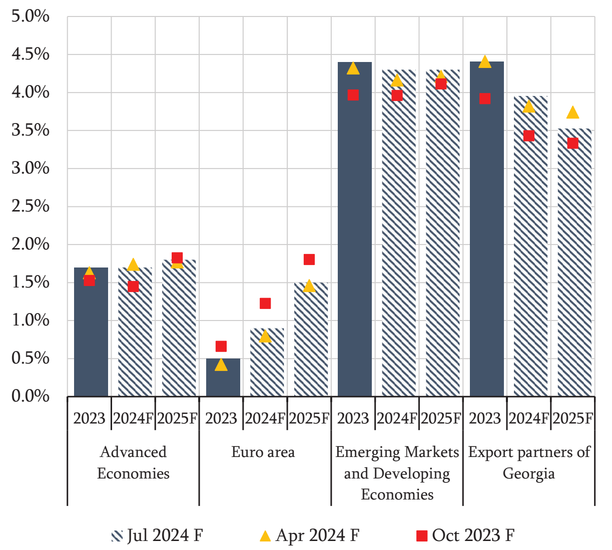
*The global economy has shown resilience to large-scale shocks and is continuing its gradual recovery. Despite pessimistic expectations, the global economy has rebounded at a faster-than-expected rate. Following an unprecedented tightening of monetary policy worldwide, inflation has steadily started to decline. The demonstrated resilience was supported by a strong labor market, the financial resilience of households and non-financial corporations, and the fact that the contractionary monetary policy did not prove restrictive to economic growth. However, risks in the global macrofinancial environment continue to be a significant challenge for the world's central banks. Amid a strong growth of service prices, inflation remains elevated, meaning that the pace of exiting from the tight monetary policy will depend on the rigidity of inflation. Moreover, economic growth continues to lag behind pre-pandemic levels due to factors such as still-high interest rates globally, weak productivity growth, and geopolitical fragmentation. Given the ongoing military conflicts, the economic activity of neighboring countries remains uneven and is characterized by high uncertainty. These developments pose risks to the local macrofinancial environment.*

**The global economy has demonstrated resilience against large-scale shocks and continues to recover gradually.** In response to rising inflation, amid the economic shocks and challenges of recent years, monetary policy has been significantly tightened in both developed and developing countries. Historically, such tightening has had negative ramifications for economic growth and has led to recession. Similar pessimistic expectations related to economic growth were observed in the past years as well, however, this time the risk of recession did not materialize, and the economy experienced a soft landing. The faster-than-expected rate of economic recovery and the initial signs of success in combating inflation indicate that the global economy was prepared for these shocks and demonstrated resilience. This was supported by a strong labor market and by the fact that the transmission of monetary policy to the real economy did not prove restrictive to growth. Positive expectations on the market and the stable financial positions of households and corporations reduced the impact of tighter financial conditions on economic activity. In addition, although the level of debt has risen, the growth of fixed-rate and long-term loans mitigated the impact of tightened financial conditions on borrowers. Moreover, thanks to the accumulated savings and fiscal support provided during the pandemic, the level of investments also proved to be sustainable. All of this supported a soft landing for the global economy. It should be noted that, despite signs of stress in the global financial sector and the fall in bank share prices observed last year, the financial sector successfully coped with the challenges and avoided a potential crisis. Additionally, despite high inflation, the risk of the development of a wage-price spiral did not materialize, partly due to an appropriate monetary policy response. However, various challenges in the global economy remain noteworthy.

**Despite the demonstrated resilience, the pace of global economic growth still lags behind pre-pandemic levels. Moreover, the dynamics of economic growth vary significantly by region.** Despite signs of stagflation, the global economy is growing at a low, yet steady pace, driven by factors such as a strong labor market, rising wages and high savings in developed countries. Unemployment turned out to be lower than expected in a number of countries, partly due to increased demand for services amid the economic recovery. As the services sector is more labor-intensive, this supported household incomes and aggregate demand. Therefore, based on the July 2024 forecasts of the International Monetary Fund (IMF), the growth rate of the global economy in 2024 is projected to be 3.2 percent, which represents upward revisions of 0.3 and 0.1 percentage points (pp) compared to the October 2023 and January 2024 forecasts, respectively. As for 2025, growth is expected to reach 3.3 percent (see Figure I.1). It should be noted that the pace of economic recovery has been lower compared to the historical figures, which is a result of still-high interest rates globally, weak productivity growth, and geopolitical fragmentation. In addition, growth in a number of countries has been negatively affected by ongoing fiscal consolidation measures that aim to reduce public debt by increasing revenues and reducing spending. Thus, although global growth was higher than expected, it is still below pre-pandemic levels. In addition, the first quarter of 2024 saw an increase in economic inequality between countries, which has a particularly negative effect on low-income economies and hinders their development. However, in the second quarter these dynamics were partially offset, which was supported by the convergence of economic activity with its potential. It should also be noted that a number of countries have experienced higher-than-expected growth. Economic indicators improved in Europe, which is explained by increased activity in the services sector. Improvement was also observed in China. However, the larger-than-expected slowdown in economic growth in the United States, as driven by weaker demand and trade, is particularly noteworthy for the global economy.

**Despite the gradual reduction in the global price level, inflationary rigidity and related risks remain significant challenges for central banks.** As a result of tighter monetary policies, the supply chain recovery, and a decline in China's export prices, food and oil prices have both decreased, positively impacting the reduction of inflation, particularly in developed countries. According to the April 2024 forecasts of the IMF, global inflation will stand at 5.9 percent in 2024, and at 4.5 percent in 2025. However, baseline inflation remains elevated, which is supported by rising prices on services. It should be noted that, compared to developed countries, inflation is expected to decrease at a slower pace in developing economies. Moreover, the level of inflation differs significantly across countries. In the event of inflation rigidity or a worsening of geopolitical tensions, it is expected that central banks will show caution in easing their monetary policy stances and will exit their tightened positions gradually, which would have a negative impact on economic activity. This dynamic has already been observed in developed countries, where the process of reducing inflation, and consequently of interest rate cuts, has slowed down. While high inflation and the stability of the labor market supported the growth of nominal wages, productivity growth remains quite weak, which amid reduced profits, may force companies to revise their prices upwards. This process contains risks of the development of a wage-price spiral. However, according to the

Figure I.1. Economic growth in a selected group of economies[1]




Source: WEO database

existing data, the risk of such a spiral forming has not materialized and real wages are still below pre-pandemic levels. With the reduction of labor market rigidity, wage growth is expected to slow down; however, real income growth, amid falling inflation, may positively impact demand and support economic growth. Similar to developed economies, developing countries also exhibit caution in the process of exiting from their tightened monetary policies in order to avoid the aggravation of external risks caused by an excessive reduction of rates; in particular, a change in the differential between the interest rates of developed and developing economies and related currency risks.

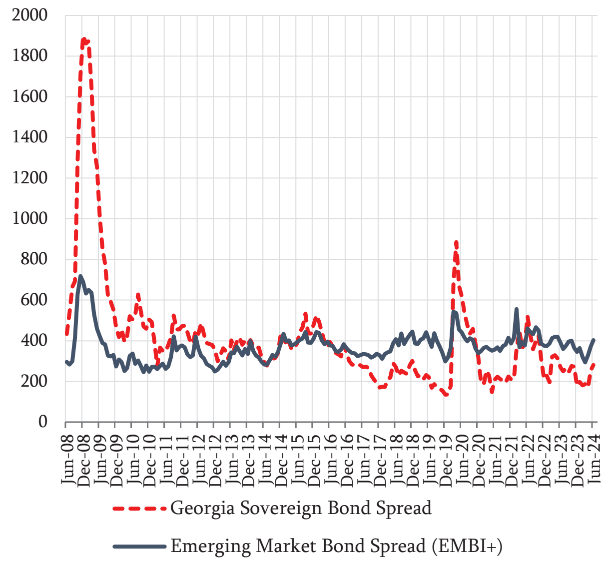
**The global financial sector overcame significant challenges last year and maintained stability; however, ongoing risks remain noteworthy.** The financial difficulties revealed in the banking sector last year and the subsequent decline in the share prices of American and European banks highlighted existing vulnerabilities in the financial sector. However, timely and large-scale supervisory activities were able to mitigate these risks and stabilize the sector. Thanks to high capital and liquidity buffers, improved profitability and increased margins, banks' share prices soon recovered; however, a risk analysis of banks by region indicates some structural challenges and a possible decline of profitability. Although reduced risk premia contributed to the growth of asset prices, if the global geopolitical situation deteriorates, investors' expectations and risk appetite may change rapidly, which would lead to a revaluation of assets and an increase in credit risks in the financial sector. In addition, risks such

1 The IMF's July forecasts have only been updated for some countries. Georgia's main export partners comprise eight countries (based on the 2023 data). The IMF's July forecast was only updated for four of these; for the remaining four, the April forecasts are used.

as an asynchronous change in monetary policy between developed and developing countries, which may result in capital outflows from developing countries and exchange rate fluctuations, are noteworthy. These risks have already materialized to some extent. Local currency depreciation pressure has been observed in a number of developing countries. Moreover, the slowdown of monetary policy easing in the United States changed market expectations and, since April, the outflow of capital from developing countries has increased, which contributes to financial risk. It should be noted that a premature easing of monetary policy could support an inflationary environment. However, if the policy easing is delayed, real conditions may tighten, which will have a negative impact on credit availability and economic growth. Although overall global financial stability has improved compared to previous years, risks remain significant.

**Uncertainty surrounding economic forecasts has slightly decreased compared to 2023, while risks related to global growth and inflation have remained largely balanced. However, short-term risks have recently become more pronounced.** Uncertainty surrounding global economic growth and inflation forecasts has diminished compared to 2023, while the forecasts have improved. According to the IMF's April 2024 projections, the probability of global growth falling below 2 percent or inflation exceeding 2023 levels is less than 10 percent, and the uncertainty surrounding these projections is more or less balanced on both sides. On the one hand, factors such as an aggravation of regional conflicts, a rise in prices caused by supply shocks, the rigidity of inflation, a possible outflow of capital from developing economies, a tightening of financial conditions, and a strengthening of the US dollar all carry negative risks for the global economy and financial stability. On the other hand, shocks such as an increase in fiscal expenditures amid the upcoming elections in many countries, a faster-than-expected easing of monetary policy, a decreasing cost of loans, and rising productivity following the development of technologies will each play a positive role in GDP growth. However, compared to the first quarter of 2024, short-term risks have become more pronounced. Particularly noteworthy, related to inflation, is the pressure on prices caused by trade and geopolitical tensions, as well as the

Figure I.2. Sovereign bond spread[2] (basis points)




Source: Bloomberg

rate of inflation in the services sector. The services sector is particularly labor-intensive and, amid low productivity, in the event of a further rise in nominal wages, producers will have to consider raising prices, which could contribute to inflation. In the second quarter of 2024, expectations about economic growth partially worsened, which was a result of a slight increase in inflation and a related expected slowdown in monetary policy easing.

**Along with the reduction of inflationary risks, global financial conditions are characterized by easing dynamics, despite the cost of borrowing still exceeding pre-pandemic levels.** Global financial conditions have eased as a result of looser monetary policies, improving market sentiment and declining risk premia. In particular, bond spreads in emerging markets and developing economies have had a decreasing trend since the second half of 2023. However, since March 2024, spread has increased, which could be an outcome of the slowdown of monetary policy easing (see Figure I.2). Credit risk perceptions have decreased for almost all segments of corporate loans, except for office real estate — a sector that has been adversely affected by post-pandemic structural changes. However, compared to the pre-COVID period, the cost of borrowing remains high. Against this background, the vulnerability of the financial sector to existing risks is noteworthy. On the one hand, factors such as changing market sentiments, capital outflow from developing countries, and a depreciation of local currencies will have a negative effect on financial conditions, resulting in tightening that will slow down economic growth. This is particularly im-

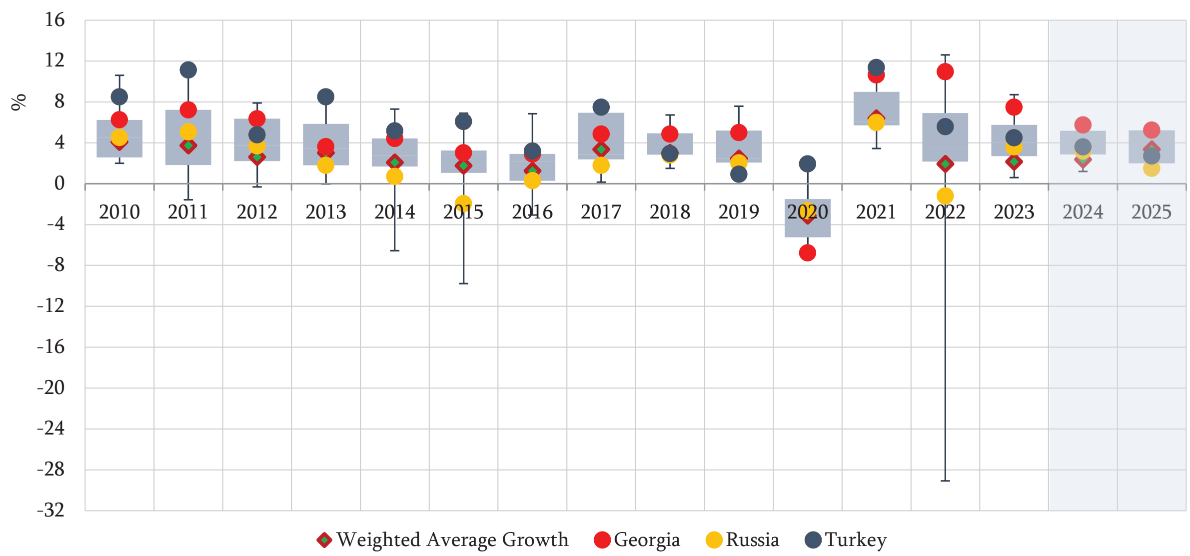
2 This takes into account not only the yields on government bonds, but also the yields on securities issued by state corporations (railways, oil and gas companies). The latter, in addition, may be characterized by individual risks that can change the sovereign risk assessment.

portant for countries whose share of foreign currency loans is high. These developments would significantly increase debt-servicing costs and create financial stability risks. On the other hand, excessive optimism and an early loosening of monetary policy could excessively ease financial conditions and cause unsustainable growth of private and public debt. This would prove particularly burdensome for countries with a high level of debt and a fiscal deficit. Macroprudential policy, adequate reserve levels, a stable macrofinancial environment, and effective management of inflationary expectations are all particularly important for mitigating the abovementioned risks.

**With the ongoing conflicts in Ukraine and the Middle East and the globally tightened financial environment, economic activity across regional countries has been heterogeneous.** In the second quarter of 2024, economic activity in Türkiye was low, which was mainly driven by the depreciation of the Turkish lira and an increase in inflation. Economic growth in 2024 is expected to slow down due to monetary policy tightening. Activity was low in Russia as well, which was a consequence of high inflation and a decrease in industrial production and retail sales. According to the IMF's forecast, Russia's real economic growth in 2024 is expected to be 3.2 percent. As compared to the April predictions, the IMF's July 2024 forecast for economic growth in 2025 was revised downwards from 1.8 percent to 1.5 percent. As a result of the war, critical infrastructural facilities have been destroyed in Ukraine, negatively affecting the country's potential GDP. According to the IMF, real growth in Ukraine in 2024 is expected to be 3.2 percent, while increasing the following year to 6.5 percent due to economic recovery. Inflation in Ukraine in 2024 is expected to be 6.4 percent. Economic activity has increased in Armenia, which was supported by credit activity and increased internal demand. Armenia's GDP growth for 2024 is expected to be at 6 percent, while inflation is projected at around 3.1 percent. The growth rate for Azerbaijan also improved in the first quarter of 2024, which was supported by increased activity in both the oil and non-oil sectors. In 2024, economic growth in Azerbaijan is expected to be 2.8 percent, while inflation is predicted to be 3.5 percent (see Figure I.3).

**According to the NBG's forecasts, alongside strong internal demand and increased economic potential, Georgia's real GDP is expected to grow by 6.8 percent in 2024**. In the first quarter of the year, Georgia experienced high economic activity with annual growth standing at 8.4 percent. This was supported by stronger-than-expected internal demand and increased purchasing power amid rising wages. Economic potential also improved, and factor productivity rose in certain sectors. GDP growth was further supported by credit activity, which accelerated against the backdrop of monetary policy easing and an increase in the maximum maturity of unsecured consumer loans. Considering the ongoing trends, the forecast for economic growth for 2024 was revised upwards to 6.8 percent (see Figure I.4). Due to rising oil and certain food prices, annual inflation increased to 2.2 percent in June. However, the inflation remains below the target level of 3 percent, a development that has also been supported by increased competition in the economy. According to the NBG's forecast, inflation will stabilize

Figure I.3. Growth distribution of the main trading partners of Georgia

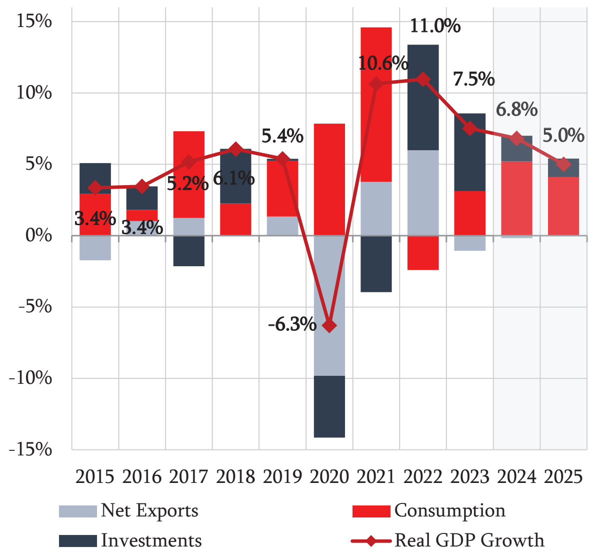



Source: WEO database, NBG

around its target level in the medium term.

**Given the increasing frequency and intensity of both supply and geopolitical shocks, financial stability risks stemming from energy security and climate change are becoming particularly noteworthy**. As a result of the Russia-Ukraine war and trade fragmentation, the EU's GDP growth was revised downward. This was mainly driven by the economic slowdown of energy-vulnerable countries and highlights the importance of energy security. It should be noted that a decline in energy prices contributed positively to the recent fall of inflation. This was facilitated by a restoration of supply chains and an increase in oil production by non-OPEC countries. However, energy supply shocks have become more frequent in recent years, underscoring the importance of strengthening energy security and reducing uncertainty related to energy resources. Moreover, the frequency and intensity of natural disasters have increased, which hinder economic growth and development. The financial sector is also affected by climate risk, which intensifies financial stability risks. Therefore, strategies to combat climate change and related problems, such as de-carbonization, the use of green technologies, and ensuring food security, have a major role to play in promoting economic and social sustainability. It should also be noted that effectively dealing with climate risk requires international cooperation, which is harder to achieve amid geopolitical fragmentation.

Figure I.4. Decomposition of real GDP growth by expenditure, YoY




Source: NBG

# II. Vulnerabilities and Risks Affecting Financial Stability

## External Vulnerabilities

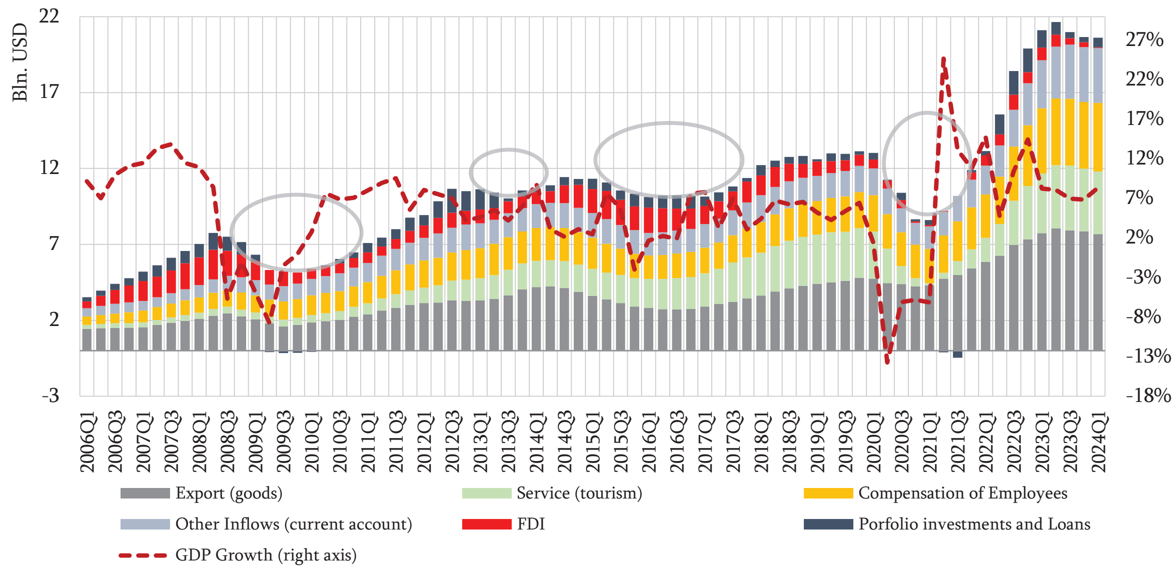
*Georgia is a small open economy that continues to be characterized by a high level of dollarization, a current account deficit, and dependence on international financial flows. This makes the local financial system vulnerable to global economic and financial trends. The weakening of the effect of migration caused by the Russia-Ukraine war was followed by a decrease in inflows from major foreign channels, which reduced the share of foreign demand in economic growth. However, structural changes to the economy, in particular, the export of information and computer services and the rise in transportation via the Middle Corridor, have supported the improvement of potential GDP.*

*It should be noted that in 2023, amid the global economic recovery and a reduction of inflationary pressures, the risks to Georgia's financial stability stemming from the foreign sector were revised downward. However, due to ongoing high levels of uncertainty, these risks remain noteworthy. Particular factors that should be taken into account include the pace of exiting from the globally tight monetary policy; a potential worsening of geopolitical fragmentation and its impact on inflation; and an asynchronous change in monetary policy between developed and developing countries, which would be followed by capital outflows from developing countries and exchange rate fluctuations. Realization of such risks would have a negative impact on Georgia and the countries of the region, and could lead to a decrease in foreign demand, an increase in the external debt burden, and a deterioration of the current account.*

**In 2023, Georgia continued to experience strong economic growth, which was primarily fueled by domestic activity, particularly investments. Compared to 2022, the contribution of external inflows declined, largely due to the waning impact of migration. Nonetheless, the vulnerability of the economy to external factors remains significant**. The migratory wave that followed the outbreak of the Russia-Ukraine war significantly increased foreign inflows in 2022, contributing to high GDP growth. The strong economic performance continued in 2023, but was mostly driven by internal demand and structural changes to the economy. Specifically, the effect of migration began to fade, while local demand grew stronger. Moreover, structural changes to the economy, such as increased exports of information, computer, and transport services, supported the expansion of the economy's potential. It should be noted that in the first quarter of 2024, foreign demand remained weak, which translated into a reduction of inflows (see Figure II.1). In particular, the income received from the export of goods decreased, which can largely be explained by the decrease in foreign demand for re-exports. This was partially offset by a decline in import expenses. However, in overall terms, net exports made a negative contribution to GDP growth in the fourth quarter of 2023. In contrast to goods exports, exports of services increased, which had a positive effect on the current account balance. Despite the fact that almost all components of the balance of payments inflows increased significantly compared to the levels seen during the pandemic, the annual growth rate has been decelerating since the second half of 2023. It should also be noted that since the second quarter of 2023, foreign direct investments (FDI) have declined, not only compared to the pre-pandemic levels but also in annual terms. The decrease in the growth rate of revenues received from international travel was a result of the reclassification of some migrants as residents, as well as the base effect and an overall decrease in the number of migrants. With the normalization of external inflows, the current account deficit is expected to widen slightly in 2024.

**Despite the globally improved macrofinancial environment, which has been reflected in declining inflation and sustained economic growth, risks to Georgia's external sector remain significant and can be transmitted to local financial stability through several channels.** Amid such large-scale global shocks and challenges as the COVID-19 pandemic, the Russia-Ukraine war, and the tightening of monetary policy in response to elevated inflation, pessimistic ex-

Figure II.1. Balance of Payment inflows in Georgia[3]




Source: NBG, GeoStat

pectations regarding economic growth started to form globally. However, the global economy ultimately proved to be more resilient than had been expected, a consequence of sound monetary policy, a strong labor market, stable demand and investments. Nonetheless, risks from the external sector still exist and remain noteworthy. Firstly, despite its downward trajectory, inflation turned out to be more rigid than expected. In the event of an excessive easing of monetary policy or a worsening of the geopolitical situation, inflationary surprises might emerge, which could affect Georgia as well. Another factor relates to ongoing conflicts that significantly worsen the macroeconomic environment, increase uncertainty and reduce foreign inflows, including exports, all of which have a negative impact on the country's economy. In the event of supply chain disruptions and an increase in inflationary pressures caused by greater geopolitical fragmentation, it is expected that central banks will show caution in their softening of monetary policies, withdrawing from the tightened position more gradually. As evidenced in the second quarter of 2024, the pace at which inflation declined slowed, which was largely due to rising prices in the services sector. This fact has already forced some developed and developing countries to decelerate their process of monetary policy easing. This, in turn, might have a negative effect on economic activity and decrease Georgia's external demand. On the other hand, if the change in monetary policy between developed and developing countries is asynchronous, this may lead to capital outflows and exchange rate fluctuations in developing countries, increasing the burden of external debt. This process has already materialized in a number of countries, where capital started to flow out, while the local currencies depreciated. Against the backdrop of weak external demand and the waning of the migration effect, this will have a negative impact on Georgia's foreign sector, and on the country's economic growth and current account balance. Despite these developments, Georgia's external sector risks have decreased compared to the previous year. Uncertainty, however, remains.

**Georgia's economy significantly depends on the macrofinancial developments in the EU, Russia and Türkiye. Globally tightened financial conditions, low economic growth and a weakening of the migration effect of the Russia-Ukraine war all had a negative effect on inflows from these countries.** According to the first quarter of 2024, the share of Russia, Türkiye and the EU in exports of goods continued to decline. Moreover, the share of these countries in total external flows decreased from 56.6 percent to 40 percent in 2023, which was largely due to a decline of inflows from Russia. However, in the first quarter of 2024 inflows increased by approximately 7 percent, reaching 47 percent, which was driven by rising inflows from the EU. Since the second quarter of 2022, the share of inflows from the EU had been declining, which was mainly caused by decreasing exports of goods and lower FDI. In the first quarter of 2024, FDI, export of goods and transfers from Türkiye decreased year on year. However, the share of inflows from Türkiye remains relatively stable, fluctuating at around 8 percent. Compared to 2019, the level of transfers and investments

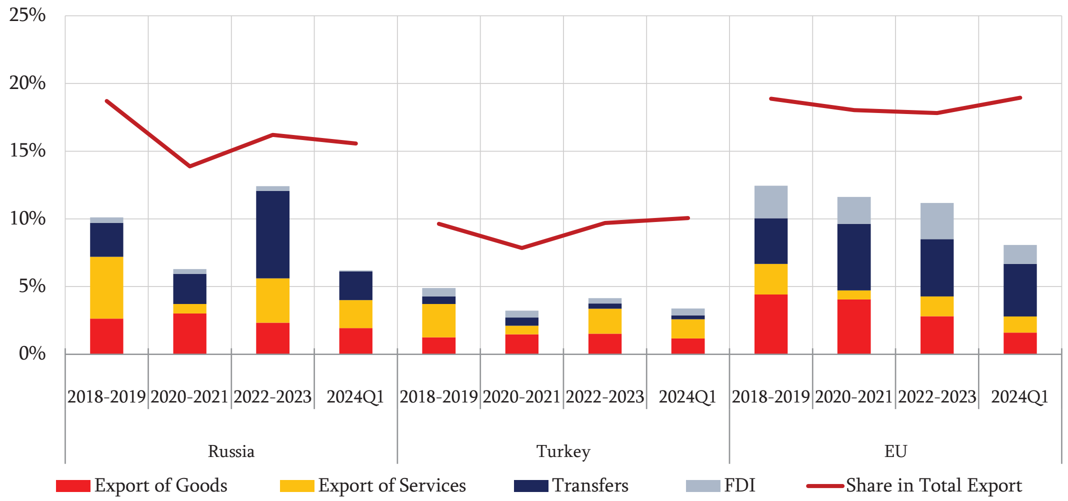
3 Calculated as the ratio of the rolling sum of the past four quarters to nominal GDP.

from Türkiye have not changed significantly, although exports of goods have increased, and revenues from tourism have recovered and have returned to pre-pandemic levels. As for inflows from Russia, compared to the past two years, their share in GDP have decreased significantly, falling by approximately 6 percentage points in the first quarter of 2024 (see Figure II.2), which was mainly due to the base effect. The most prominent was decline in money transfers. Income received from tourism also fell compared to 2022, although this was partly due to the reclassification of some migrants as residents.

Overall inflows from the abovementioned countries decreased due to the exhaustion of the base effect and the weak macroeconomic environment in the region. Meanwhile, the economic recovery of other neighboring countries and trade partners is progressing unevenly and, given the tight global financial conditions and geopolitical fragmentation, economic growth and external demand are both expected to be low. The inflation trajectory will also play an important role in the process, as the softening of monetary policy will depend on it. For Georgia, the potential risk of decreasing revenues from exports of goods and money transfers will have a negative effect on financial stability. However, these risks are balanced by the growth of revenues from exports of services and strong domestic demand.

**In 2023, the current account deficit decreased significantly; however, in 2024, after the normalization of external inflows, the deficit is expected to rise slightly.** In 2023, weak external demand and a larger growth of imports of goods compared to exports of goods contributed to a widening of the trade deficit. However, ultimately, thanks to rising exports of services, the current account deficit improved in 2023 and its share to GDP reached 4.3 percent. The rise of service exports in 2023 was a result of structural changes in the sector, along with the growth of revenues from international trade. Compensation of workers from abroad also remained at a high level. However, at the beginning of 2024, as a result of low external demand, export of goods declined and the growth of re-exports slowed. Moreover, with the exhaustion of the base effect related to migration inflows, and due to the departure of some migrants from the country, inflows received from this source also decreased, having a negative effect on the current account balance. With high economic growth, as well as the increase in imports and the expected deepening of the trade deficit, the current account deficit to GDP ratio is expected to stand at 5-5.5 percent in 2024. However, if the transit potential of the Middle Corridor increases significantly, along with a reduction of transportation costs, the additional revenue from the transport sector will have a positive effect on the current account balance.

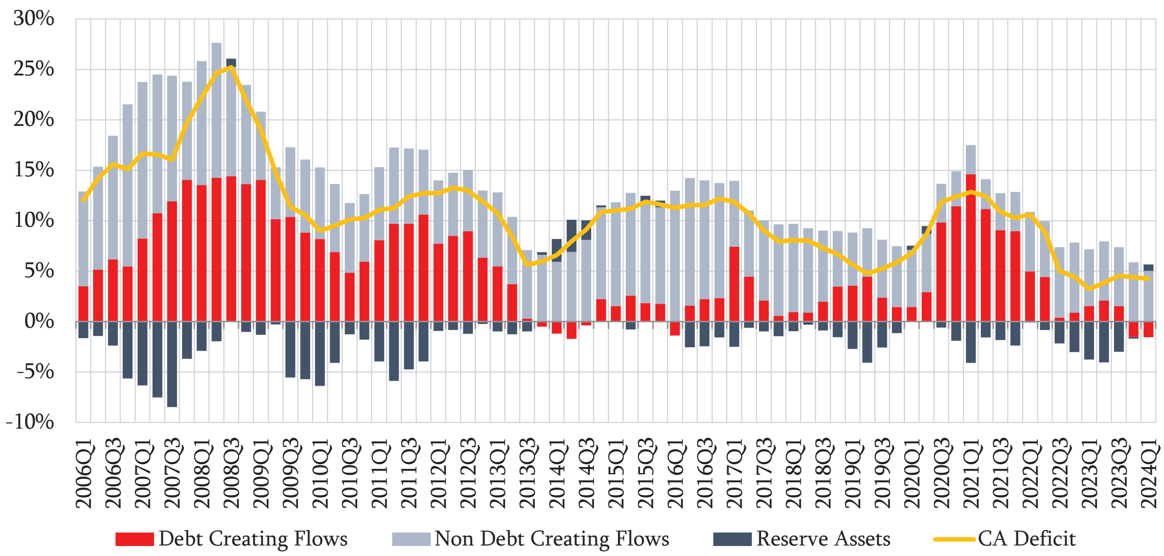
Figure II.2. Exposure to major external markets[4] (flows expressed as a share of GDP)




Source: NBG, GeoStat

4 Since Brexit, inflows from the EU no longer include flows from Great Britain. In order to exclude tourism revenues received from Great Britain from total revenues from international travel, an assumption was made about the average expenditure by each tourist from Great Britain.

Figure II.3. CA deficit and sources of financing (% of GDP)



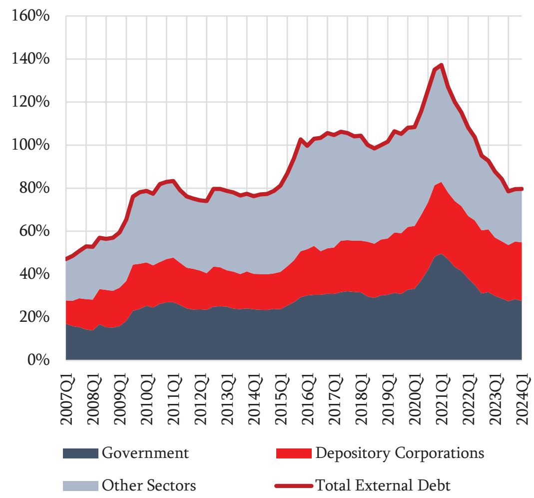

Source: NBG

According to a savings-investment analysis, the narrowing of the current account deficit in 2023 was largely driven by a sizable increase in savings and a small improvement in investments. The deficit was mainly financed with FDI. However, partially due to base effects, FDI decreased by 24 percent annually, predominantly stemming from the reduction of debt instruments and reinvestment. Since the second half of 2022, the share of debt-creating flows in financing the current account deficit has decreased significantly, while the share of non-debt creating flows has increased (see Figure II.3).

**As a result of the easing of monetary policies, improving market sentiment and declining risk premia in developed and developing countries, global financial conditions have improved; however, the cost of lending is still above pre-pandemic levels.** Maintaining a tight monetary policy in the event of inflation stiffness could lead to a tightening of global financial conditions. Moreover, should there be a worsening of geopolitical fragmentation in the region, risk premia will rise. These developments could lead to a decrease of economic activity in the region. This would negatively affect the interest rate of funds raised in foreign currency, increase the burden of short-term foreign debt, and create refinancing risks. However, the fact that Georgia has a low share of short-run debt somewhat mitigates these risks.

Amid still-tight global financial conditions, and despite the increase in external debt levels, the ratio of external debt to GDP in Georgia continued to decline in 2023. Compared to the corresponding period of the previous year, the ratio of debt-to-GDP in the first quarter of 2024 decreased by approximately 10 percentage points

Figure II.4. External debt (% of GDP)




Source: NBG

to 78.7 percent. This was supported by high economic growth and the stability of the exchange rate (see Figure II.4). In the event of an economic slowdown or a depreciation of the local currency, the ratio of external debt to GDP might increase suddenly, as it occurred during previous crises. However, these risks are less likely in the current period.

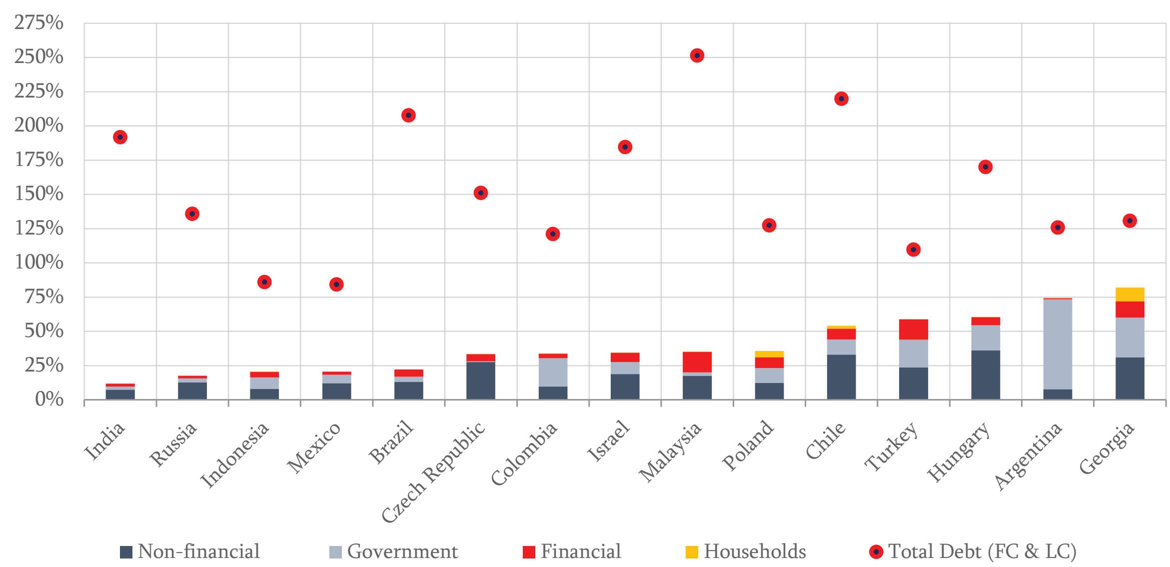
In the first quarter of 2024, the share of foreign currency-denominated debt in Georgia's total external debt increased slightly and reached 88.8 percent. Despite a slight improvement over past years, the level of foreign-currency loans remains high, which creates vulnerability to exchange rate fluctuations. In order to decrease exchange rate risk, it is important to further increase the share of local-currency loans. In the event of an asynchronous change in monetary policy between developed and developing countries, there is the risk of sudden capital outflows from developing countries, which would result in currency depreciation, increased debt service burdens, and pressure on international reserves, all of which would create risks for debt sustainability. Apart from that, a possible rise in the risk premium could be transmitted to foreign currency-denominated funds via the interest rate channel, creating additional refinancing risk and leading to a higher burden of foreign debt.

It should also be noted that in the first quarter of 2024, the share of short-term debt in external debt increased by 0.8 percent and reached 24.8 percent. Although a rise in short-term loans increases refinancing risks, the share of such loans in Georgia is low compared to its peer countries.

**In 2023, the share of total debt to GDP increased in many developing countries, including Georgia. Moreover, in Georgia the share of foreign currency-denominated loans in external debt is one of the highest.** In 2023, the level of global debt increased by USD 15 trillion, reaching USD 313 trillion. The ratio of global debt to GDP has been decreasing for the third consecutive year, although the rate of decline has been moderated by slowing economic growth and inflation. The change in the debt-to-GDP ratio differs significantly across countries, decreasing in developed countries whilst being on the rise in developing countries—a development that could contain risks, given the still-high interest rates, low economic growth and the potential appreciation of the USD. Moreover, in a number of countries the fiscal deficit remains at a high level. In the event of an aggravation of regional conflicts or further trade fragmentation, there is risk of a further deterioration of fiscal balance, which will increase dependence on foreign sources of financing. However, if macrofinancial conditions worsen, access to such financing might decrease significantly.

In Georgia and comparable countries, the total debt-to-GDP ratio increased in 2023. However, in Georgia, the share of foreign currency-denominated loans to GDP decreased by 3 percent and reached 82 percent. Despite the fact that Georgia's total debt is not significantly higher than that of other emerging economies, its share of foreign currency loans remains one of the highest across all borrower groups, especially for households (see Figure II.5). However, a sizable share of Georgia's external debt is borrowed from international financial institutions on concessional terms, which implies a lower debt burden compared to the baseline.

Figure II.5. Foreign currency debt by type of borrower: Cross-country comparison (% of GDP, as of 2023Q4)

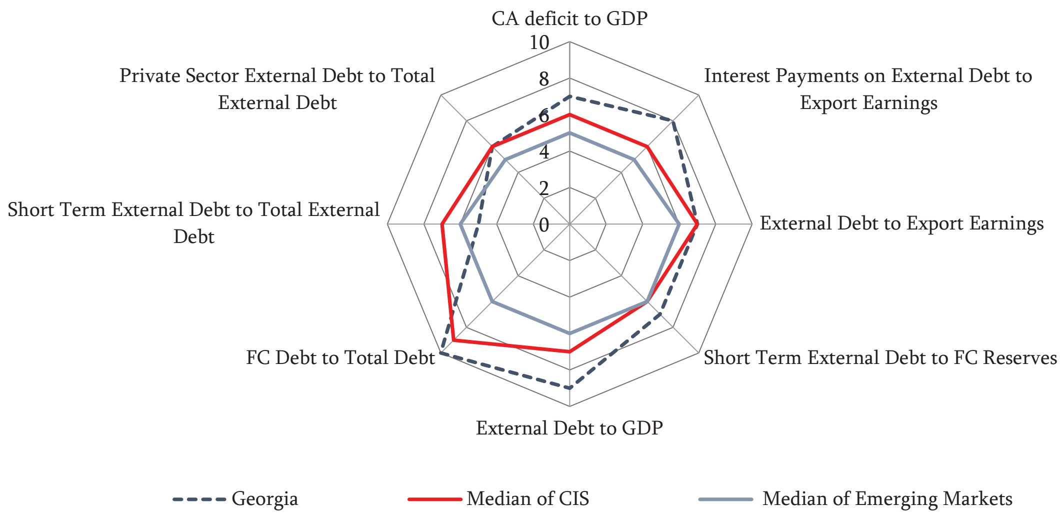



Source: NBG, International Finance Institution; Statistical data of selected countries

**Despite the fact that some of Georgia's external vulnerability indicators have improved compared to 2022, the country's external vulnerability remains higher compared to the median of the region and emerging market economies (EMEs).** In Georgia and the region, some external vulnerability indicators improved, some worsened, and others remained unchanged; while among EMEs as a whole, most of these indicators worsened. In the case of Georgia, improvements were observed for the current account deficit and interest payments on external debt to export earnings; while the share of short-term debt in total debt was the indicator that worsened the most—something that may carry certain risks in the event of a deterioration of macrofinancial conditions. The ratio of short-term debt to foreign currency reserves was also revised in a negative direction. In the region, improvements were mostly observed for debt-related indicators, while current account deficits worsened. For EMEs, a worsening was mostly observed for debt-related indicators.

It should be noted that in 2023 Georgia's external vulnerability indicators improved more than those of EMEs. In spite of this, the majority of these indicators remain elevated compared to the median observed in EMEs (see Figure II.6). Specifically, Georgia has higher interest payments on external debt to export earnings and a greater share of foreign currency loans in total external debt. However, the favorable maturity structure of external debt in Georgia indicates a lower risk of refinancing in the event of monetary policy tightening.

Figure II.6. External vulnerability indicators relative to emerging markets and CIS countries[5] (as of 2023)




Source: NBG, IMF, WB

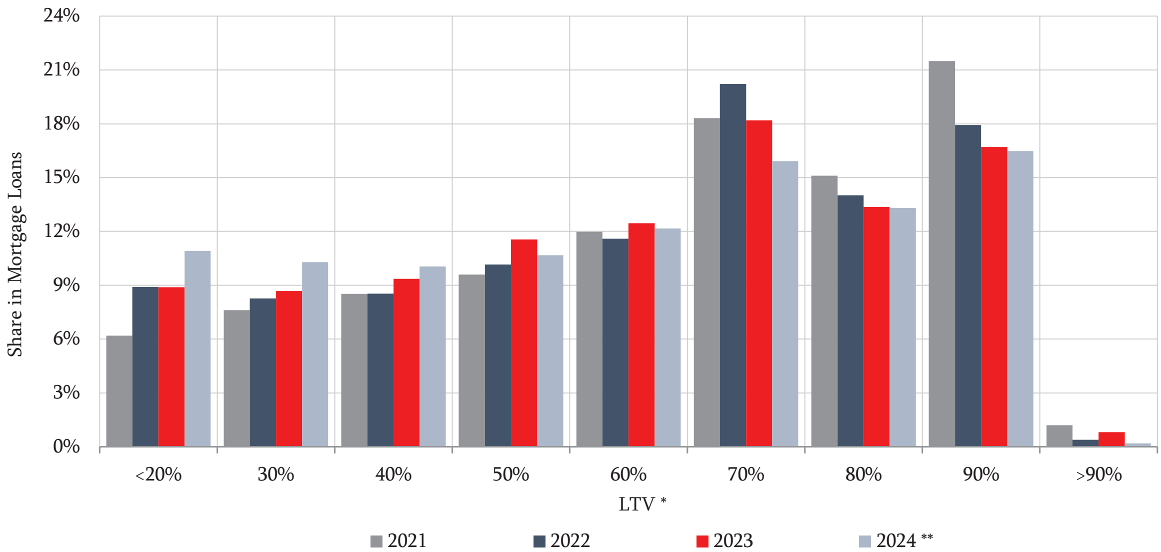
5 These rankings are based on global distributions of the corresponding indicators. A higher rank corresponds to higher vulnerability.

## Household Sector Analysis

*Household loans exhibit a balanced distribution, and the current easing of monetary policy may help reduce the debt service burden. Furthermore, with average wages continuing to rise and unemployment at historically low levels, households' economic conditions have improved compared to previous years. Credit growth in the household sector is also high. Macroprudential measures introduced by the National Bank of Georgia have effectively contributed to the reduction of household loan dollarization. However, unhedged borrowers remain exposed to significant currency risk.*

**The household loan portfolio demonstrates a sound distribution, and loan quality is good**. The responsible lending regulations introduced by the National Bank of Georgia have positively impacted the quality of household loans. Similar to previous years, the distributions of payment-to-income (PTI) and loan-to-value (LTV) ratios remain healthy (see Figures II.7 and II.8). Households maintain financial buffers that mitigate the risk of default and enhance the resilience of the sector to economic and financial shocks. In 2024, the share of borrowers with a payment-to-income (PTI) ratio exceeding 50 percent increased to 23 percent. This rise is primarily attributable to the practice of issuing loans with contractual maturities shorter than the maximum allowed. However, when calculated based on the maximum maturity, the PTI ratio remains at a low level. Additionally, the macroprudential policies implemented by the National Bank of Georgia have contributed to a continued decline in dollarization, which has a positive impact on household loan quality. Consequently, the household non-performing loan (NPL) ratio has remained consistently low.

Figure II.7. Distribution of the LTV ratio




* Distribution of the LTV ratio is constructed based on the quantity of loans issued during the year.
** The value for 2024 includes mortgage loans issued in the first and second quarters of the year.

Source: NBG

**Average wages continue to rise, while unemployment stands at a historically low level**. Although the annual growth of wages has decelerated compared to previous periods, it remains above pre-pandemic levels, reaching 11 percent in the second quarter of 2024 (see Figure II.9). Given the low-inflation environment, nominal wage growth has translated into real wage gains, contributing to an improvement in households' economic conditions compared to previous years. However, the economic vulnerability of low-income households to macroeconomic shocks remains a concern, particularly in light of persistent income inequality. It should be noted that inflation dynamics in recent periods confirm that there is no clear evidence of a wage-price spiral developing.[6] Additionally, labor market conditions have shown positive trends, as reflected in the decline of the unemployment rate to a historic low of 13.7 percent (see Figure II.9) and a modest improvement in labor force participation. However, the unemployment rate remains high and labor force participation in Georgia lags behind that of its peer countries. Nevertheless, it is important to note that these statistics do not fully account for certain forms of employment, potentially leading to an underestimation of overall labor market performance.

**The current trajectory of the monetary policy rate is expected to positively impact household debt-servicing costs. However, the rise in the share of fixed-rate loans seen in recent years should be taken into account**. With adjustable-rate loans comprising 42 percent of the credit portfolio, monetary policy easing is likely to benefit households. In anticipation of monetary policy easing, the share of household loans with fixed interest rates increased in previous periods. However, as the refinancing rate declines, borrowers have the opportunity to adjust their interest rates or to take advantage of refinancing options. As a consequence of the prolonged tightening of monetary policy worldwide, the interest rate risk on foreign currency loans remains at a noticeable level. However, it is noteworthy that both the Federal Reserve and the European Central Bank have cautiously begun the process of monetary policy easing.

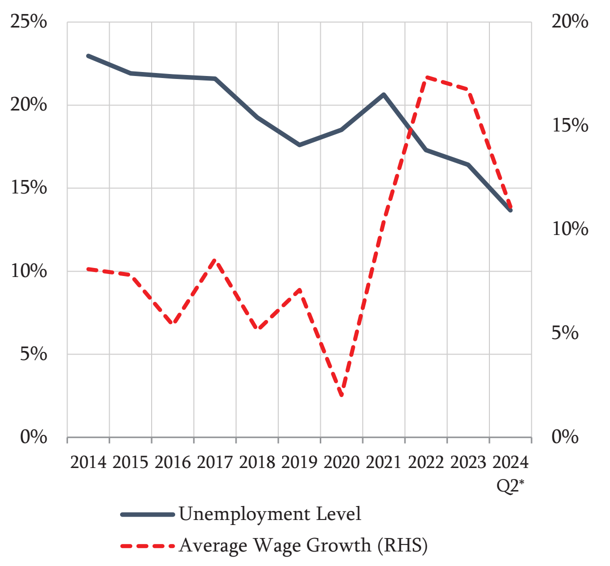
**Household credit activity is quite strong**. In the second quarter of 2024, annual household credit growth reached 17.1 percent, which was primarily driven by an increase in consumer loans (see Figure II.10). Notably, unlike the corresponding period of the previous year, the exchange rate has made a positive contribution to household credit growth. Consumer credit

Figure II.8. Distribution of the PTI ratio


* Distribution of the PTI ratio is constructed based on the quantity of loans issued during the year.
** The value for 2024 includes mortgage loans issued in the first and second quarters of the year.

Source: NBG

Figure II.9. Labor market indicators: unemployment level and growth of the average wage (YoY)

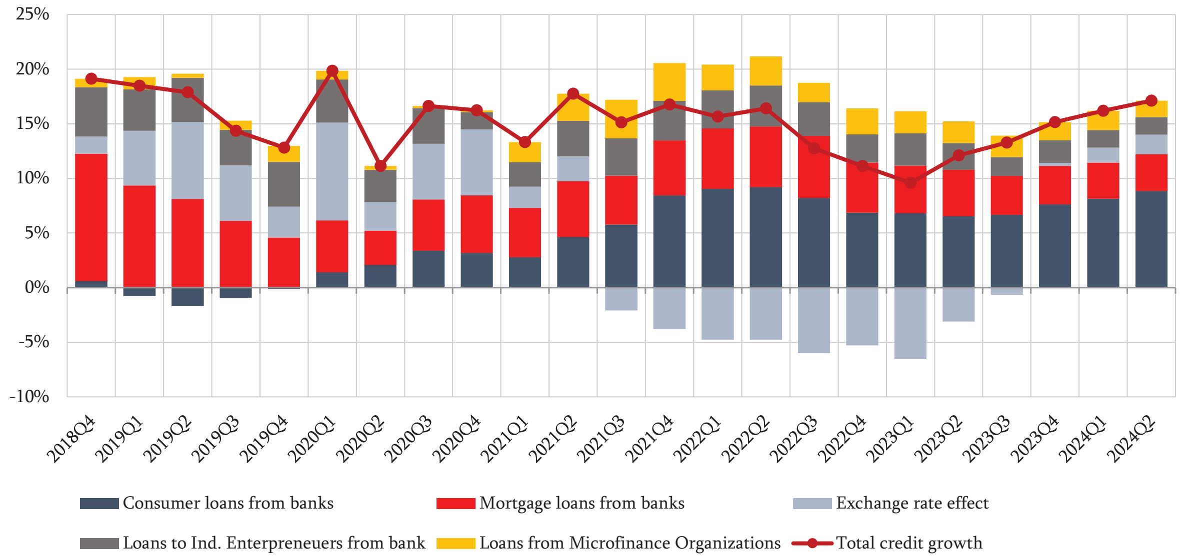



* For the second quarter of 2024, average wage growth is calculated compared to the corresponding level for the second quarter of 2023.

Source: GeoStat

6 See [Financial Stability Report, 2023, Household Sector Analysis.]

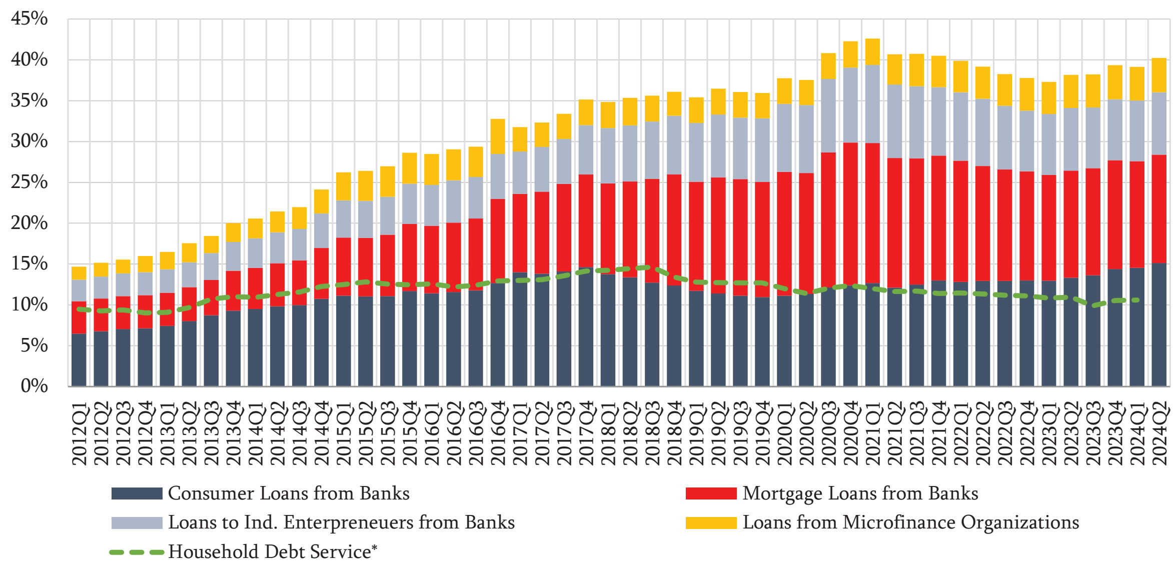
Figure II.10. Decomposition of households' annual credit growth




Source: NBG

growth was mainly driven by the rapid expansion of unsecured loans, while mortgage loan growth remains moderate, reaching 9 percent in June 2024, excluding exchange rate effects. The National Bank of Georgia continues to closely monitor consumer lending trends and stands ready to deploy relevant macroprudential tools if needed. Maintaining sound consumer lending standards is essential to ensure household debt sustainability. A similar trend was observed in 2022, in response to which the National Bank of Georgia introduced a temporary measure and reduced the maximum maturity of unsecured consumer loans to three years. Following a slowdown in consumer credit growth, the NBG reversed this decision at the end of 2023, increasing the maximum loan maturity back to four years. As for the household debt to GDP ratio, this slightly increased in the second quarter of 2024, compared to the corresponding period of the previous year. This change was mainly driven by consumer loan growth, but the mortgage loans to GDP ratio was also a significant contributor. It is worth noting that the household debt burden has remained stable, fluctuating around 40 percent in recent years (see Figure II.11).

Figure II.11. Household debt to GDP ratio

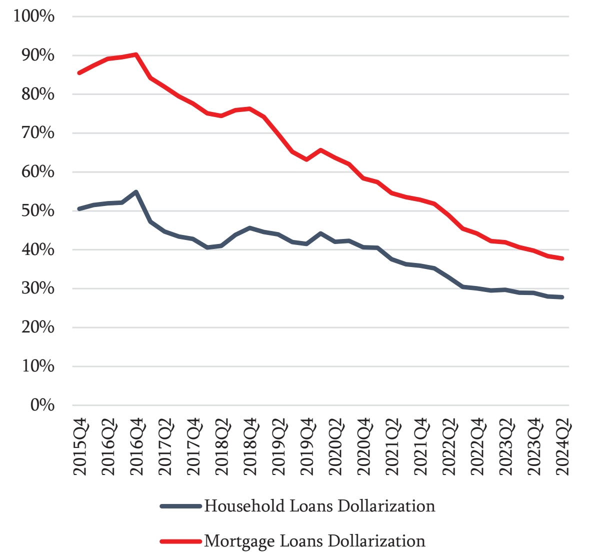



*Debt-service payments (interest and principal payments) / household disposable income*

Source: NBG

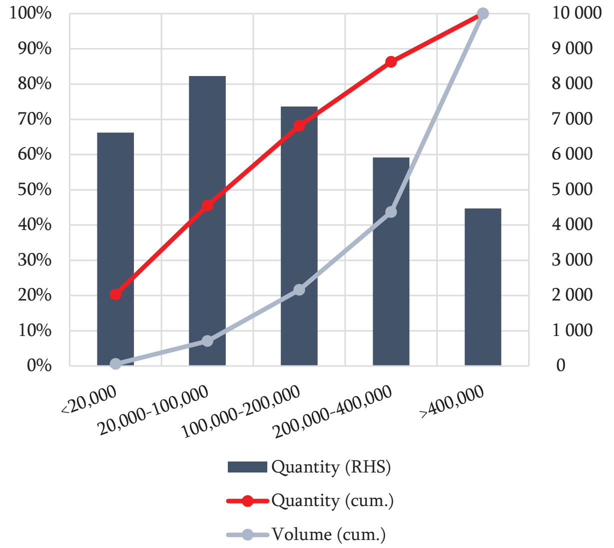
**As a result of the NBG's macroprudential policy, household loan dollarization continues to decline. However, the currency risk of unhedged borrowers remains a concern in the event of exchange rate fluctuations**. Household loan dollarization has decreased to 28 percent, reflecting the effectiveness of the NBG's long-term de-dollarization strategy (see Figure II.12). According to the decision of the Financial Stability Committee, the limit on foreign currency loans was gradually increased to GEL 400,000[7], while the maximum maturity for foreign currency mortgage loans has been capped at 10 years. These measures have contributed to the reduction in household loan dollarization, particularly for mortgage loans, thereby mitigating currency risk for unhedged borrowers. Amid ongoing political tensions in the region, the uncertainty around exchange rate dynamics increases currency risk. However, the National Bank of Georgia has implemented measures to mitigate risks associated with exchange rate fluctuations. According to foreign currency loan portfolio data, there are currently 32.6 thousand active borrowers (or groups of borrowers) with foreign currency loans. For point of comparison, in 2021 and 2022, there were 66 thousand and 41 thousand such borrowers, respectively. Notably, 32 percent of foreign currency (FC) loan borrowers have loans exceeding GEL 200,000, which account for 78.4 percent of the total volume of FC loans. Such large loans are typically issued to high-income borrowers and are considered to carry lower risk (see Figure II.13).

Figure II.12. Household loan dollarization




Source: NBG

Figure II.13. Distribution of the foreign currency loan portfolio, June 2024



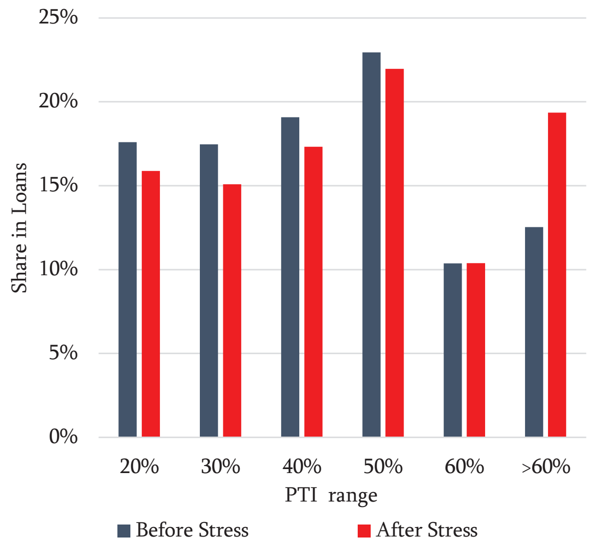

Source: NBG

7 The limit for unhedged foreign currency loans increased to GEL 400,000 from 1 May 2024.

## Sensitivity Analysis of the Household Sector

**Sensitivity analysis indicates that the distribution of the household PTI (Payment-to-Income) ratio remains healthy. Households will be able to continue servicing their loans even under a severe macroeconomic shock.** As a result of the macroprudential policies implemented by the NBG in previous periods, the risk to household creditworthiness has decreased. Under the severe-risk scenario — assuming a cumulative exchange rate depreciation of 40 percent and a 5.4 percentage point increase in the unemployment rate — the household PTI distribution remains healthy (see Figure II.14). In such a scenario, household buffers would diminish, and the share of borrowers with PTI ratios exceeding 60 percent would increase from 13 to 19 percent. Nevertheless, borrowers would still retain sufficient financial capacity to meet their debt obligations.

Figure II.14. Sensitivity of household PTI to macroeconomic stress




Source: NBG

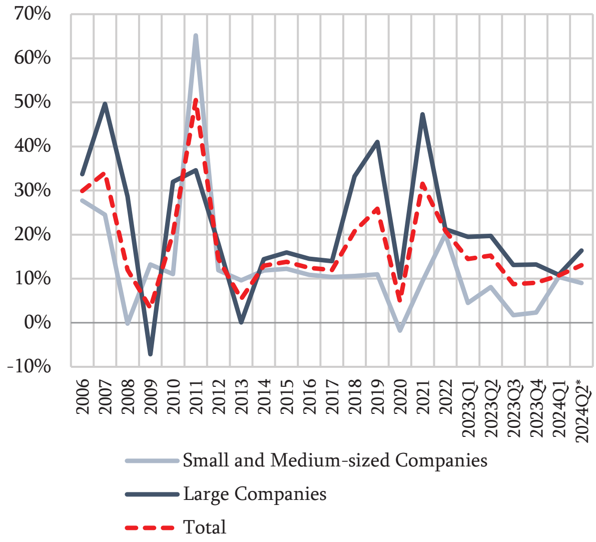
## Overview of Non-financial Companies

*In the first half of 2024, despite the increased uncertainty resulting from existing global geopolitical tensions, non-financial companies continue to grow at a stable pace. Overall, the resilience of non-financial companies has increased, although certain sectors, such as the healthcare and telecom sectors, have seen an increase in the share of non-performing loans. The share of bank loans in the financing structure of companies continues to increase. The volume of bonds issued in the local market is also growing, especially those denominated in foreign currency. At the same time, the pace of de-dollarization of both domestic and total debt of non-financial companies has slowed down significantly. It should be noted that, amid the high economic growth in the last two years, the growth rate of bank loans of non-financial companies accelerated in the first half of 2024 and surpassed those of European countries. Nevertheless, the debt burden of companies, as a ratio of debt to nominal GDP, remains below its long-run level.*

*Considering the setbacks caused by the COVID-19 pandemic, the profitability, liquidity and solvency indicators of non-financial companies improved by 2022. At the same time, the share of short-term debt in the total financing of non-financial companies has also decreased. Amid globally tightened financial conditions, the high dollarization of companies' liabilities indicates the existence of certain risks in this segment. However, according to the sensitivity analysis of non-financial companies, under the moderate-stress scenario, the debt-servicing capacities of companies remain at a healthy level, while risks to their financial stability do not increase substantially.*

**After the post-pandemic recovery, the turnover of non-financial companies continues to grow at a steady pace**. In the final quarters of 2023, a particularly low growth rate of turnovers was observed for small- and medium-sized (SME) companies (see Figure II.15). However, in the first quarter of 2024, companies of all sizes had almost equal growth in their turnover, of around 10 percent. According to preliminary estimates for the second quarter, non-financial companies are expected to continue their steady growth, which will be reflected in growth of about 16 percent for large companies and 9 percent for small- and medium-sized firms. At a sectoral level, high growth can be observed in the real estate sector (see Figure II.16). A significant acceleration of the growth rate was also observed in the telecom sector, which is a reflection of the development of the IT sector. Meanwhile, the high growth in the service sector is related to the growth of transportation-related activities and cargo turnover. During the first two quarters of 2024, there was a slight increase in turnover in the healthcare sector, which saw a significant drop in April that was followed by an acceleration of turnover in June. Relatively moderate growth has been observed in other sectors.

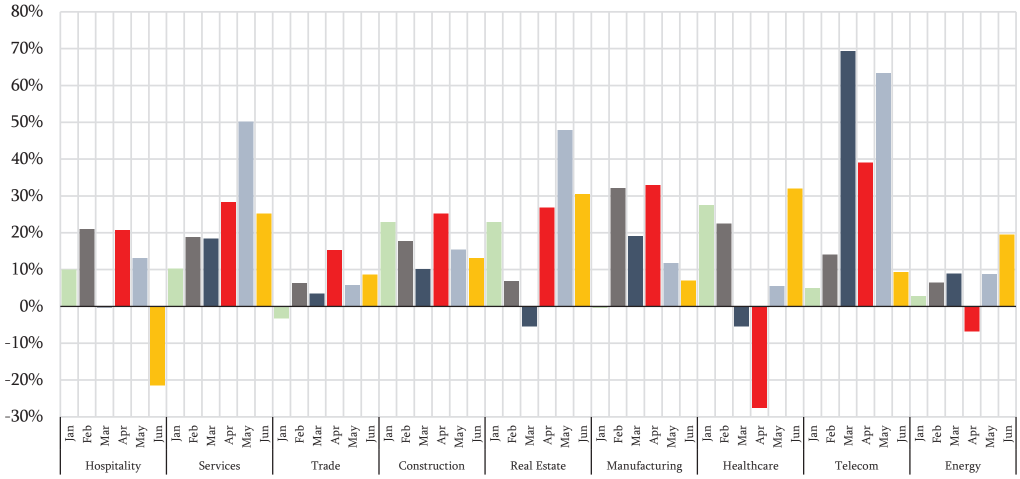
Figure II.15. Annual growth in turnover by company size




* Initial estimates.

Source: GeoStat

Figure II.16. Annual growth in turnover in selected sectors (2024/2023)

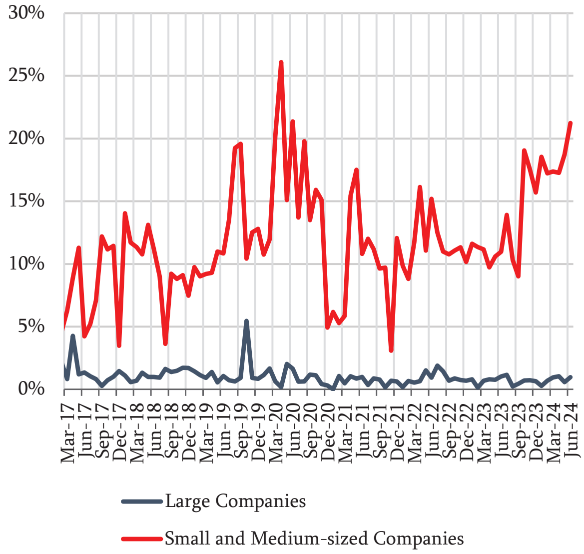



Source: Revenue Service of Georgia

**From the fourth quarter of 2023, the share of rejected loans in the small- and medium-sized company segment increased significantly (see Figure II.17).** Since October 2023, the share of rejected loan applications for small- and medium-sized companies has doubled and exceeded 21 percent by June 2024. In contrast, the same share for large-sized companies was less than 1 percent. In the SME segment, the share of rejected loans issued in GEL has significantly increased. In particular, a high growth of rejections was observed in the service, agriculture and trade sectors.

**The share of non-performing loans (NPLs) remains at a low level in almost all sectors of the economy, facilitated by the stable macrofinancial environment in the country (see Figure II.18).** Following the post-pandemic recovery, the quality of loans issued has improved. During the first half of 2024, compared to the end of 2023, the share of non-performing loans in the majority of sectors decreased even further. Although a slight increase in the share of NPLs can be observed in the energy sector, compared to other sectors, the share remains at a much lower level, below 1 percent. It is noteworthy that the share of non-performing loans in the healthcare sector has increased for a second consecutive year – a development that could lead to further discretion on the part of commercial banks. This could be reflected in a reduction of loans to the sector. During the first half of 2024, the share of non-performing loans has also increased dramatically in the telecom sector. However, it is worth considering that, on aggregate, the loans granted to the healthcare and telecom sectors represent less than 5 percent of the total portfolio of loans granted to non-financial companies. Hence, the impact of the increase in the share of non-performing loans in these two sectors on the quality of the total loan portfolio of non-financial companies is negligible, although it remains noteworthy at the sectoral level.

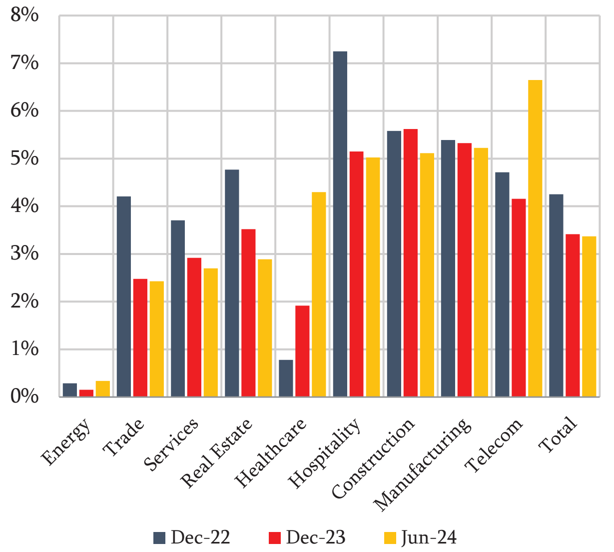
Figure II.17. Share of rejected non-financial company loan applications




Source: NBG

**Following the tightening of global financial conditions, the dependence of non-financial companies on external sources of financing has slightly decreased. Moreover, increasing dynamics in the volume of domestic bank loans and corporate bonds in their financing structures is apparent.** In 2024, the total volume of debt in companies reached a record high level and exceeded GEL 38 billion (see Figure II.19). An increase in domestic bank loans made a significant contribution to the growth of debt. The share of domestic bank loans in the total debt portfolio has also reached a historical maximum of about 70 percent, which is 4.4 percentage points higher than in the same period of the previous year. In contrast, as a result of the tightening of global financial conditions from the third quarter of 2022, the funds raised by companies from external sources continues to decrease. Consequently, since the second half of 2023, the share of external financing in the total debt has significantly decreased, and as of the second quarter of 2024, is 4.8 percentage points lower than the same period of the previous year. In addition, since the beginning of 2024, the volume of external financing in private companies has been decreasing, while in state-owned companies it is increasing.

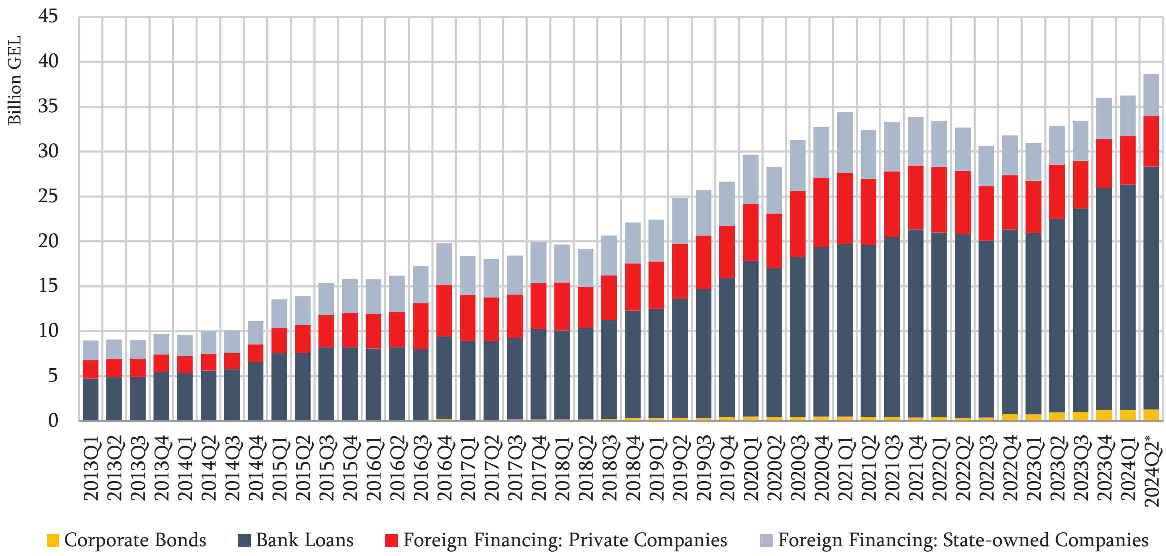
Figure II.18. Share of non-performing loans in total non-financial company loans in selected sectors (end of period)




* From 2023, as a result of the transition to IFRS reporting, the shares of NPLs are calculated using the updated methodology.

Source: NBG

Figure II.19. Debt structure of non-financial companies**




* Initial estimates.
** The data does not include intercompany loans raised from abroad.

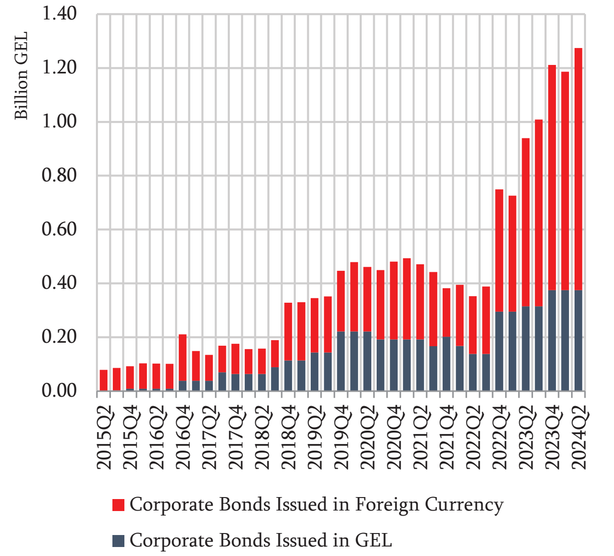
Source: NBG

Recently, there has been a significant increase in the issuance of non-financial corporate bonds in the local market. By the end of 2023, the volume of bonds issued by public offering on the local market doubled. Despite the small share of bonds in the total debt portfolio of non-financial companies (about 3.3 percent), the sharp increase in the volume of domestic bonds denominated in foreign currency is nonetheless noteworthy (see Figure II.20). For such companies, this highlights the significance of risks arising from exchange rate fluctuations, especially in the background of globally tightened financial conditions and increased uncertainty.

**During the last four quarters, the pace of reduction in the dollarization of the total debt of non-financial companies slowed down (see Figure II.21).** The decrease in the share of external debt was balanced by the increase in domestic bonds issued in foreign currency. Meanwhile, the dollarization of bank loans in the domestic credit portfolio stabilized. Finally, in the first half of 2024, compared to the same period of the previous year, the dollarization of the domestic debt of companies increased by 1 percentage point (excluding the exchange rate effect, it decreased by 0.6 percentage points), and at 64.9 percent remains at a high level. Taking into account the external debt, the dollarization of the total debt of non-financial companies is at 74.3 percent, which is 1 percentage point less than the previous year (excluding the exchange rate effect, it is 2.3 percentage points less). Consequently, the share of foreign currency-raised debt in the financing structure of companies is still high.

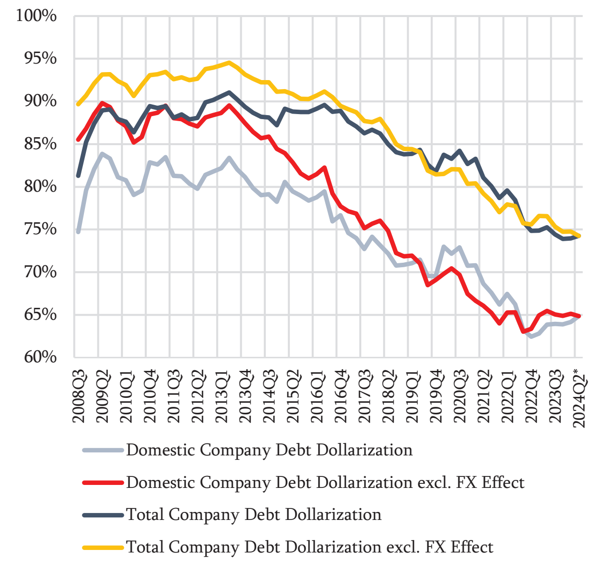
Against the background of globally tightened financial conditions, the significant dependence of companies on external sources of financing and the high dollarization of liabilities underline the vulnerability of the sector. In the event of improper hedging of the abovementioned risk, the debt burden of companies becomes characterized by high sensitivity to exchange rate fluctuations, which is a pattern that has been highlighted many times over the last decade. A number of regulations have been introduced in response to such cases. In January and May of 2024, the NBG made changes to one such regulation. In particular, according to the May update, financial institutions can issue new foreign currency loans to individuals whose total debt (including the newly issued debt) is up to GEL 400,000 only under hedged currency risk conditions.

Figure II.20 Bonds of non-financial corporations issued by public offering in the local market (stock)




Source: NBG

Figure II.21. Non-financial company debt dollarization

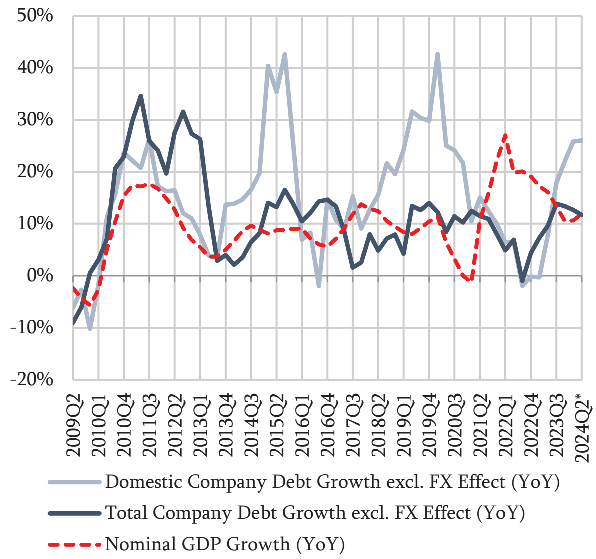



* Initial estimates.
** The data does not include intercompany loans raised from abroad.

Source: NBG

**From the third quarter of 2023, lending to non-financial companies in the domestic market accelerated significantly, which was mainly a result of the high growth in bank loans.** Starting from the second half of 2023, due to a significant reduction in inflation, the growth of nominal GDP slowed down; whereas, in the wake of the economic recovery and the gradual easing of monetary policy, lending activity increased. As a result, the growth rate of the debt of non-financial companies exceeded the growth rate of nominal GDP, which led to a gradual increase in the debt burden (see Figure II.22). In the second quarter of the current year, accelerated credit activity and a depreciation of the national currency made a significant positive contribution to the increase in the debt burden. At the same time, nominal GDP growth continues pulling this indicator down, although its contribution has significantly decreased compared to the previous year (see Figure II.23). Against this background, in the event of a normalization of real economic growth, along with an additional depreciation of the GEL in the following periods, the debt burden of companies may grow at a faster-than-expected rate. It should be noted that the significant impact of the exchange rate on the debt burden is caused by the high dollarization of companies' debt and indicates risks associated with liabilities raised in foreign currency for unhedged corporate borrowers. As a result, given the existing degree of uncertainty, financial sustainability risks related to the debt burden of companies are noteworthy.

Figure II.22. Annual growth rates of nominal GDP** and non-financial company debt

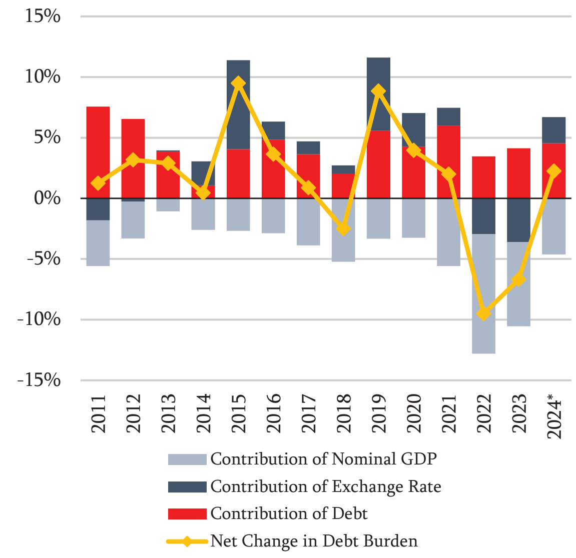



* Initial estimates.

** Nominal GDP of the last four quarters.

Source: NBG, GeoStat

Figure II.23. Decomposition of the annual change in the total company debt-to-GDP ratio (as a percent of the last four quarters' nominal GDP)

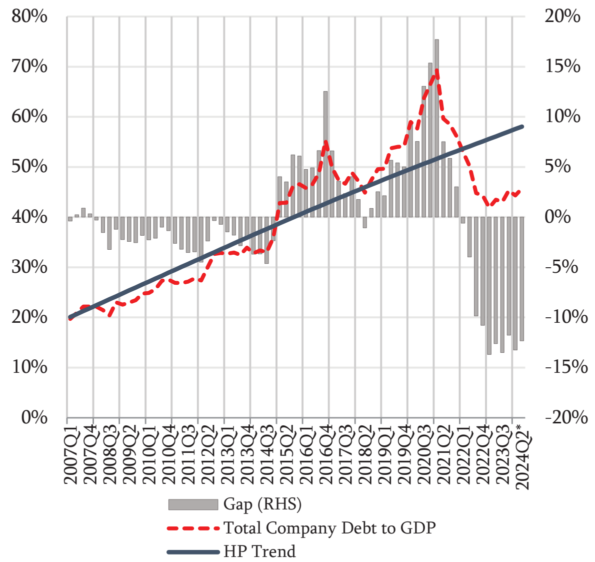



* Initial estimates of the first half of the year

Source: NBG, GeoStat

**Despite the increase in lending as a result of loose credit conditions, the ratio of total non-financial company debt to nominal GDP remains below its long-term trend, which is a reflection of higher-than-expected nominal GDP growth. However, based on bank loans data, the debt burden of Georgia's non-financial companies is commensurate with that of other European countries.** The ratio of total company debt to nominal GDP, a common measure of the debt burden, has been below its long-term trend for more than two years now. However, the recent dynamics of loans and nominal GDP help to eliminate this gap (see Figure II.24). The average growth of bank loans of non-financial companies in Georgia over the last four quarters, as compared to the same period of the previous year, exceeded the growth of loans in other European countries (see Figure II.25). It should further be noted that, considering the above, against the backdrop of high economic growth in Georgia, the ratio of bank loans of non-financial companies to nominal GDP is comparable with that of other European countries – as is indicated by the closeness of this indicator to that of Europe's average (see Figure II.26).

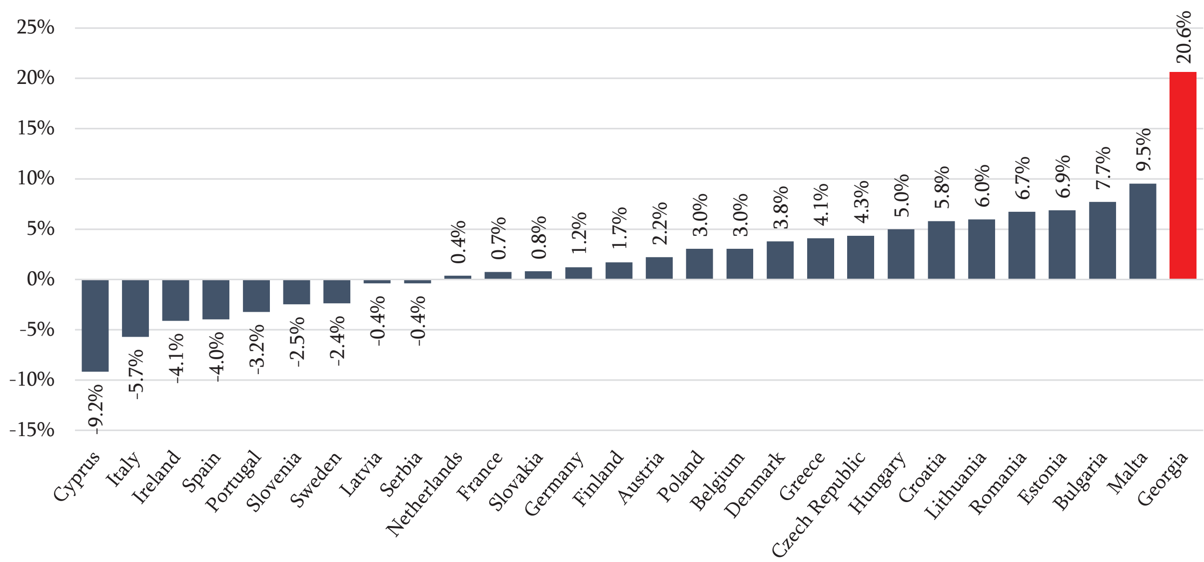
Figure II.24. Total corporate debt to GDP ratio, its long-term trend[8] and gap




* Initial estimates

Source: NBG, GeoStat

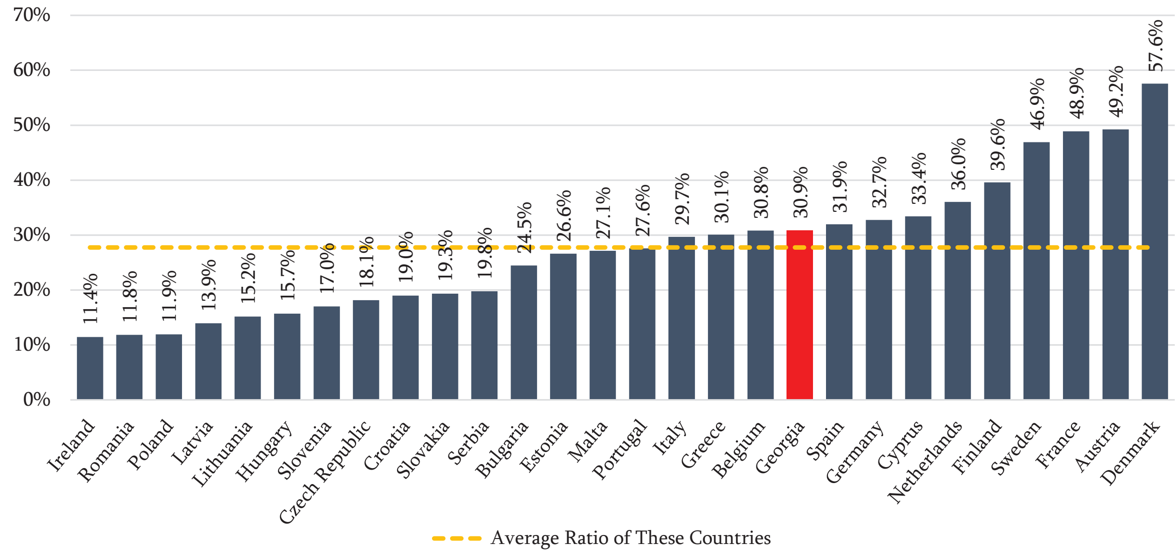
Figure II.25. Average annual growth rate of bank loans of non-financial companies in the last four quarters (2023 Q1 – 2024 Q1)




Source: NBG, Eurostat

8 The long-term trend of the total company debt to GDP ratio is estimated using a two-sided HP filter with a smoothing parameter of 400,000.

Figure II.26. Non-financial company bank loans to GDP* ratio (2024 Q1)

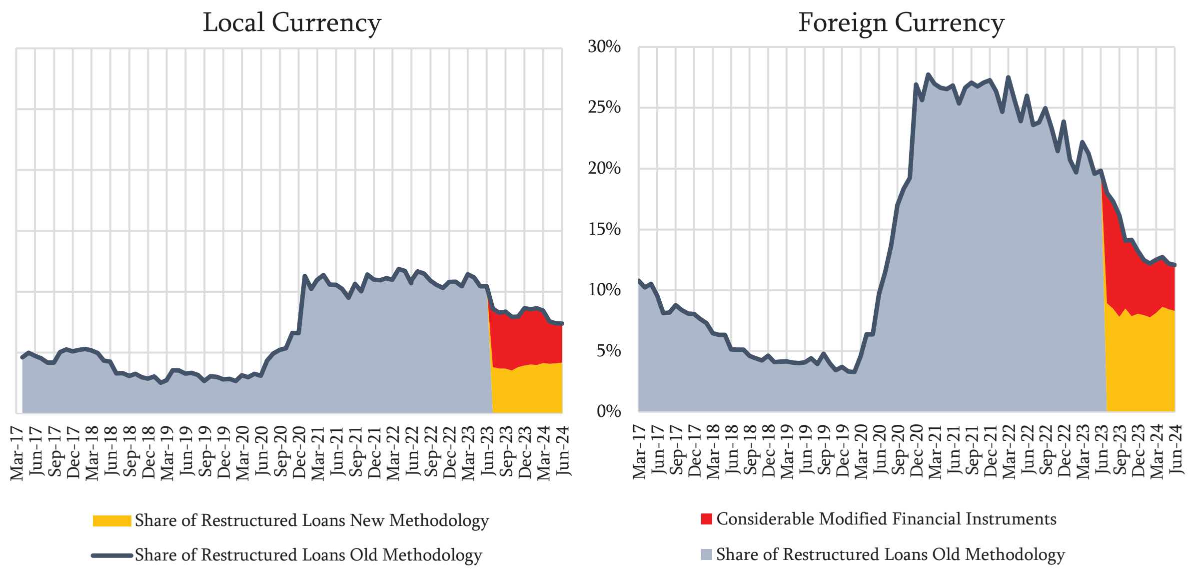



* The last four quarters' nominal GDP.

Source: NBG, Eurostat

**In recent months, the share of restructured loans issued in foreign currency has significantly decreased, while the share for GEL remains at a stable level (see Figure II.27).** It should be noted that, as a result of the transition to the IFRS methodology for financial reporting, from July 2023, changes have been made in the classification of loans. Accordingly, a new category – Considerable Modified Financial Instruments – was separated from the restructured loans as calculated under the old methodology. According to the IFRS methodology, the share of restructured loans has been stable over the last year, both in GEL and in foreign currency. However, according to the old methodology, there was a decrease in both GEL and, especially, foreign currency restructurings, which, in addition to general methodological changes, was related to individual changes in banks' approaches to classifying loan restructuring. *It should be noted that in subsequent financial stability reports, the data from July 2023 onwards will only reflect the dynamics of the share of restructured loans as classified by the IFRS methodology*.

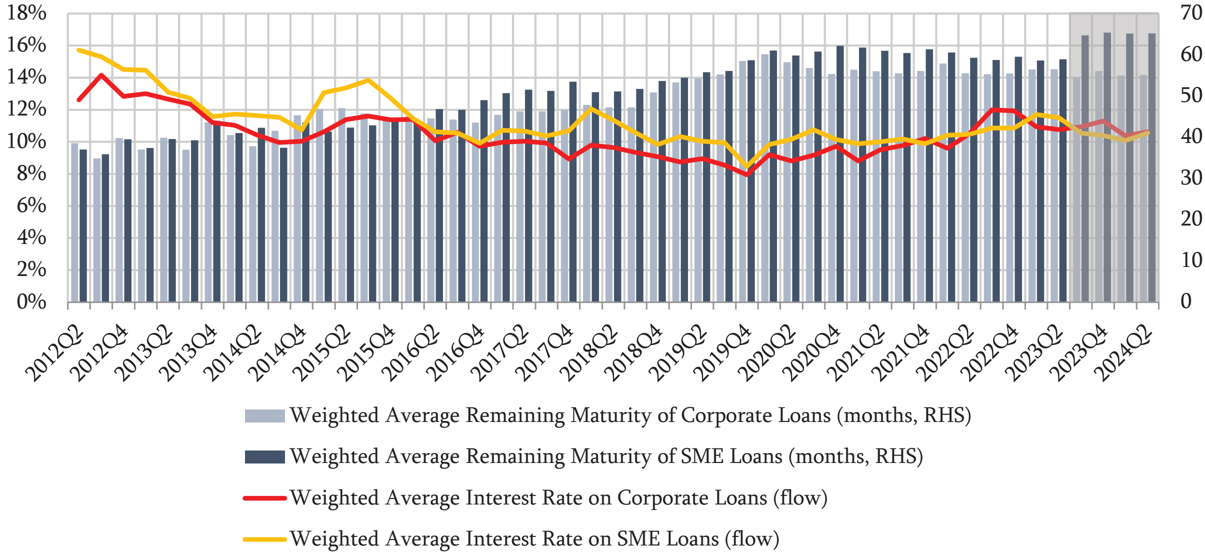
Figure II.27. Share of restructured loans in total non-financial company loans issued by banks by currency




Source: NBG

**In recent quarters, weighted average interest rates on loans to non-financial companies have been characterized by a downward trend, while the remaining maturity has hardly changed (see Figure II.28).** The easing of monetary policy by the NBG has made a significant contribution to the reduction of interest rates. During the last four quarters, remaining maturities in the corporate segment have slightly decreased, while in the small- and medium-sized segment they have remained practically unchanged. It is noteworthy that from July 2023, as a result of the transition to the IFRS methodology for financial reporting, the micro company segment was separated from small- and medium-sized companies. Therefore, the sharp increase in the remaining maturity of the small- and medium-sized segment over the last four quarters is due to this methodological change.

Figure II.28. Weighted average interest rates and the remaining maturity of company loans from banks

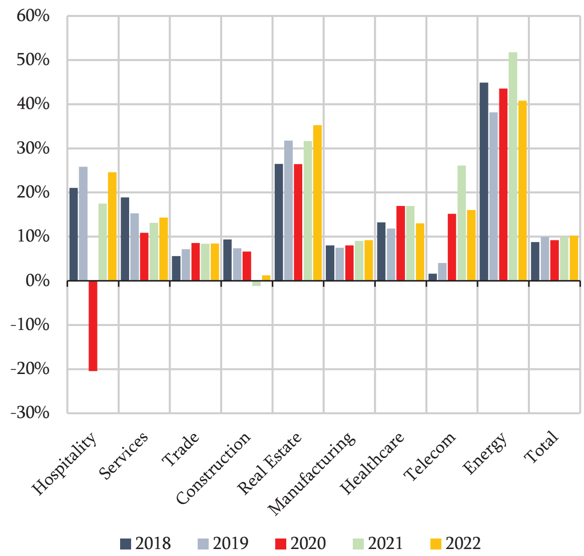



* The highlighted area reflects the transition to the IFRS methodology for financial reporting.

Source: NBG

**After overcoming the initial setbacks of the COVID-19 pandemic, non-financial companies have continued to recover, as is reflected by the increase in their profitability in the following years.** A company's EBITDA[9] margin represents the share of revenue that is used to service its financial obligations. It is one of the indicators of profitability. Based on the median values of this indicator, the profitability of non-financial companies operating in those sectors that were directly affected by the COVID-19 pandemic deteriorated sharply in 2020 (see Figure II.29). The hospitality sector suffered the most in the wake of the nationwide lockdown, although it has since shown a strong recovery and high profitability. For firms in the construction sector, the pandemic had a continuous effect. In particular, following an initial decrease in profitability, in 2021 a large part of such companies made a loss that was related to an increase in prices of construction materials and transportation costs. It should be noted

Figure II.29. Median EBITDA margin of companies by sector




* The sample of companies for the calculation of the indicator remains unchanged over the years.

Source: SARAS[10], authors' calculations

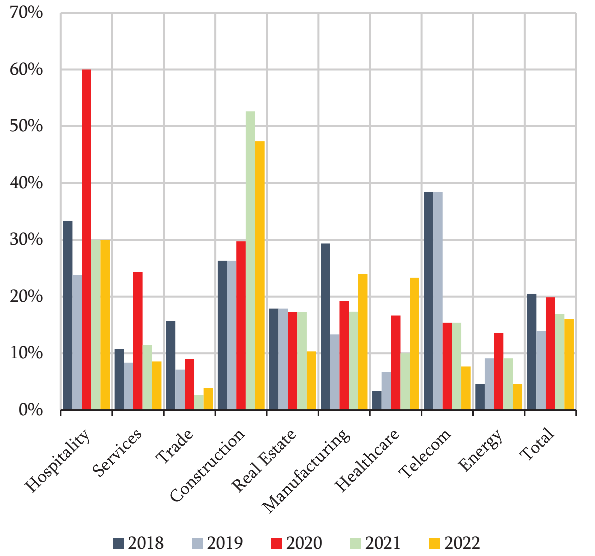
9 EBITDA refers to earnings before interest, taxes, depreciation and amortization.

10 Service for Accounting, Reporting and Auditing Supervision of Georgia.

that even in 2022 the construction sector was characterized by the lowest rate of profitability. During the pandemic, profitability in the service sector also significantly decreased, which was largely the result of a reduction in transportation services. In the subsequent period, the profitability of the sector improved, although it remained below pre-pandemic level. The pandemic has also had a negative impact on the profitability of the real estate sector, which was most likely a reflection of increased global uncertainty and worsening macroeconomic conditions in Georgia. Meanwhile, there was no decrease in the profitability of other sectors, and a significant improvement was observed in the healthcare and telecom sectors, which for the former was related to the increased demand for medical services and for the latter to the transition to online working in the background of the lockdown. In the same period, the share of loss-making companies also increased significantly, and in the hospitality sector reached the 60 percent mark (see Figure II.30). Over the following period, in the wake of the post-pandemic recovery, an improvement of profitability indicators in the majority of non-financial companies was clearly evident, which will increase their ability to pay off their obligations.

**The majority of non-financial companies maintain adequate solvency indicators**. The ratio of a company's total debt to EBITDA shows how many periods it will take for the company to pay off its debt, assuming its debt and profitability remain unchanged. Accordingly, low values for this measure indicate a high level of solvency for a company. Companies operating in Georgia, both at the aggregated and the sectoral level, do not face debt service difficulties (see Figure II.31). The negative values of the indicator indicate that at least half of the sampled firms made losses and were unable to service the debt. Therefore, during the mentioned period, the existing debt could not be reduced. In 2020, some companies made losses. Companies in the hospitality sector were most affected by the pandemic. Consequently, the total debt to EBITDA ratio in the hospitality sector was negative. As a result of the pandemic, in order to overcome their challenges and improve their financial state, a large number of companies in the hospitality sector took on additional debt in the subsequent period, as is indicated by the increasing dynamics of the above-mentioned indicator. The same can be said about the growth of the same indicator in the service sector in 2021. In the post-pandemic period, the median ratio of total debt to EBITDA in other sectors mostly decreased, which was also supported by an increase in their profitability (see Figure II.29). In the 5-year period, a particularly striking improvement in this indicator of the debt burden was seen in the energy sector, with it falling below the low-to-medium risk threshold.

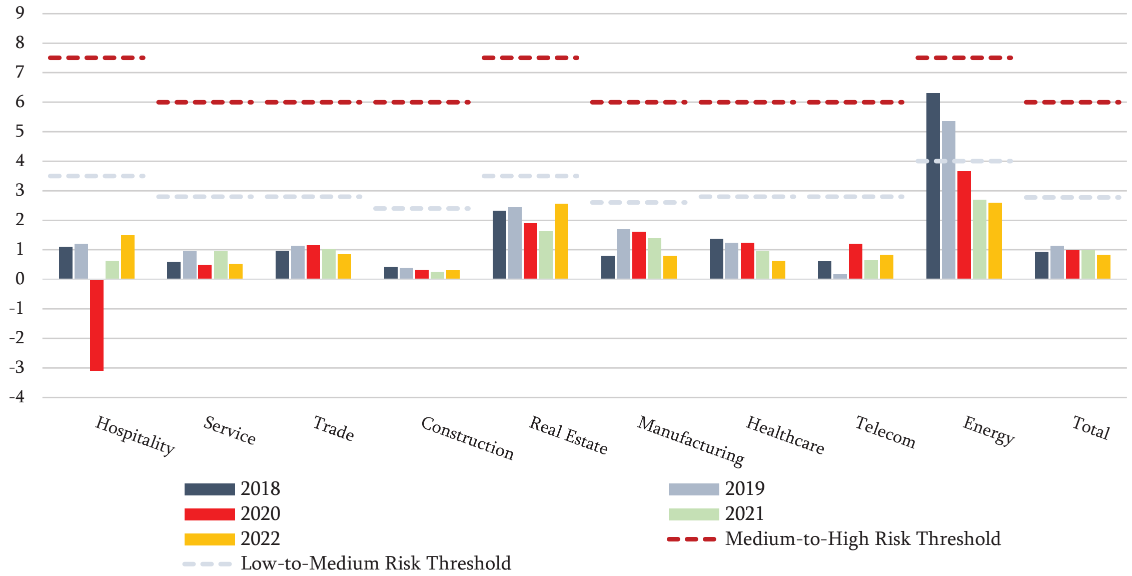
Figure II.30. Share of loss-making companies by sector




* The sample of companies for the calculation of the indicator remains unchanged over the years.

Source: SARAS, authors' calculations

Figure II.31. Median debt burden of non-financial companies by sector



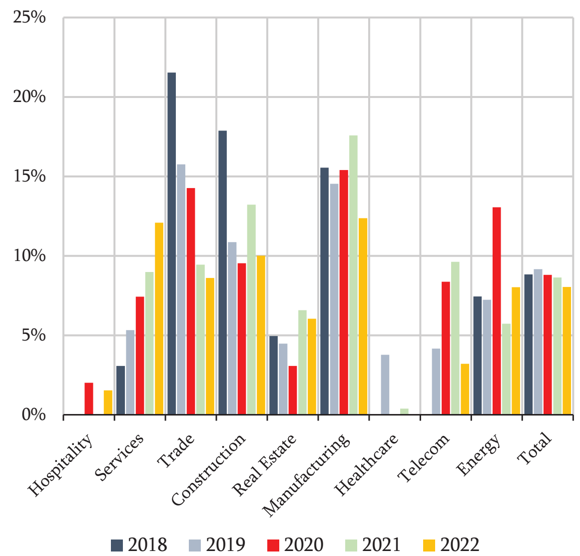

* The risk thresholds are determined according to the Credit Risk Management Rule[11] and the Methodology of Financial Instruments Expected Credit Losses Assessment and Credit Risk Category Determination[12].

** The sample of companies for the calculation of the indicator remains unchanged over the years.

Source: SARAS, authors' calculations

**The share of short-term debt in the financing structure of non-financial companies remains at a stable level.** In 2022, compared to the previous year, the share of short-term debt in the majority of non-financial companies decreased (see Figure II.32). In addition, due to the tightened financial conditions in Georgia, firms started refraining from taking on new long-term debts, which could explain the increasing dynamics of the share of short-term debt in the service sector. It is also worth noting that the share of short-term debt in the hospitality sector is less than 3 percent. Consequently, due to the low amounts of short-term debt, the sector has relatively little requirement for liquid assets. The reduction of short-term debt in 2022 was also related to the tightening of financial conditions, resulting in companies taking on relatively fewer new loans and shifting to servicing existing debts. This is also indicated by the reduction of the debt burden (see Figure II.24). Against the background of easing credit conditions due to the reduction of the monetary policy rate from the end of 2023, the share of relatively long-term credit contracts in non-financial companies is expected to increase. This will lead to an additional decrease in the share of short-term debt in the total financing portfolio.

Figure II.32. Median share of non-financial company short-term debt in total debt by sector*




* Short-term debt consists of a company's borrowings with maturities of less than a year.

** The sample of companies for the calculation of the indicator remains unchanged over the years.

Source: SARAS, authors' calculations

11 See https://nbg.gov.ge/fm/ინდივიდუალურ_სამართლებრივი_აქტები/ნორმატიული_აქტები/საბანკო/2023/284-04.pdf

12 See https://nbg.gov.ge/fm/ინდივიდუალურ_სამართლებრივი_აქტები/ნორმატიული_აქტები/საბანკო/2024/ifrs-9-eng-0807.pdf

## Sensitivity Analysis of Non-financial Companies

**In the case of a deterioration of the macrofinancial environment, the debt-servicing capacity of companies will remain at a healthy level, while the risks to their financial stability would not increase substantially.** The impact of macrofinancial shocks on non-financial companies related to tightened global financial conditions can already be felt to some extent. Under these conditions, it is especially important to assess the financial stability of companies in case of a possible additional deterioration of the macroeconomic environment. The expected impact of selected shocks on companies' debt-servicing abilities was estimated using sensitivity analysis (see Table II.1). The magnitudes of the shocks correspond to the moderate-stress scenario as discussed in Macrofinancial Risk Scenarios section of this report.

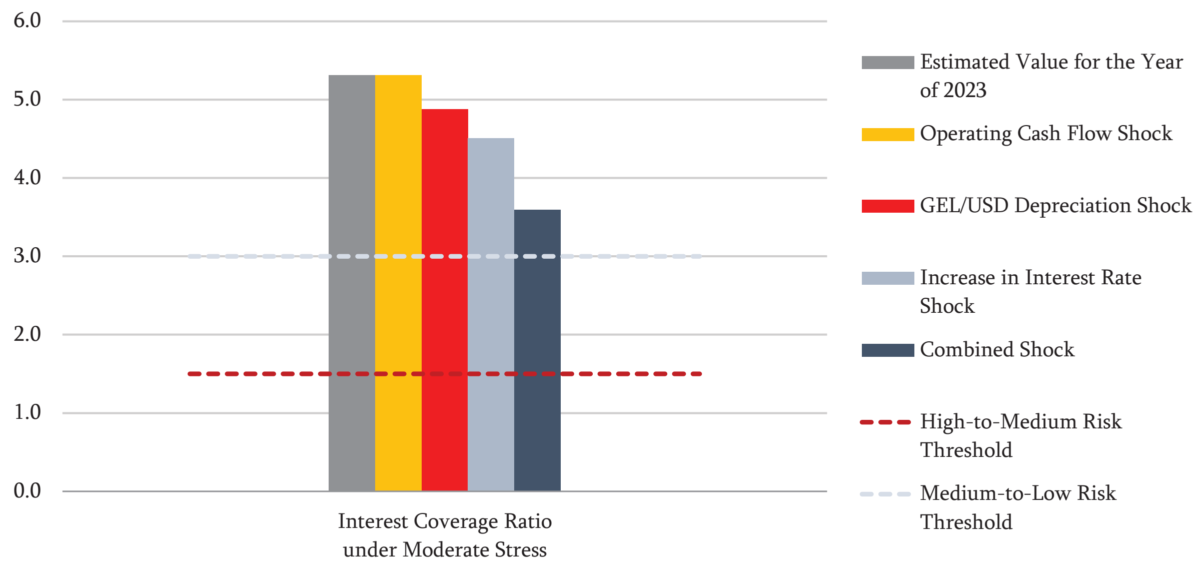
Table II.1. Macro-financial shocks for the sensitivity analysis of companies

| | Increase in market interest rate shock | GEL/USD exchange rate depreciation shock | Drop in operating cash flows shock* |
|---|---|---|---|
| Moderate Stress | 2.0% | 15% | 0% |

* In the sensitivity analysis, operating cash flows are proxied by EBITDA

Figure II.33 shows the median interest coverage ratio[13] (ICR) estimates for companies at the 2023 level, the stressed ratios under each selected shock, as well as the combined impact of all the shocks. The median interest coverage ratio, as of 2023, is estimated at 5.3, which falls in the low-risk category, according to Standard & Poor's corporate methodology.[14] The sensitivity analysis reveals that an increase in the market interest rate would have the highest impact among the selected individual shocks. Regardless, the impact of the shock was not only determined to be negligible, but the interest coverage ratio still falls into the low-risk category even under the combined impact of the selected shocks; although it does come close to the medium-risk threshold.

Figure II.33. Sensitivity analysis: impact of selected shocks on the median interest coverage ratio



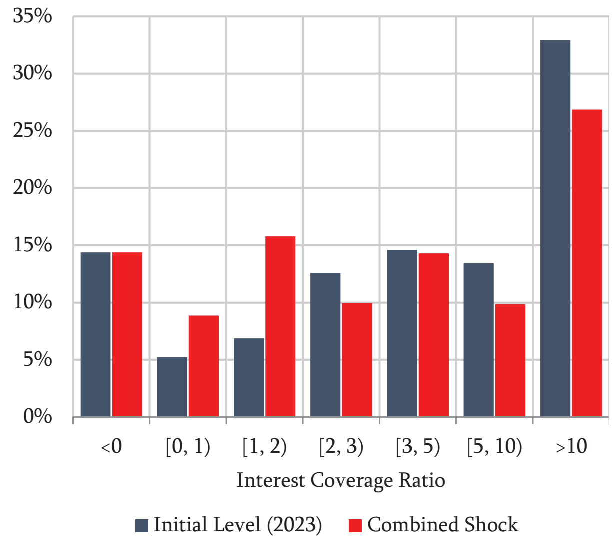

Source: SARAS, authors' calculations

13 The interest coverage ratio is calculated as the ratio of EBITDA to gross interest expense.

14 S&P Global Ratings: Global Nonfinancial Corporate Medians History And Outlook Midyear 2024: https://www.spglobal.com/_assets/documents/ratings/research/101599648.pdf

**It is also important to consider the distributional effects caused by the selected shocks under the moderate-risk scenario on companies' interest coverage ratios**. As companies migrate from higher to lower interest coverage ratio ranges, as a result of the realization of the selected combined shock, their debt-servicing abilities deteriorate. If their coverage ratio falls below one, companies can no longer service their debt using the cash inflows generated from their operational activities – a situation commonly known as debt at risk. When companies enter this zone, their credit risk surges. This can induce systemic issues since commercial banks have sizable exposure to the liabilities of non-financial companies. The sensitivity analysis shows that, when assessing the initial 2023 level, the share of assets of companies facing debt service difficulties was 19.6 percent. Under the moderate-stress scenario, given the combined impact of the selected shocks, the deterioration of macrofinancial factors, and the realization of vulnerabilities related to debt characteristics, the share of companies facing debt service difficulties increases by 3.7 percentage points (see Figure II.34). In particular, considering the size of assets, the share of companies with an interest coverage ratio of less than one increases to 23.3 percent. Furthermore, as a result of the shock, the share of assets located near the debt-at-risk threshold increases significantly. This all indicates the vulnerability of non-financial companies to the aforementioned shock. It should be noted here that part of companies' debts take the form of inter-company loans, which are raised on favored terms and, in certain cases, can de-facto represent equity. Consequently, the results of the mentioned sensitivity analysis somewhat overestimate the impact of the stress; however, given the limited data available, a more reliable assessment cannot be obtained.

Figure II.34 Asset-weighted distribution of company interest coverage ratios

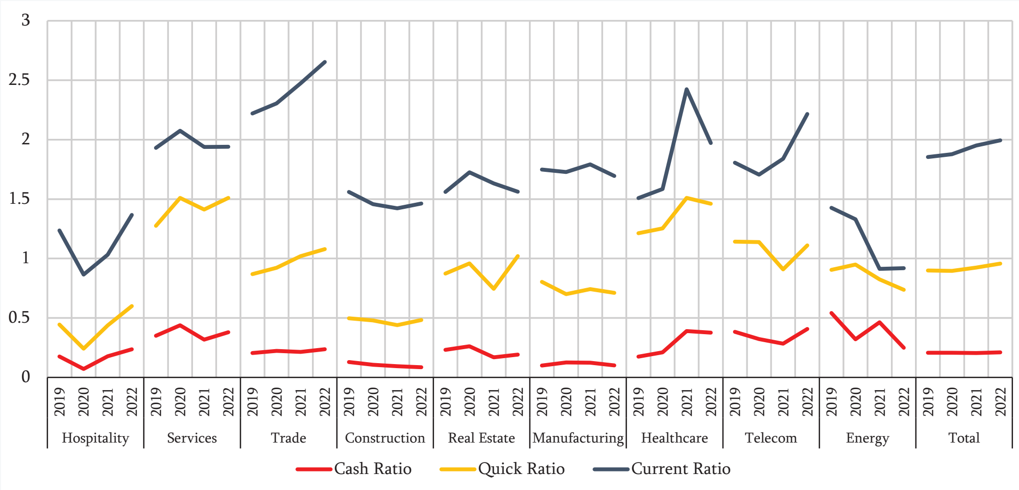



Source: SARAS, authors' calculations

## Box 1. Liquidity Analysis of Non-financial Companies

Liquidity determines a company's ability to meet its existing short-term liabilities. It is used to evaluate a company's financial stability, operational efficiency, reliability and riskiness. Liquidity is one of the primary indicators for making financial, investment or operational decisions, and is used for strategic planning. Three main indicators are used to evaluate the liquidity of a company: the cash ratio, quick ratio and current ratio.[15] The cash ratio is the most stringent measure of liquidity and includes only the most liquid assets, such as cash, cash equivalents and marketable securities. The quick ratio additionally includes relatively less liquid assets, such as trade and other short-term requirements, along with the components of the cash ratio. Whereas the current ratio also takes into account a company's inventories, along with the abovementioned liquid assets. The median values of these liquidity indicators can be used by a firm to understand the central tendencies of the sector in which it operates, as well as to compare its own indicators and identify weaknesses (see Figure B1.1).

Figure B1.1. Liquidity of non-financial companies by sector (median values)




* The sample of companies for the calculation of the indicators remains unchanged over the years.

Source: SARAS, authors' calculations

In this box, for the liquidity analysis of the non-financial company segment, liquidity ratios are calculated as the asset-weighted average indicators. The values of these indicators are derived for each sector and the economy as a whole. In order to assess the liquidity of a particular sector or the economy as a whole, the use of asset-weighted average values is more appropriate than the use of median values, as doing so takes into account the contribution of companies of all sizes and, hence, provides a better opportunity to see the overall picture. It should be noted that the contribution of large companies, which are the key players within a specific sector, will be relatively high in the derivation of the ratios. Therefore, the values of these ratios differ from similar median ratios.

The non-financial companies presented in the analysis have coped with the various challenges associated with the COVID-19 pandemic, tightened financial conditions, and the Russia-Ukraine war, and have maintained high levels of liquidity (see Figure B1.2). The pandemic had a significant negative impact on both foreign and domestic tourism in Georgia, which primarily affected high-contact sectors, such as the hospitality sector. Against the background of the cancellation of hotel reservations and a sharp decrease in the use of high-contact entertainment

15 The cash ratio is calculated as the ratio of the sum of a company's cash, cash equivalents and marketable securities to its current liabilities. The quick ratio consists of trade and other short-term receivables, along with the variables included in the cash ratio. The current ratio is calculated as the ratio of a company's current assets to its current liabilities; it includes a company's inventories in the numerator, along with the variables included in the quick ratio.

facilities, in 2020 and 2021, firms in this sector accumulated excess inventories, which was reflected in the increase in the current ratio. Subsequently, due to an increase in bookings, the sector's liquidity improved as the quick ratio increased and the share of inventories decreased. The pandemic also affected the service sector, where, in the background of the nationwide lockdown, the reduction of cash payments, along with the growth of courier services, contributed to the accumulation of an excess volume of cash and cash equivalents. This was reflected in the improvement of liquidity in the service sector. In the subsequent period, all liquidity indicators in the sector continued to improve.

During the given period, the healthcare sector handled the challenges of the pandemic and increased its liquidity indicators. In the wake of the pandemic, activity in the sector increased dramatically, as did all liquidity indicators. Moreover, with the growth of the cash ratio, the quick ratio increased at relatively slower pace, which indicated a decrease in short-term receivables and an increase in cash and cash equivalents. In this period, a particularly high increase was observed in the current ratio, which indicates the accumulation of inventory. Subsequently, in the post-pandemic period, the current ratio in the healthcare sector decreased, along with the amount of inventories, while the remaining liquidity indicators continued to grow at a stable pace.

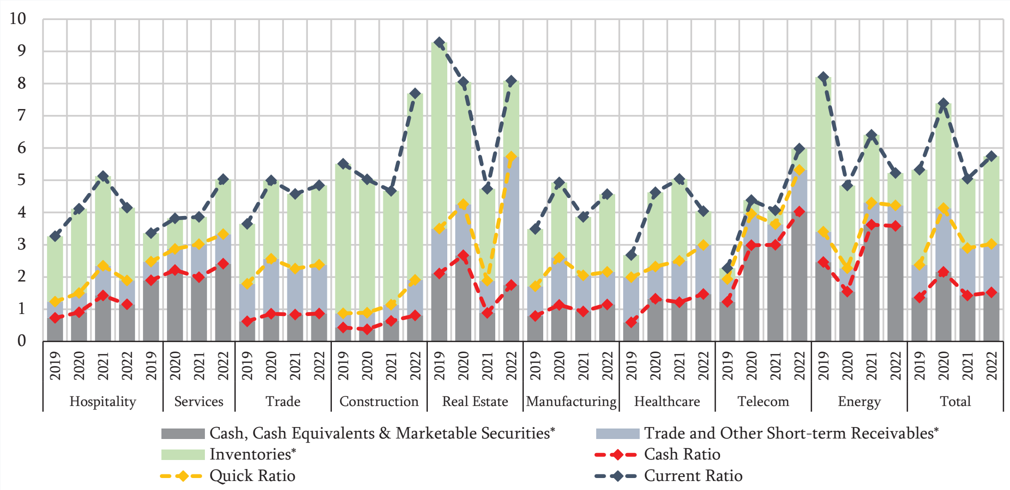
During the pandemic, liquidity in the construction sector deteriorated due to the depreciation of the domestic currency, along with the increase in transportation costs and prices of construction materials. The quick and cash ratios changed only slightly, and the deterioration of liquidity was mainly reflected in the reduction of the current ratio, which indicates the consumption of existing, previously accumulated inventories – a result of increased costs for construction materials and the disruption of supply chains. It should be noted that, in the subsequent period, an excess accumulation of inventories was observed in the sector, which may indicate the inefficient usage of short-term assets or it might result from expectations of an increase in demand for construction services.

The real estate sector met the pandemic with high levels of liquidity. The main impact of the pandemic on the real estate sector took place in 2021, and was manifested in a deterioration of all three liquidity indicators. Furthermore, there was a notably sharp increase in liquidity in 2022, which was likely a result of increased tourist and migration flows resulting from the Russia-Ukraine war and increased savings in the country since the pandemic. The quick ratio has increased significantly, which, in light of the growing demand for real estate, may be a reflection of an increase in sales of real estate with deferred payments.

Liquidity indicators in the information and communications sector continued to improve, mainly as a result of the increase in cash and cash equivalents. These changes in the sector indicate the acceleration of its development and noticeable structural changes seen in 2024.[16] During the given period, the manufacturing and trade sectors maintained high levels of liquidity. In 2020, the improvement of liquidity indicators in the manufacturing and trade sectors mainly took place at the expense of the growth of inventories and short-term receivables. The energy sector was initially characterized by a large volume of inventories, but these saw a noticeable decline during the pandemic. However, following the post-pandemic recovery, the cash ratio increased significantly, indicating improved liquidity and reflecting the soundness of the sector.

16 See https://nbg.gov.ge/fm/პუბლიკაციები/ანგარიშები/მონეტარული_პოლიტიკის_ანგარიში/2024/2024q2-eng.pdf

Figure B1.2. Liquidity of non-financial companies by sector (asset-weighted mean ratios)




* As a ratio to current liabilities.
** The sample of companies for the calculation of the indicators remains unchanged over the years.

Source: SARAS, authors' calculations

At the individual company level, liquidity is characterized by certain heterogeneity; however, in the given period, both at the sectoral level and in the economy as a whole, the segment of non-financial companies was characterized by high liquidity. Furthermore, the recent tendency of an easing of monetary policy and the high growth of economic activity will contribute to an additional improvement of the liquidity indicators of non-financial companies.

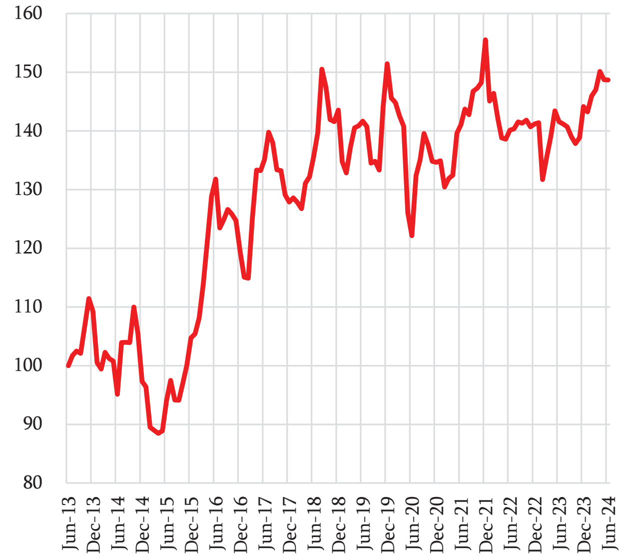
## Real Estate Sector Analysis

*Real estate market prices remain stable, there is strong demand and no signs of significant shifts in market activity. On the supply side, the number of permits issued for multi-dwelling buildings has risen substantially, which could pose a risk of excess supply. Following the gradual fading of migration effects, rental prices for residential properties have stabilized, but continue to exceed their long-term trend. The quality of loans issued to the construction and real estate sectors remains sound, and mortgage loan growth is stable. However, the annual growth of loans to developer companies has increased significantly, warranting attention. Monitoring of the real estate market is thus essential.*

**Real estate market demand remains stable and the migration effect has faded**. The house affordability index has shown a slight improvement in recent periods, driven by rising average wages (see Figure II.35). In turn, house affordability appears to be a fundamental factor underpinning real estate demand. While the earlier surge in demand was partially attributed to migration, the market maintains its resilience even after the migration effect faded.

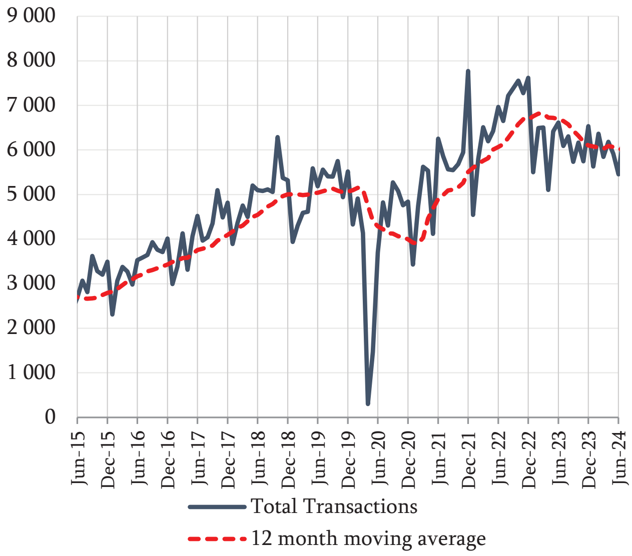
**Currently, real estate market indicators reveal resilience. However, as a significant shift in real estate market activity might pose financial stability risks, the sector requires continuous monitoring**. In 2022, real estate market activity surged, with annual growth reaching double digits; this likely reflects the impact of strong local demand and increased migration. High growth rates were observed nationwide, as well as in Tbilisi and Batumi. The number of transactions in 2022 increased by 17.3 percent in Tbilisi and 21.3 percent nationwide. Due to this base effect, Tbilisi recorded a 6.2 percent annual increase in 2023, followed by a 0.7 percent decline in the first half of 2024. Despite this slight decrease, real estate activity in Tbilisi remains stable, with no signs of a dramatic shift (see Figure II.36). Therefore, according to the NBG's assessment, overall real estate market activity is stable.

Figure II.35 House affordability index (2013=100)[17]




Source: NBG, authors' calculations .

Figure II.36. Number of housing transactions

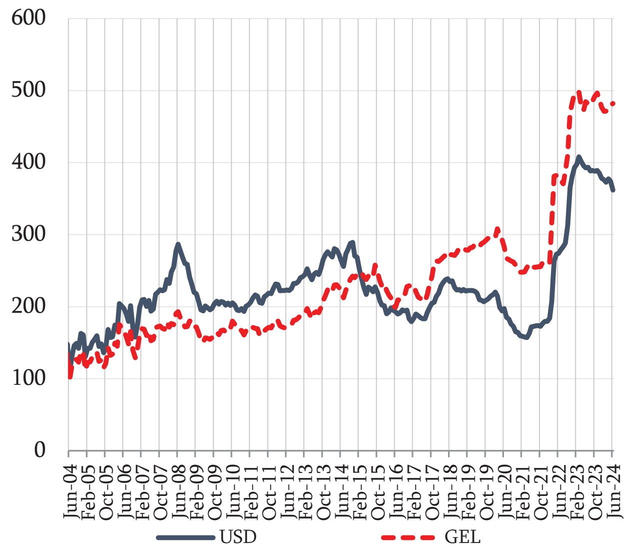



Source: National Agency of Public Registry

17 The house affordability index is based on the wage-to-payment ratio, which takes into account property prices, the maturity of mortgage loans, interest rates, and average wages.

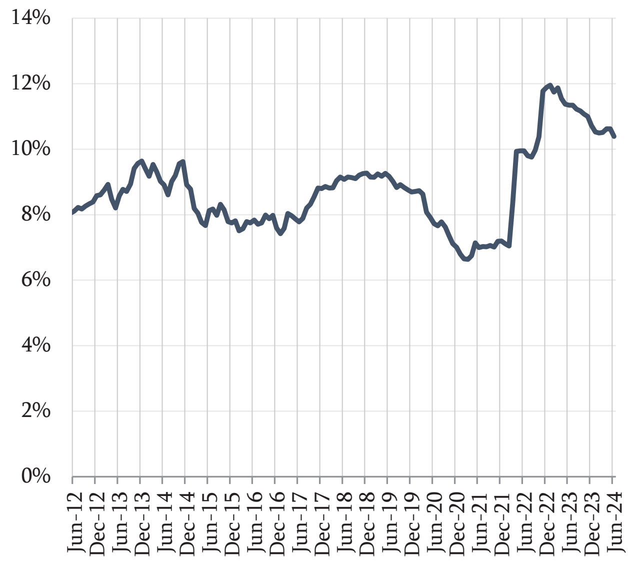
**Along with the fading of migration effects, rental prices for residential real estate have stabilized, and a decline in USD-denominated rent has been observed, although it still exceeds its long-term trend**. In 2022–2023, rental prices surged sharply due to the rise in migration, but the rent index has followed a declining trend since April 2023, particularly in USD terms (see Figure II.37). This decline does not pose a risk to financial stability, as it has been gradual and was anticipated following the sharp, one-time increase related to migration. The reduction in rental prices has also contributed to a decline in the capitalization index, which measures the rent-to-price ratio and serves as an indicator of the attractiveness of real estate as an investment asset (see Figure II.38). Therefore, if this downward trend in rental prices persists, it could affect the attractiveness of real estate as an investment.

Figure II.37. Residential real estate rent price index




Source: NBG

Figure II.38 Capitalization index (rent-to-price ratio)



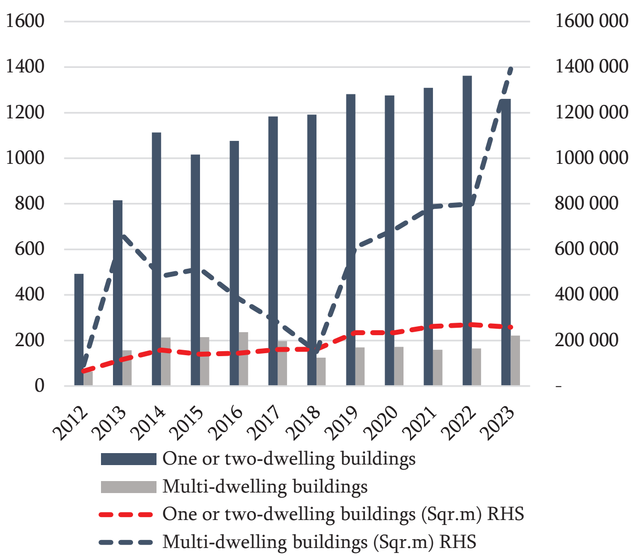

Source: NBG

**Demand for residential real estate has weakened in Batumi, as reflected in the drop in the total number of transactions.** In 2023, real estate sector activity in Batumi fell by 9.3 percent compared to the previous year, with the pace of decline accelerating to -16 percent in the first half of 2024, primarily due to a reduction in non-residents' transactions. It should be noted that a significant share of demand in Batumi comes from non-residents, making that market more vulnerable. This trend was particularly evident in previous years, when strong local demand was accompanied by a significant share of foreign buyers in certain periods. The slowdown in real estate activity in 2023 and 2024 can largely be attributed to the base effect, reflective of the high growth observed in 2022.

**The dynamics of construction permit issuance should be considered in the assessment of real estate market trends.** In 2023, the number of construction permits issued for multi-dwelling buildings saw a 34.5 percent annual increase, reflecting strong supply-side momentum. Additionally, the volume of multi-dwelling construction permits grew significantly compared to 2022 (see Figure II.39). Besides, increased construction activity in the suburbs of Tbilisi also warrant attention, as this may introduce risks of oversupply. In contrast, the trend for detached houses has shifted. In 2023, the number of construction permits issued for detached houses declined by 7.4 percent compared to 2022, suggesting a potential fading of the previously observed shift in housing preferences.

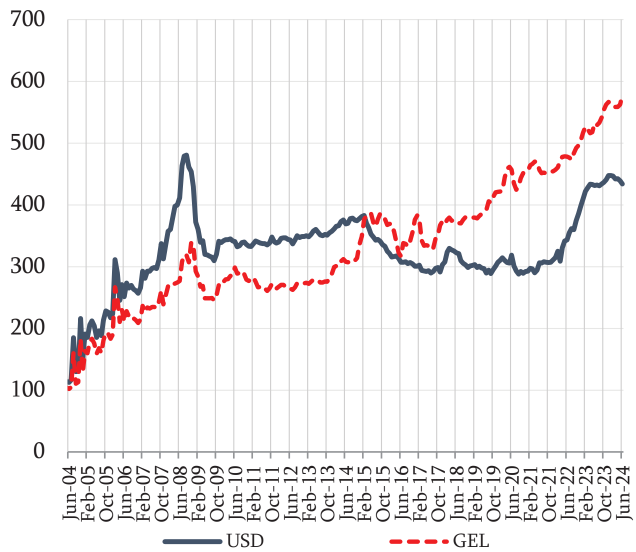
**Real estate prices have remained resilient, though their growth rate has slowed** (see Figure II.40). It should be noted that the pace of price increases is higher for newly built properties than for older ones (see Figure II.41).[19] In addition, price dynamics vary across different districts. As mentioned earlier, the migration effects seen in 2022-2023 contributed to price increases, with the subsequent price moderation largely driven by the fading of these temporary effects. Given the downward trend in rental prices and the current high price levels, an overloading of the market could reduce the investment attractiveness of real estate, which had increased during the 2022-2023 period. However, it is important to note that internal migration remains a significant factor each year, supporting demand and contributing to market resilience. To assess current supply-side conditions, it is essential to monitor construction cost dynamics, which are currently accelerating. As of June 2024, construction costs[20] recorded an annual growth rate of 8.5 percent, reflecting rising input prices.

Figure II.39. Number and volume of construction permits issued[18]




Source: Tbilisi City Hall

Figure II.40. Residential real estate price index




Source: NBG

18 Detached houses include class I, II and III one- or two-dwelling buildings as determined in resolution N255.

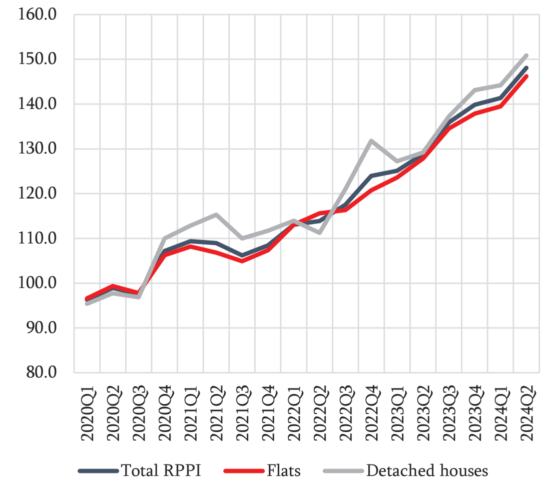
19 GeoStat, Residential Property Price Index, which only includes newly built houses.

20 GeoStat, Construction Cost Index.

**The demand for commercial real estate is stable**. This indicates that the commercial real estate market functioned normally throughout 2023. Despite the partial maintenance of remote working arrangements and the activation of online sales, there remains strong demand for commercial properties and office spaces. In 2024, the National Bank of Georgia assessed the dynamics of commercial property prices, noting an upward trend in price movements within the commercial real estate market (see Box 2. Commercial Real Estate Price Index for Tbilisi).

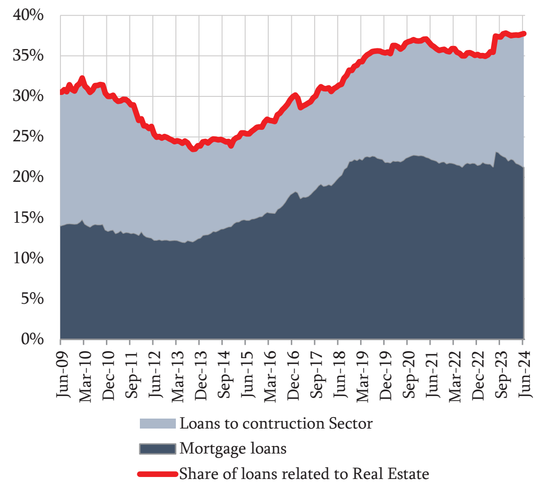
**The share of loans issued to the construction and real estate sectors within total loans is significant. However, these loans remain healthy, and the growth of mortgage lending is sustainable**. As of June 2024, the share of loans related to construction has risen to 38 percent, while mortgages account for 21 percent of the banking sector's credit portfolio. Therefore, given the importance of the construction sector, the banking sector remains vulnerable to risks associated with the real estate market. To mitigate potential risks, the National Bank of Georgia has implemented responsible lending regulations. These regulations, along with existing macroprudential policies, have contributed to the improved quality of mortgages and construction sector loans, as evidenced by the low levels of non-performing loan ratios. Furthermore, the mortgage portfolio is granular and well-diversified, which reduces the overall risk associated with this type of lending. The practice of offering customers internal installments by construction companies is an important factor to consider when assessing real estate market risks. Additionally, the annual growth of loans issued to developer companies has increased significantly. The National Bank of Georgia is aware of these risks and has established regulations for commercial banks regarding the financing of real estate developers and the principles for issuing mortgage loans for properties that are unfulfilled or under construction. Under these regulations, commercial banks are required to adhere to the guidelines set by the NBG when issuing mortgage loans. The guidelines are partially recommendatory and address critical aspects for financing real estate development projects, ensuring that lending practices are aligned with risk mitigation strategies.

Figure II.41. Residential property price index (RPPI) for new dwellings (2020=100)



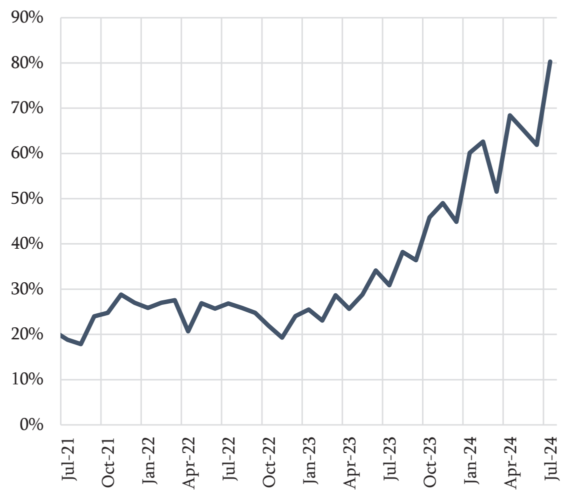

Source: GeoStat

Figure II.42. Loans related to real estate




Source: NBG

Figure II.43. Annual growth of loans issued to the real estate development sector (excluding the exchange rate effect)

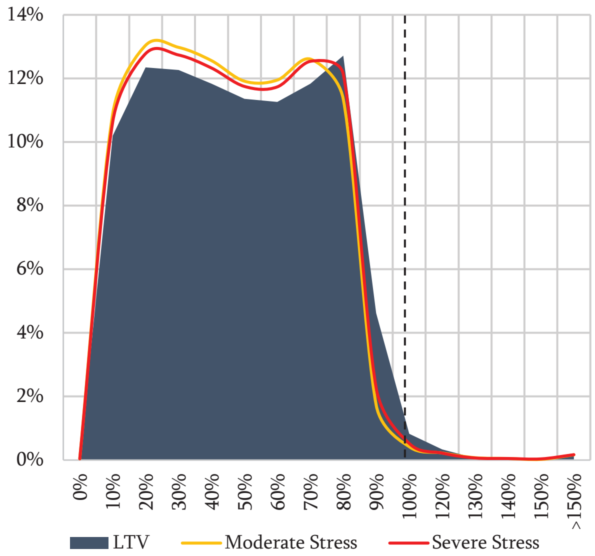



Source: NBG

## Sensitivity Analysis of Real Estate Sector

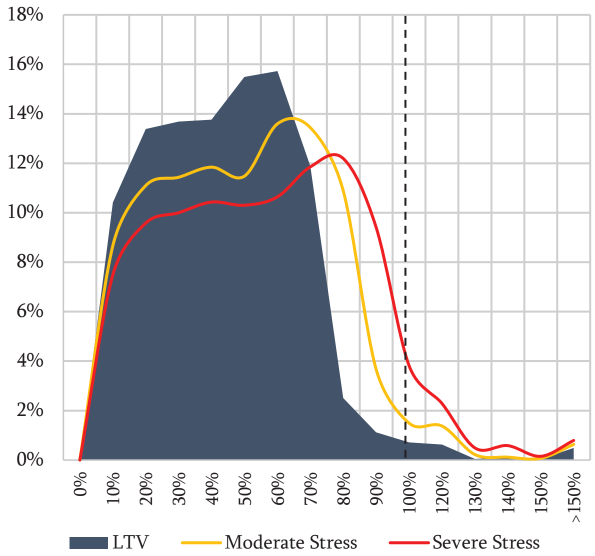
**Under the moderate-risk scenario[21], the loan-to-value ratio (LTV) distribution does not change significantly, while under the severe scenario, the share of mortgage loans with a loan-to-value ratio exceeding 100 percent increases up to 3 percent**. Under the scenarios of both moderate and severe stress, the distribution of loan-to-value for mortgage loans issued in the national currency does not change significantly (see Figure II.44). However, under the severe-risk scenario, if the national currency depreciates by 25 percent against the US dollar and the euro, and real estate prices expressed in national currency increase by 4 percent, then around 8 percent of mortgage loans issued in foreign currency will have a loan-to-value ratio of more than 100 percent, which is 6 percentage points higher than under the baseline scenario (see Figure II.45).[22] It should be noted that in the case of a realization of the moderate-risk scenario, around 4 percent of mortgage loans issued in foreign currency will exceed 100 percent of the LTV ratio. It is further worth mentioning that a sharp decrease in demand for residential real estate may worsen the quality of banks' real estate portfolios and contribute to the accumulation of systemic risks. Loans issued in foreign currency carry a relatively higher risk. In order to reduce that risk, since 2019, the National Bank of Georgia has determined the maximum LTV ratio at 70 percent for mortgage loans issued in foreign currency and at 85 percent for loans issued in the national currency. However, according to the principles of the responsible lending regulation, collateral only serves as an additional protection against risks, a borrower's solvency remains the main prerequisite for loan repayment.

Figure II.44. Distribution of the LTV ratio for mortgage loans issued in the national currency according to the risk scenarios




Source: NBG

Figure II.45. Distribution of the LTV ratio for mortgage loans issued in foreign currency according to the risk scenarios




Source: NBG

21 For more details, see the Macrofinancial Risk Scenarios section of this report.

22 The calculation uses the loan-to-value ratio (LTV) recorded in the current period.

## Box 2. Commercial Real Estate Price Index for Tbilisi

Commercial real estate is an important part of the real estate sector. Following the monetary policy tightening in developed countries and the slowdown of economic growth and structural changes caused by the pandemic, the real price of commercial real estate fell by 12 percent globally in 2023[23]. This could carry certain risks for economies, as well as the broader financial system. In the case of Georgia, the commercial real estate market is vulnerable to macroeconomic shocks and could become a source of financial stability risks. Monitoring the sector thus becomes particularly important.

This box presents the annual commercial real estate price index for Tbilisi, which is largely based on the Eurostat methodology[24] and uses commercial property prices available at the time of lending or on the balance sheet of local banks. The first step for calculating the index uses an econometric model, in which the dependent variable is price per square meter (in logarithmic form); while the independent variables include the various characteristics of commercial real estate: the total area of the property ($A^t$), the condition of the property ($C_j^t$) and its location ($D_i^t$). The condition of the real estate (j) includes three categories (requires renovation, black/white/green frame, and renovated), while location (i) includes four categories (where different districts are grouped taking into account their location and price per square meter). Therefore, each property could belong to one of 12 categories (renovated in the center, requiring renovation in the suburbs, etc.). Using the regression results, it is possible to evaluate the logarithmic price of a square meter $(\widehat{lnP_k^t})$ for each category of real estate:

$$\widehat{lnP_k^t} = \widehat{\beta_0^t} + \widehat{\beta_{C_1}^t} * C_1^t + \widehat{\beta_{C_2}^t} * C_2^t + \widehat{\beta_{D_1}^t} * D_1^t + \widehat{\beta_{D_2}^t} * D_2^t + \widehat{\beta_{D_3}^t} * D_3^t + \widehat{\beta_A^t} * \bar{A}^t$$

Where $\beta^t$'s represents the regression coefficients in period t. $C_j^t$ and $D_i^t$ represent the dummy variables for the condition and location of a property, which can take two possible values (1 or 0); while $A^t$ measures the average size of a property in period t. Therefore, in each period we determine the average size of commercial real estate and have 12 possible categories describing its location and renovation status, and for each of those 12 categories we estimate the corresponding logarithmic price per square meter. To calculate the weighted average price, we also use the corresponding weights of each category ($z_k^t$) in each period.

To derive the commercial real estate index, we calculate Laspeyres and Paasche indices using estimated prices and weights. These indices allow us to conduct a more complete analysis of different reasons for price changes over time. The Laspeyres index uses the weights ($z_k^0$) of different categories of commercial real estate in the base period (2019) and compares their weighted average price in each period to their weighted price in the base period. Therefore, the Laspeyres index measures how the price of the base period real estate changes over time:

$$P_{Laspeyres}^t = \frac{\exp\left[\sum_{k=1}^{12} \widehat{lnP_k^t} z_k^0\right]}{\exp\left[\sum_{k=1}^{12} \widehat{lnP_k^0} z_k^0\right]}$$

The Paasche index, on the other hand, measures how the current price of typical real estate changes compared to the base period:

$$P_{Paasche}^t = \frac{\exp\left[\sum_{k=1}^{12} \widehat{lnP_k^t} z_k^t\right]}{\exp\left[\sum_{k=1}^{12} \widehat{lnP_k^0} z_k^t\right]}$$

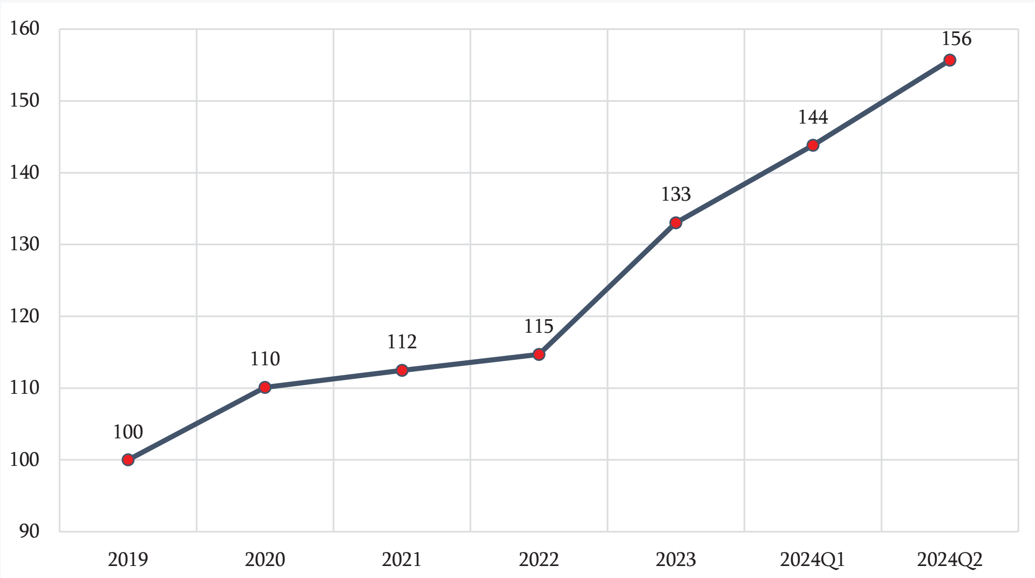
23 Global Financial Stability Report, April, 2024.

24 Handbook on Residential Property Price Indices (RPPIs), Eurostat (2013).

To derive the final index, we use the Fischer index, which is a geometric average of the Laspeyres and Paasche indices: $P_{Fischer}^{t}=[\ P_{Laspeyres}^{t} * P_{Paasche}^{t}\ ]^{0.5}$. Since the Laspeyres index does not consider the qualitative change in typical real estate over time (for example, it does not take into account that, as prices increase, people prefer to substitute commercial real estate with cheaper options), it overestimates the price of commercial real estate; the Paasche index, on the other hand, assumes that over time all properties are substituted and therefore underestimates the weighted prices. Also, the Laspeyres index does not consider a change in people's preferences, while the Paasche index completely changes consumer behavior in each period. By weighting these indices, we get the Fischer index, which constitutes a more balanced and complete measure of price change. Therefore, using the Fischer index, we are able to observe commercial real estate price dynamics.

Based on 2019-2024 data, commercial real estate prices in Tbilisi are rising; however, there was a significant slowdown during the pandemic, which can be explained by the drastic decline in economic activity and the rise of telecommuting. In 2023, the price growth reached double digits, a result of the base effect and high economic growth. Commercial real estate prices have continued to increase in the first and second quarters of 2024.

Figure B2.1. Commercial Real Estate Price Index for Tbilisi




Source: NBG, authors' calculations

# III. Financial Sector

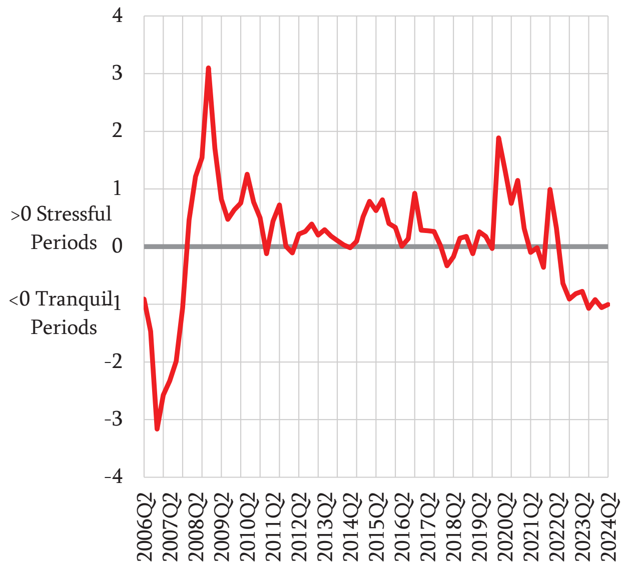
## Financial Sector review

*The financial sector is resilient and, as a result of the NBG's consistent supervisory policy, has accumulated solid capital and liquidity buffers. Despite a decrease, dollarization remains a significant challenge for the financial sector. However, considering the recently implemented macroprudential measures, it is expected that the trend of decreasing dollarization will continue, mitigating the associated risks.*

**Risks stemming from the global geopolitical situation remain, creating uncertainty regarding macroeconomic trends. Nevertheless, the Georgian financial system remains resilient and is well prepared to withstand possible shocks.** Similar to the previous year, the financial stress index (FSI)[25] has continued to decline, driven by improvements in liquidity, capital adequacy, and loan quality, as well as a decrease in volatility in the risk premium and exchange rate (see Figure III.1).[26] Thus, despite ongoing geopolitical tensions and heightened uncertainty about macroeconomic trends, the Georgian financial system is well prepared to withstand possible shocks.

**The loan growth rate has increased and is now above its long-term sustainable level. Amidst global uncertainty, if financial conditions tighten, maintaining this elevated growth rate could pose risks. However, it is expected that, with the normalization of high economic activity, loan growth will return to its long-term trend.** From the second half of 2023, the loan growth rate (excluding the FX effect) was above the nominal GDP growth rate (see Figure III.2). In June 2024, the growth rate of total loans amounted to 17.8 percent, which is above its long-term sustainable level.[27] It is worth men-

Figure III.1. Financial Stress Index (deviation from the average)




Source: NBG

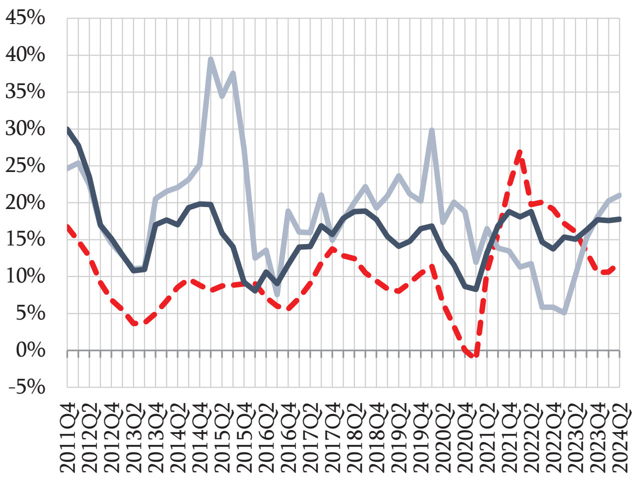
25 Considering the fact that the banking system accounts for more than 90 percent of the Georgian financial sector, the FSI mainly combines the profitability, interest rate spread, capital and asset quality indicators of the banking sector. In addition, the index combines the exchange rate and risk premium indicators. The index is constructed by standardizing the variables and then weighting them.

26 It should be noted that the improvement in the loan quality and capital adequacy indicators is partly due to the shift to IFRS 9 standards, which also contributed to the decline in the FSI.

27 The sustainable level of loan growth is where the growth rate aligns with potential GDP growth and the inflation target.

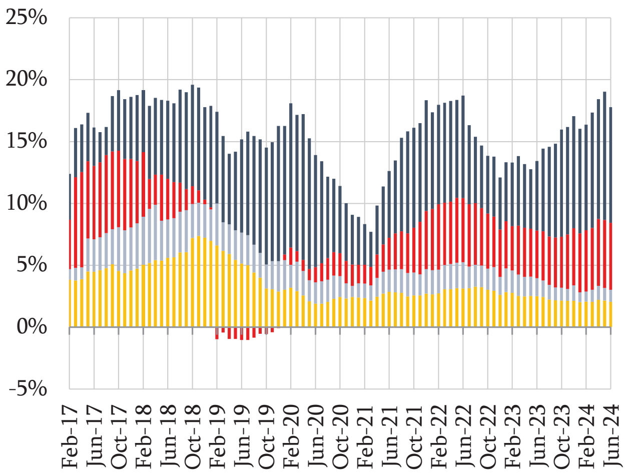
tioning that the share of variable interest rate loans amounts to 43 percent in GEL loans and 52 percent of those in foreign currency. Therefore, amidst global uncertainty, if financial conditions tighten, credit risk in the banking system will increase.[28] However, it is expected that, with the normalization of high economic activity, loan growth will return to its long-term trend. It should be mentioned that business loans made a contribution of 9.4 percentage points to the total growth of loans (see Figure III.3). The growth rate of consumer loans started to increase from September 2023, and in June 2024 amounted to 25 percent (see Figure III.4). This was partially caused by the increase in the maximum maturity period from three to four years. Considering the current tendency of lending activity, at the end of 2024, other things being equal, loan growth will be around 18 percent.

Figure III.2. Annual growth of nominal GDP[29] and credit[30]



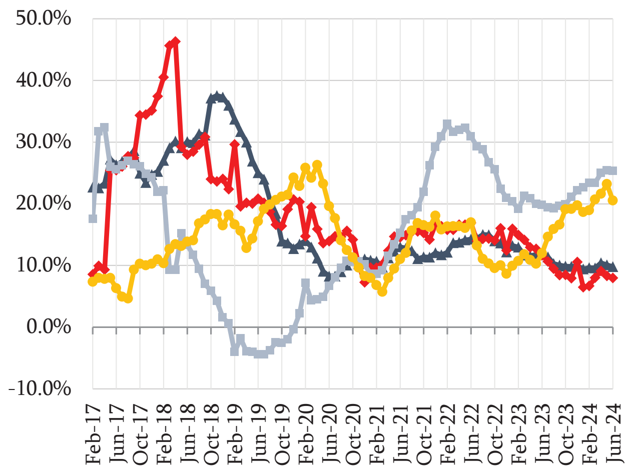

Source: NBG

Figure III.3. Decomposition of the annual growth rate of bank loans (excl. FX impact)




Source: NBG

Figure III.4. Annual growth rate of bank loans (excl. FX impact)




Source: NBG

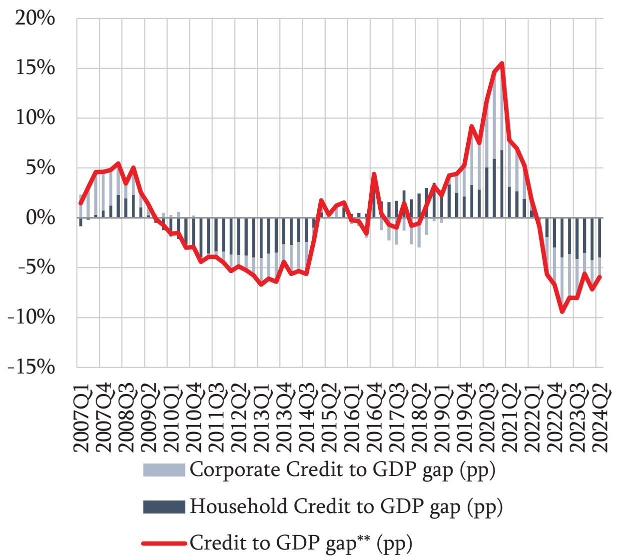
28 Resulting from a possible increase in foreign interest rates, risk premia, etc.

29 Nominal GDP is calculated using the data of four consecutive quarters.

30 Credit includes loans directly issued by commercial banks and microfinance institutions as well as bonds issued domestically by the non-financial sector.

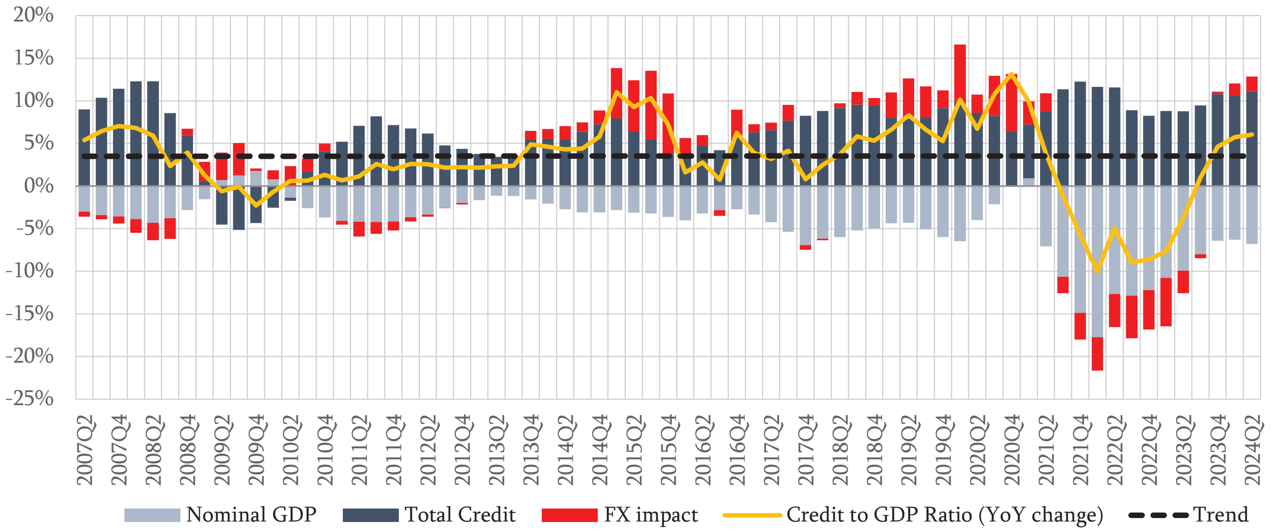
**Amidst strong economic activity, the credit-to-GDP ratio remains below its trend[31], and there is currently no need to adjust the cyclical component of the countercyclical buffer**. Over the past year, the credit-to-GDP ratio has continued to rise and, as of the second quarter of 2024, has become more closely aligned with its long-term trend (see Figure III.5). The increase in the credit-to-GDP ratio reflects the impact of high credit growth, with a smaller contribution also being attributed to the exchange rate depreciation (see Figure III.6). During the previous year, the NBG's Financial Stability Committee decided to set the cycle-neutral countercyclical capital buffer (base rate) at 1%. However, in order to mitigate the impact of globally tightened financial conditions on the local economy, the countercyclical capital buffer will only be accumulated gradually.[32] It is expected that, other things being equal, the credit-to-GDP ratio will gradually approach its trend by the end of 2024.

Figure III.5. Credit-to-GDP gap




Source: NBG

Figure III.6. Decomposition of the YoY change in the credit-to-GDP ratio



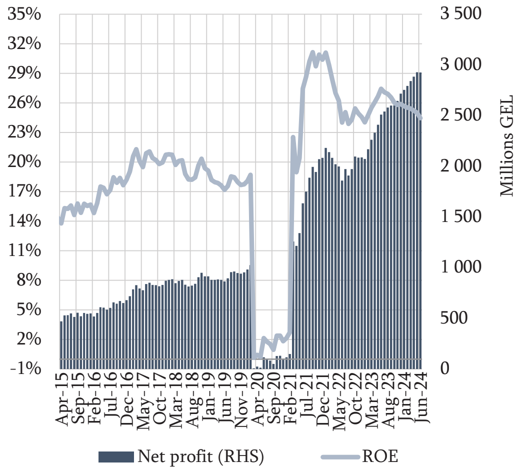

Source: NBG

31 The credit-to-GDP trend is estimated using an HP filter in line with the Basel recommendations (λ=400,000).

32 See: nbg.gov.ge/financial-stability/committee.

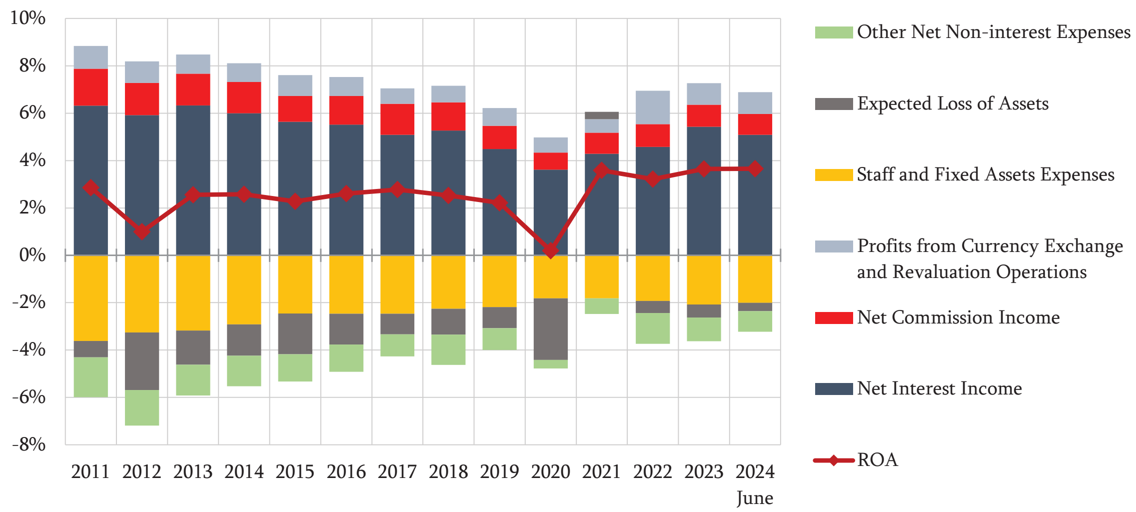
**The profitability indicators of the banking system remain stable**. Similar to the previous year, the profitability of the banking system continues to be at a solid level, primarily supported by low expected credit losses and increased net interest income due to heightened credit activity. If the current trend of profitability is maintained, it is expected that the ROE will be around 25 percent by the end 2024 (see Figure III.7). Strong profitability is an important source for increasing capital, and it provides banks with a significant buffer to absorb potential shocks. However, it is important to ensure that financial institutions do not accumulate excessive risks in an effort to make short-term profits. In recent years, the share of non-interest income in total income[33] has been largely stable and, in the second quarter of 2024, amounted to 30 percent. Income from foreign exchange trading and translation has made a significant contribution to the formation of non-interest income, the share of which was 43 percent in June. In addition, the share of net commission income is high, amounting to 44 percent (see Figure III.9). Non-interest income is generally considered to be a stable source of income due to lower procyclicality, but open banking and other initiatives stimulating competition will put pressure on such income.

Figure III.7. Profitability[34] in the banking sector




Source: NBG

Figure III.8. ROA decomposition for the banking sector

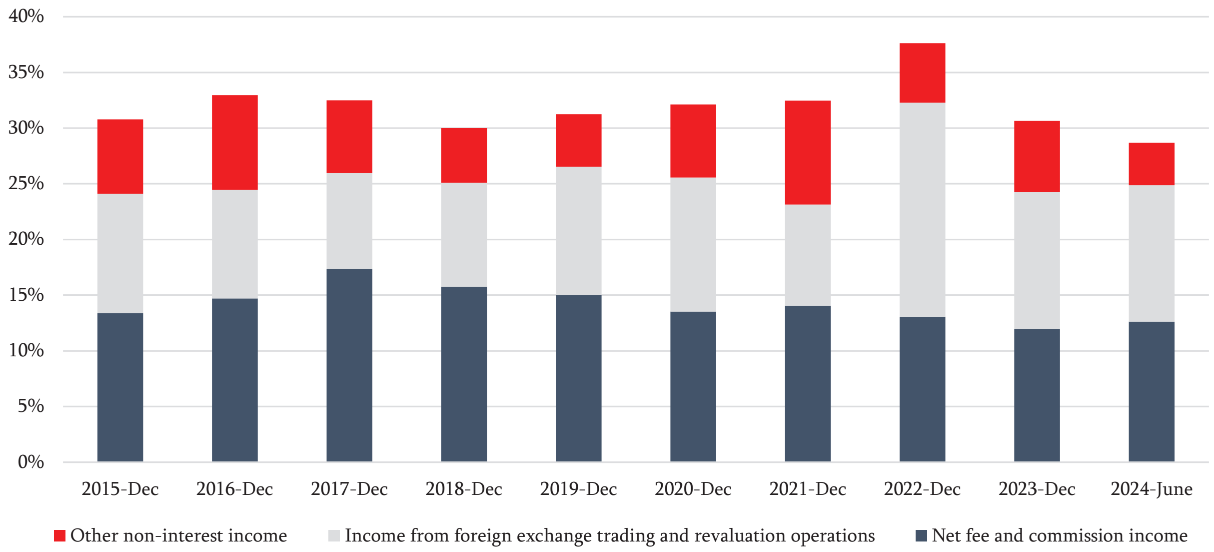



Source: NBG

33 Net interest income + non-interest income.

34 This calculation is based on the data of the last 12 months. In these calculations, NBG's net income is calculated as the sum of net interest income and net non-interest income less the amount of allowance for possible losses on loans and other financial assets, after allowing for contingencies and taxes. IFRS net income is calculated as the sum of net interest income (expense) and net non-interest income (expense) less expected losses and impairments, after income taxes.

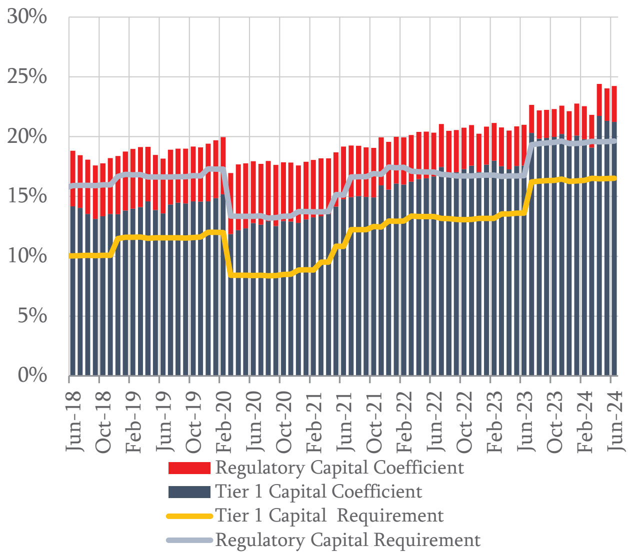
Figure III.9. The structure of non-interest income for the banking sector




Source: NBG

**As a result of historically stable profitability and the earlier implementation of supervisory requirements, the banking system remains well-capitalized to withstand potential shocks arising from the uncertain geopolitical situation**. The capital ratios of the banking system remain at a solid level (see Figure III.10). The accumulation of capital has been a result of both historically stable profitability and the requirements for additional supervisory capital. In addition to meeting minimal capital requirements, banks are required to hold combined buffers (conservation, countercyclical and systemic buffers) and the buffers under Pillar 2 (the unhedged currency-induced credit risk buffer, credit portfolio concentration risk buffer, net stress test buffer, net GRAPE buffer and the credit risk adjustment buffer (CRA)). It is noteworthy that, as a result of the transition to IFRS 9, the capital requirements have increased, which has mainly been driven by the introduction of the CRA buffer. The purpose for establishing the CRA buffer is to reduce the credit risk caused by insufficient expected credit losses set up for assets, and to determine an adequate capital buffer. It should be noted that all banks have fully restored the capital buffers that were released during the COVID-19 pandemic. In the first half of 2024, the majority of commercial banks maintained solid capital buffers (see Figure III.11).

Figure III.10. Capital adequacy in the banking sector (Basel III)[35]

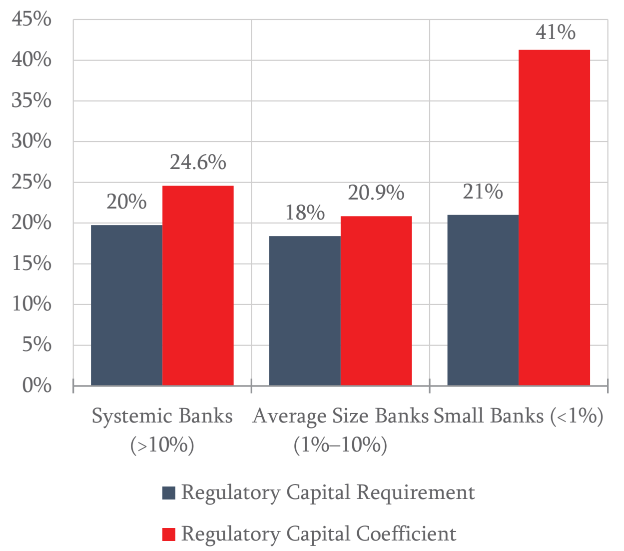



Source: NBG

35 The capital adequacy ratios were calculated using a local approach until June 2023, and according to the IFRS 9 methodology thereafter.

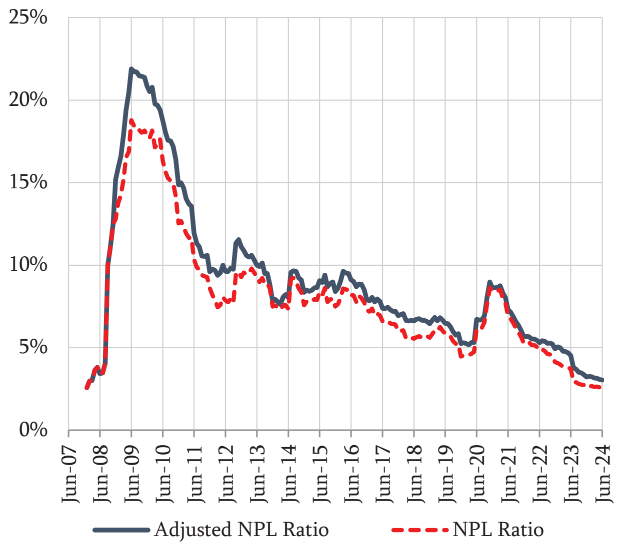
**The share of non-performing loans remains low**. The share of non-performing loans has continued to decline since the second half of 2023 and currently stands at 2.6 percent (see Figure III.12). It should be noted that the initial decline in the non-performing loan ratio was mainly due to the transition to IFRS 9. It should be noted that the non-performing loans coverage ratio remains at an adequate level. As of June 2024, the ratio of expected loan loss reserves to non-performing loans stood at 70 percent (see Figure III.13).

Figure III.11. Distribution of capital adequacy in the banking sector



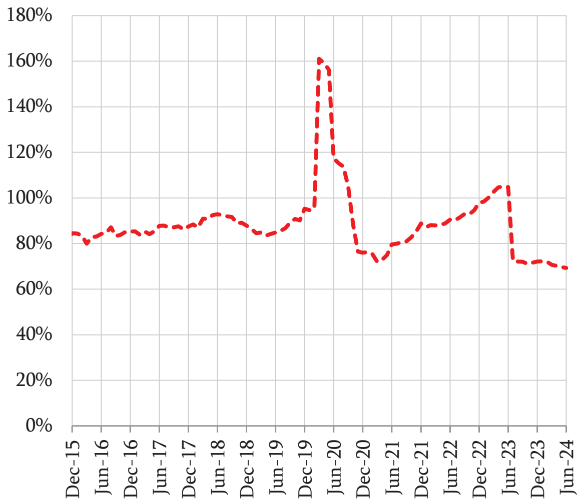

Source: NBG

Figure III.12. NPL ratio for bank loans[36]




Source: NBG

Figure III.13. NPL coverage[37] in the banking sector




Source: NBG

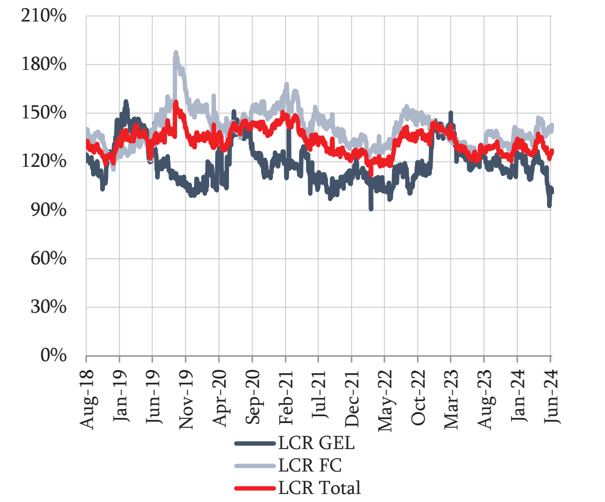
36 Until June 2023, the calculations were made according to the NBG's methodology, which includes non-standard, doubtful, and loss loan categories. However, from July 2023 onward, this indicator has been calculated according to IFRS 9.

37 Until June 2023, the calculations were made according to the NBG's methodology, as the ratio of the loan loss reserves to non-performing loans. However, from July 2023, it has been calculated according to the IFRS 9 methodology, as the ratio of expected credit loss reserves to non-performing loans.

**The banking system's liquidity profile remains balanced for both short- and long-term maturities**. The liquidity coverage ratio (LCR) for the banking system in both the domestic and foreign currencies significantly exceed the minimal requirements (see Figure III.14). Over the past year, the net stable funding ratio (NSFR) has consistently remained near 130 percent, significantly surpassing the minimum requirement of 100 percent. It is noteworthy that, compared to the previous year, the share of non-resident deposits remained unchanged, amounting to 18 percent in the current period (see Figure III.15). To reduce liquidity risks, the National Bank of Georgia maintains higher liquidity requirements for non-residents' deposits of natural and legal persons compared to residents' deposits. In 2023, there was a substantial rise in foreign currency deposits from Russian residents in Georgia. This increase posed a concentration risk and adversely impacted the liquidity position of the system. Consequently, the Financial Stability Committee decided to increase the liquidity requirement (outflow rate) from 40 to 80 percent for foreign currency deposits held by Russian residents. The outflow rate previously ranged between 30-40 percent. It is notable that the volume of accounts and deposits held by Russian residents has stabilized, although their share of total deposits has decreased compared to the previous year (see Figure III.16). At the same time, banks continue to hold the majority of these resources as liquid assets, without using them to replace long-term stable liabilities. Based on these assessments and considering the current geopolitical situation, a significant outflow of these deposits is less likely in the medium term. Accordingly, the Financial Stability Committee has decided to set the liquidity requirement for foreign currency deposits of Russian residents at a level similar to that of other non-resident deposits, averaging 40 percent. In addition, banks are recommended to regularly analyze the composition of their non-resident deposits and, if necessary, to mitigate risks by maintaining an adequate internal liquidity buffer.

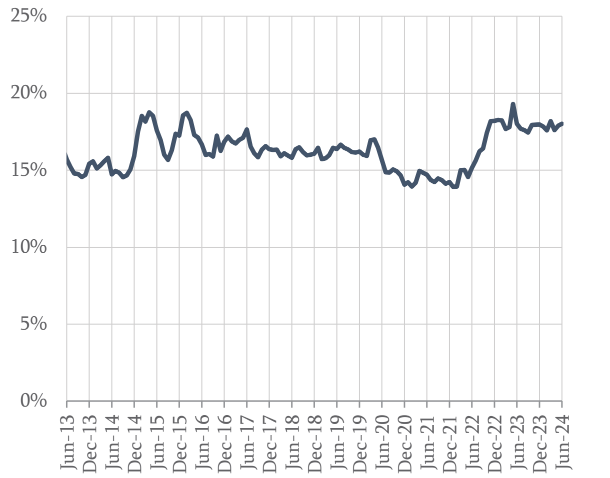
38 The minimal requirement of the LCR in GEL amounts to 75 percent, while for FX and in total it amounts to 100 percent.

Figure III.14. Liquidity coverage ratio (LCR) for the banking sector[38]



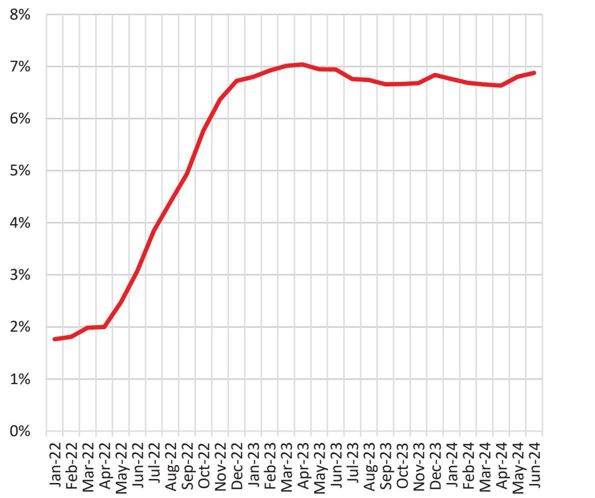

Source: NBG

Figure III.15. Share of non-resident deposits in total deposits




Source: NBG

Figure III.16. Share of deposits held by Russian residents

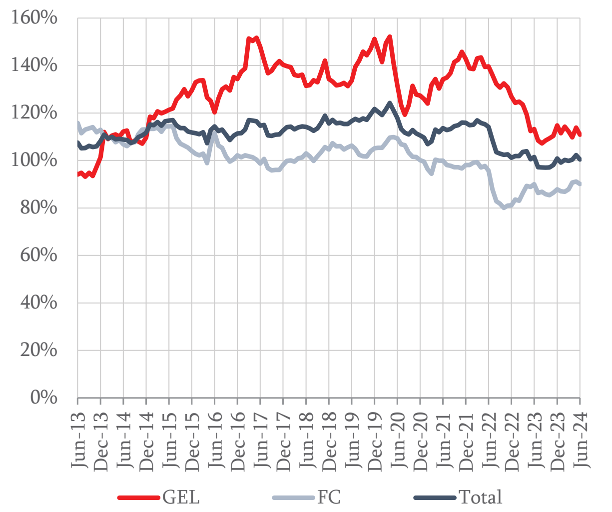



Source: NBG

**In recent years, the share of deposits used to finance GEL loans has been growing. However, it is crucial to actively attract more GEL deposits to reduce reliance on alternative funding sources**. Compared to June 2023, there has been a marginal decrease in the loan-to-deposit ratio, which can be attributed to the growth in GEL deposits during this period. Due to the measures implemented to support the de-dollarization policy, it is likely that the loan growth in GEL will increase. Therefore, although the loan-to-deposit ratio in GEL has reduced recently (see Figure III.17), it is crucial to actively attract more GEL deposits to reduce reliance on alternative funding sources.[39] However, despite the fact that, compared to deposits, borrowed funds are generally less stable sources of funding, such funds in Georgian commercial banks are mainly of a long-term nature and are mostly financed by parent or development-oriented international financial institutions, which reduces liquidity risks. It is also noteworthy that, in order to further diversify funding sources, a greater increase in the share of covered bonds in wholesale funding is necessary. The loan-to-deposit ratio in foreign currency remains in the range of 90 percent indicating that loans in foreign currency are financed through relatively stable funds. Therefore, the liquidity risk in foreign currency, in this regard remains low. Given that the NBG is more flexible in supplying liquidity in the local currency, the stability of foreign currency funding is crucial.

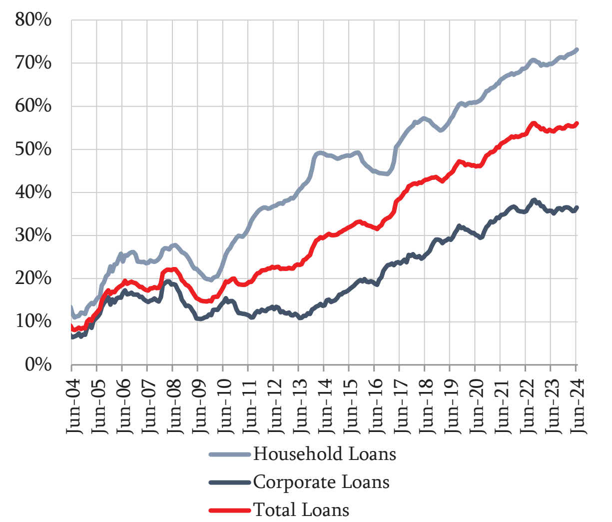
**In recent years, dollarization has declined but remains at a high level, and the risks associated with this are some of the main challenges facing the financial sector**. In recent years, the share of loans issued in the local currency has been increasing, and in June 2024, amounted to 56 percent (see Figure III.18). Despite a significant decline observed in recent years, dollarization remains at a high level (see Figure III.19) and increases credit risk in foreign currency more than in local currency. This is due both to the high proportion of variable-rate loans in foreign currency and to the fact that a large part of borrowers in foreign currency are still unhedged. Consequently, in the event of globally tightened financial conditions and increased volatility in the exchange rates of regional currencies, the financial system faces an increase in credit risk. In order to mitigate this risk, the NBG increased the limit for unhedged foreign currency loans to GEL 400,000 from 1 May 2024.[40] It should be noted that, in order to partially insure against currency-induced credit risk, banks are obliged to maintain an additional capital buffer. It is also noteworthy that, in recent years, deposit dollarization has declined significantly, but remains at a high level. In June 2024, compared to the same period of the previous year, the dollarization of total deposits, excluding the FX effect, decreased by 3.2 percentage points, settling at 49.5 percent. Additionally, resident deposits experienced a 2.8 percentage point decline in dollarization, reaching 42.2 percent.

Figure III.17. Loan-to-deposit ratio




Source: NBG

Figure III.18. Larization at a fixed exchange rate




Source: NBG

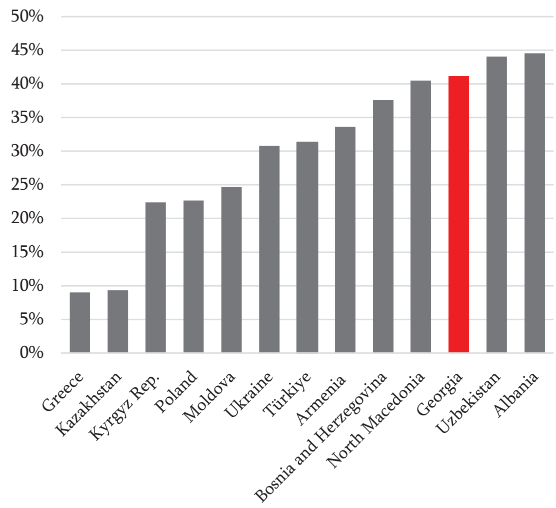
39 It should be noted that equity capital is denominated in GEL. Therefore, the loan-to-deposit ratio will be naturally higher in the domestic currency than in foreign currency.

40 See: https://nbg.gov.ge/en/financial-stability/committee

**The banking sector is highly concentrated; however, this does not limit competition in the market, as evidenced by the trend of decreasing interest rate spreads in recent years**. On the one hand, for systematically important banks, high levels of market concentration can lead to improved efficiency and increased asset diversification. On the other hand, high levels of concentration might be associated with low competition in the market. However, in the case of Georgia, over recent years, interest rate spreads have had a declining trend. Therefore, it can be concluded that high concentration does not prevent competition. It is also worth noting the improvement of the efficiency of the banking sector, as evidenced by the tendency of the reduction of the ratio of total non-interest expenses to income of the banking system (see Figure III.20).

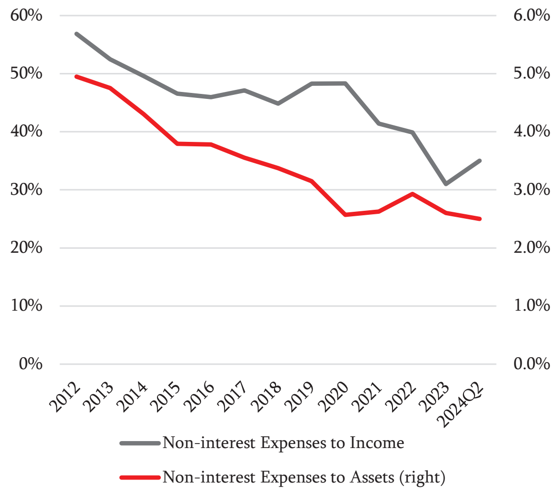
**The share of innovations and innovative organizations in the financial sector are increasing, serving to enhance competition and bring about new opportunities.** To foster responsible and innovative technologies in the financial sector, the National Bank of Georgia maintains effective communication with financial technology innovators through its Financial Innovation Office.[42] Throughout the year, the Financial Innovation Office maintained close contact with USAID, the German Economic Team (GET), BaFin, GFin, and other organizations regarding innovations in the financial sector, in order to exchange insights on new developments and supervisory approaches. It should also be noted that the NBG has developed a framework for a regulatory laboratory, which allows representatives of the financial sector to test innovative services and products in a supervised environment in real time.[43] In 2023, an innovative remote identification service of one entity participated in the real environment testing phase of the regulatory laboratory. In 2023, the National Bank of Georgia began collaborating with the BIS Innovation Hub (BISIH) on the topic of the digital lari. The NBG also joined the mBridge and Aurum projects of the BIS Innovation Hub's Hong Kong Center, gaining opportunities to share technologies, knowledge, and expertise. It is also noteworthy that in 2023, the NBG received the Central Bank Digital Currency (CBDC) Initiative award for its digital lari project.

Figure III.19. Loan dollarization by country (2023)[41]




Source: IMF

Figure III.20. The ratio of non-interest expenses to income for commercial banks




Source: NBG

**The banking sector has not experienced significant cybersecurity threats over the year. However, the expanding use of technology within the financial system does elevate such risks**. Globally, the number of cyberattacks has doubled compared to the pre-pandemic period. The financial sector is particularly vulnerable to such attacks, with approximately 20 percent of total cyber fraud targeting financial institutions. Moreover, against the backdrop of tense geopolitical situations, cybersecurity risks are becoming even more complex and threatening on a global scale.[44] In 2023, similar to the previous year, the banking sector primarily experienced phishing and distributed denial-of-service (DDoS) attacks, as a result of which hackers tried to steal confidential and sensitive information from customers for their own

41 The data for Armenia is taken from the website of the Central Bank of Armenia. According to the IMF, the dollarization of loans in Armenia in 2022 was 30 percent.

42 See https://nbg.gov.ge/en/page/financial-innovation-office

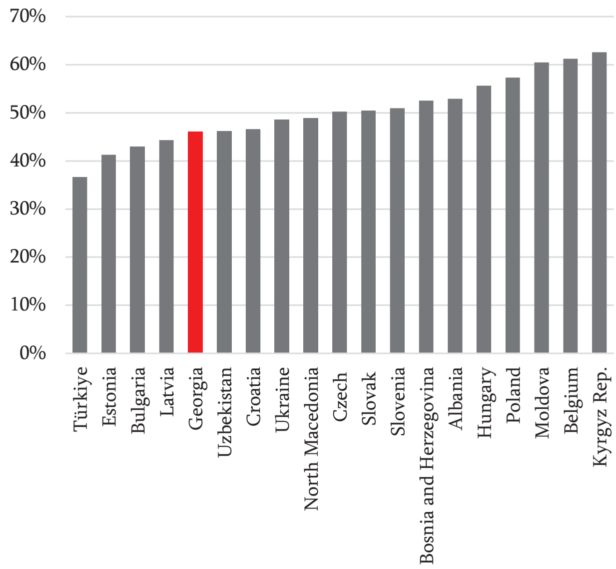
43 See https://nbg.gov.ge/en/page/regulatory-laboratory

44 See https://www.elibrary.imf.org/display/

use (in the case of phishing) and disrupted or attempted to disrupt commercial banks' services for a certain period (in the case of DDoS attacks). The NBG, together with commercial banks, actively worked to prevent such incidents by improving appropriate control mechanisms. With the development of remote service channels and financial technologies, ensuring and maintaining cybersecurity at an adequate level remains one of the most significant challenges for the financial sector. Taking this into account, the banking sector is required to implement and regularly assess cybersecurity control mechanisms within the established supervisory requirements for cybersecurity. It should be noted that, compared to the previous year, in 2023, the total operational losses of Georgian commercial banks decreased by 32 percent, amounting to GEL 29.7 million. Operational losses were primarily recorded in retail banking services and, to some extent, in commercial banking service business lines.

**The non-banking financial sector has solid capital buffers**. In the first half of 2024, the assets of the non-banking financial sector amounted to GEL 2.6 billion, which accounts for 3.0 percent of the total assets of the financial sector. The largest share of non-banking financial institutions' total assets, GEL 2 billion, belongs to microfinance organizations. In June 2024, compared to the previous year, the quality of the loan portfolio of microfinance organizations improved and the NPL ratio amounted to 4.7 percent. It is noteworthy that loan dollarization in the portfolios of microfinance institutions declined significantly to nearly 1.0 percent. In the recent period, the capital adequacy ratio for microfinance organizations amounted to 39 percent, which serves as an additional buffer against potential shocks.

Figure III.21. The ratio of non-interest expenses to income for commercial banks by country (2023)[45]




Source: IMF.

45 In the indicator calculated by the IMF's methodology, "commission and other expenses received from services" are included in non-interest expenses, while in Figure III.21 these expenses are deducted from non-interest income.

## Macro-Financial Risk Scenarios

*A quantitative assessment of financial sector resilience under various macrofinancial risk scenarios is an important part of financial stability analysis. The macrofinancial risk scenarios are based on the risks and vulnerabilities that have been discussed in the previous chapters of this report. In order to inform macroprudential policy about existing trade-offs and the impact of adverse external developments on the domestic economy and financial system, different risk scenarios are assessed over a three-year horizon.*

**Two risk scenarios are considered in order to capture the downside risks originating from adverse global and regional developments in the macrofinancial environment**. The moderate-risk scenario reflects reasonably likely and moderately adverse outcomes, while the severe-risk scenario replicates unlikely, but still plausible, instances of severe stress. This approach permits an examination of how the domestic economy would perform under varying degrees of stress and reveals the possible nonlinear effects of external shocks. The risk scenarios are benchmarked against a baseline based on the NBG's macroeconomic forecast as published in the July 2024 Monetary Policy Report.[46]

**The moderate-risk scenario considers an additional tightening of global financial conditions amid an escalation of regional conflicts worldwide and the tightening of global trade conditions**. The prolongation of the Russia-Ukraine war and the escalation of the conflict in the Middle East will lead to a sharp increase in oil prices and transportation costs. In the meantime, the ongoing geo-economic fragmentation in the world will cause additional supply chain disruptions and further limit trade flows. Amid high uncertainty regarding the geopolitical situation, prices on international markets are characterized by high volatility and inflationary risks remain. In response to emerging inflationary pressures and inflationary expectations, the world's leading central banks, such as the US Federal Reserve System (Fed) and the European Central Bank (ECB), will respond more rigidly than expected and will further tighten their monetary policies.

The additional tightening of global financial conditions creates risks of capital outflows from developing and emerging market economies. Due to such a risk, such countries postpone the easing of their monetary policies in order to mitigate the scope of the depreciation of local currencies and to limit additional inflationary pressures. Consequently, global financial conditions remain tighter for longer. All this, against the background of the unfavorable economic conditions and increased interest expenses in those countries, will put additional pressure on households and companies, and further delay the economic recovery.

In the moderate-risk scenario, capital outflows from Georgia's trading partner countries will hinder their economic growth, a result of globally tightened financial conditions stemming from high uncertainty amid the tense geopolitical situation. This negatively affects market sentiment and, consequently, decreases financial and trade flows in these countries. As a result of such risks in partner countries, a decrease of Georgia's trade revenues, and increasingly high uncertainty worldwide, risks of capital outflow from Georgia become apparent. Considering the current global challenges and Georgia's high dependence on the external sector, under this scenario, the sovereign risk premium of Georgia increases and will only start to decrease from 2026. Similarly, the exchange rate is under depreciation pressure due to a deteriorating external balance, tightened global financial conditions and increased risks of capital outflow. As a result, due to the still-high dollarization of loans, the debt burden for foreign currency borrowers increases and their solvency decreases.

In this scenario, households and companies reduce their consumption and investment spending amid deteriorating expectations and increased debt burdens. Some companies with financial stability risks will face solvency issues due to reduced revenues and increased debt-servicing costs. These risks become aggravated by the expected depreciation of the national currency and the high dollarization of loans. Furthermore, a decrease in both foreign and domestic demand could lead to a decrease in the activity of some businesses. Those less diversified companies, which mainly depend on the markets of the countries involved in the conflicts or that are under their direct influence, are particularly vulnerable. As a result, unemployment in the country increases and, due to reduced incomes, households also face difficulties in servicing their debt. The rise in credit risk worsens the availability of loans and further hinders the pace of economic recov-

46 See https://nbg.gov.ge/fm/პუბლიკაციები/ანგარიშები/მონეტარული_პოლიტიკის_ანგარიში/2024/2024q3-eng.pdf

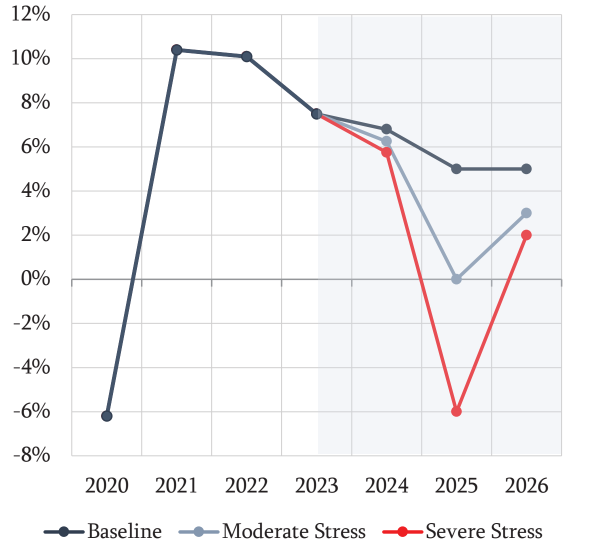
ery. Against the backdrop of the deteriorating macroeconomic environment, the economy of Georgia will stagnate in 2025, with economic growth gaining positive dynamics only from 2026.

Under the moderate-risk scenario, the disinflationary effect of weak demand will be overshadowed by the inflationary pressure resulting from the exchange rate depreciation, deficits in various goods due to trade restrictions, and an increase in oil prices. As a result, inflation will increase significantly in Georgia by the end of 2024. If trade restrictions are maintained, a higher-than-expected increase in interest rates in developed countries will lead to capital outflows in 2025, which will further exacerbate inflation. In the wake of increased actual inflation and inflationary expectations, the National Bank of Georgia will have to tighten its monetary policy this year. It will continue the tightening into 2025 and it will remain in a tightened state over the medium term.

According to the moderate-risk scenario, considering the unstable environment in the country, the high level of unemployment and tightened credit conditions, real estate activity will decrease in the medium term. At the initial stage, due to increased construction costs, amid increased labor force costs and a depreciated national currency, real estate prices expressed in GEL will increase. However, the attractiveness of the Georgian real estate as an investment asset is decreasing, which will significantly increase the demand-supply imbalance in the real estate market. As a result, prices expressed in GEL, due to high inflation, will continue to grow. Whereas due to the high depreciation of the GEL, real estate prices expressed in US dollars will fall. In the coming years, the increase in real estate prices will mainly be driven by an improvement of expectations, and the increase in aggregate demand. In the moderate-risk scenario, the total decline in GDP growth over the three-year period, as compared to the baseline scenario, is equal to approximately 7.5 percentage points.

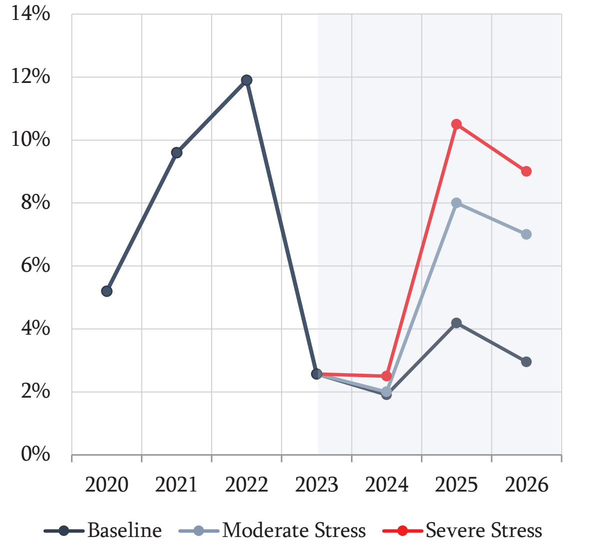
**According to the severe-risk scenario, the duration of global geo-economic fragmentation lasts longer than under the moderate-risk scenario, leading to fundamental changes in global markets.** In this hypothetical scenario, the aggravation of the ongoing conflicts in the world and the subsequent geo-economic fragmentation represent significant obstacles to the normalization of tightened global financial conditions. Escalation of existing conflicts creates immediate pressure on the prices of commodities. In addition, the uncertainty related to the duration of the conflicts will increase

Figure III.22. Risk scenarios: average annual real GDP growth (YoY)




Source: NBG staff estimates

Figure III.23. Risk scenarios: average annual CPI inflation




Source: NBG staff estimates

inflationary expectations. As a result, inflation will gain an upward trend globally, which puts the credibility of central banks at risk. Hence, the world's leading central banks respond with a sharper tightening of monetary policy. The long-term maintenance of tightened global financial conditions will also cause the so-called neutral level to rise to a relatively high level.

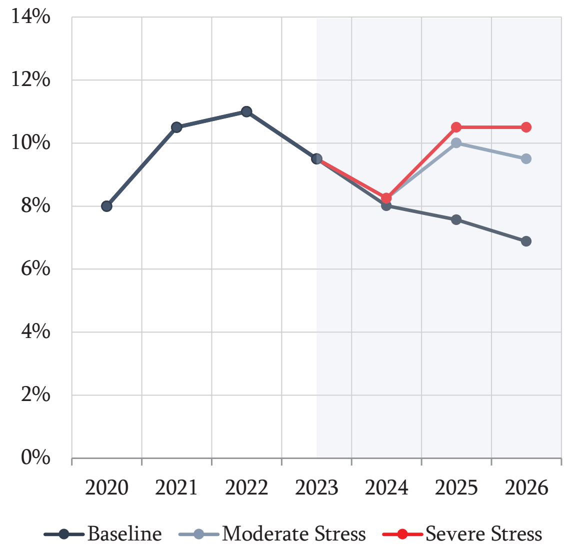
Under this scenario, worsening expectations and high uncertainty are followed by a reassessment of risks in global financial markets, leading to further tightening of financial conditions and a sharp decline in the value of investment assets. Following the ongoing structural changes and increased uncertainty in international markets, investors become more prudent, which causes capital outflows from emerging markets and developing economies to relatively low-risk, reliable assets. Such fundamental shifts will lead to significant changes in the global economic growth potential, which will be reflected in a medium-term decline in global activity.

Under the severe-risk scenario, developing countries with small open economies, will be in a particularly difficult position. Such countries, including Georgia's trading partners, will experience a massive outflow of capital due to the reassessment of risks; meanwhile, due to the tightened monetary policy as a response to increased inflationary pressures, the countries will also face stagflation risks. As a result, their sovereign risk premia rises significantly and their local currencies depreciate sharply.

In the severe-risk scenario, considering the deterioration of economic activity in trading partners, as well as the impeded trade flows due to geo-economic fragmentation, a decrease in foreign demand and a decline in Georgia's exports are expected, which will increase the country's current account deficit. At the same time, the weak foreign demand in Georgia will be accompanied by a significant decrease in domestic demand stemming from the sharply worsened expectations of households and companies. Considering the high dollarization of loans, a sharp tightening of financial conditions and the depreciation of the national currency will lead to a significant increase in the debt burden, which further drags down domestic demand. Due to the severely worsened financial condition of borrowers and the increased debt burden, the financial system suffers significant losses and the subsequent tightening of credit conditions aggravates the economic situation even further. Against the backdrop of high uncertainty and worsening financial conditions, some businesses facing solvency problems reduce their production scale, while some cease operations. All this significantly increases the level of unemployment in the country and additionally reduces domestic demand. Along with the outflow of capital, a sharp increase in the level of unemployment will significantly deteriorate the production potential of the country, which worsens expectations of a recovery of the business sector and the economy as a whole in the medium term.

In the severe-risk scenario, domestic production decreases, which creates a shortage of some types of goods and, consequently, causes an increase in prices. In addition, due to the significant depreciation of the exchange rate, the contribution of the imported component of inflation and intermediate costs also increase.

Figure III.24. Risk scenarios: annual average monetary policy rate




Source: NBG staff estimates

As a result, inflation will be higher compared to the moderate-risk scenario, and a decrease is expected only from 2026. To reduce inflationary expectations, there is a prerequisite to tighten the monetary policy even further than under the moderate-risk scenario. However, along with the recessionary risks arising from the deteriorating macrofinancial environment, which are accompanied by declining economic potential due to fundamental factors, the risks of a protracted recovery of the economy over the medium term are also apparent. Accordingly, while the initial tightening of the monetary policy would be carried out with a trajectory similar to that under the moderate-risk scenario; the subsequent return to the neutral level would take place at a relatively slow pace.

According to the severe-risk scenario, as a result of the significantly worsened macroeconomic environment in the country, along with increased risk aversion among investors, Georgia's risk premium increases. This is reflected in capital outflows in the initial stage, and in the delay of inflows of new investments in the later period. The decrease in financial inflows in the country, as well as high uncertainty, would significantly reduce activity in the real estate market. Depreciation of the GEL, increased costs of labor and construction materials will push real estate prices higher. However, as a result of the increased risk and the deteriorating macroeconomic situation in the country, the Georgian real estate sector will lose its attractiveness for investors. As a result of excess supply of and low demand for real estate, there will be downward pressure on real estate prices, which will negatively affect the balance sheets of financial institutions and further hinder the recovery of the economy. In the severe-risk scenario, the total decline in GDP growth over the three-year period, as compared to the baseline scenario, is equal to approximately 15 percentage points.

Table III.1. Macro-financial risk scenarios*

| Variable \ Scenarios | Current value* | Baseline scenario | | | Moderate risk scenario | | | Severe risk scenario | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | 2024 | 2025 | 2026 | 2024 | 2025 | 2026 | 2024 | 2025 | 2026 |
| Fed Funds Rate | 5.5% | -0.25 pp | -1.0 pp | -1.0 pp | +0.0 pp | +0.5 pp | -1.0 pp | +0.5 pp | +1.5 pp | -1.0 pp |
| ECB Policy Rate | 4.25% | -0.25 pp | -0.75 pp | -0.75 pp | +0.0 pp | +0.75 pp | -1.0 pp | +0.25 pp | +1.5 pp | -0.5 pp |
| Country Risk Premium | 2.6% | +0.0 pp | +0.65 pp | -0.25 pp | +0.15 pp | +1.75 pp | -0.5 pp | +0.4 pp | +2.5 pp | -1.0 pp |
| GEL/USD Nominal Exchange Rate** | 2.72 | Appr. 0% | Appr. 0% | Appr. 0% | Depr. 12% | Depr. 10% | Appr. 5% | Depr. 15% | Depr. 25% | Appr. 10% |
| Nominal Effective Exchange Rate Index (1995=100)** | 396.9 | Appr. 0% | Appr. 0% | Appr. 0% | Depr. 8% | Depr. 6% | Appr. 3% | Depr. 10% | Depr. 15% | Appr. 6% |
| Change in Real Estate Prices (in GEL, YoY) | 13.1% (2023) | 8.5% | 6.5% | 5.5% | 8.0% | 6.0% | 4.5% | 8.0% | 4.0% | 3.0% |
| Real GDP Growth (YoY) | 7.5% (2023) | 6.8% | 5.0% | 5.0% | 6.25% | 0.0% | 3.0% | 5.75% | -6.0% | 2.0% |
| Unemployment Rate | 16.4% (2023) | -2.7 pp | +0.0 pp | -0.2 pp | -2.4 pp | +3.0 pp | +1.0 pp | -2.4 pp | +5.5 pp | +2.5 pp |
| CPI Inflation (YoY) | 2.6% (2023) | 1.9% | 4.2% | 3.0% | 2.0% | 8.0% | 7.0% | 2.5% | 10.5% | 9.0% |
| Monetary Policy Rate*** | 8.0% | +0.0 pp | -0.4 pp | -0.7 pp | +0.25 pp | +1.75 pp | -0.5 pp | +0.25 pp | +2.25 pp | +0.0 pp |

* The values under each scenario display the average change in the corresponding macrofinancial indicators compared to the previous period. The numbers for 2024 show changes relative to the current values. The current values correspond to 31 July 2024, unless otherwise stated.

** In the scenarios, the change of the exchange rates in the current year refers to the period remaining until the end of the year. The exchange rate change in the following year reflects the change compared to the December average rate of the current year.

*** The current value of the monetary policy rate reflects the Monetary Policy Committee's decision made on 30 July 2024. In the scenarios, the change in the monetary policy rate corresponds to the change in the value of the rate of the given year. The assumption for the current year in the scenarios refers to the period remaining until the end of the year.

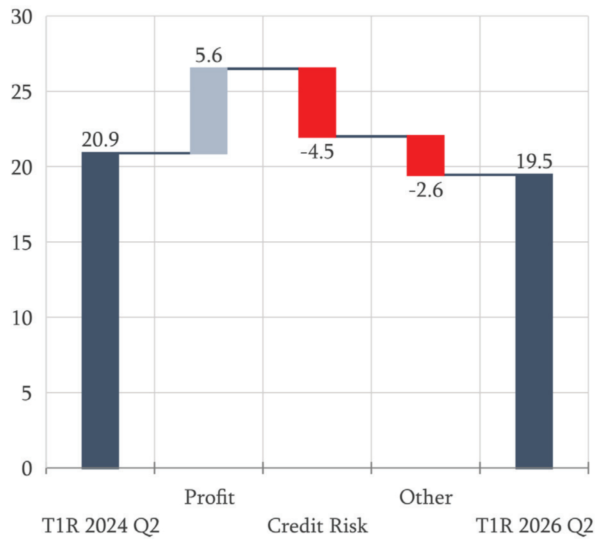
## Financial Sector Resilience

*This section provides a quantitative assessment of the resilience of the banking sector in terms of the macrofinancial risk scenarios discussed above. According to the results of stress tests, the banking sector remains resilient even under the most severe scenario. Despite facing high credit losses in the event of a realization of the severe-risk scenario, the existing buffers will allow the banking system to maintain an adequate capital level. It should be noted that stress tests provide an analysis of hypothetical risk scenarios, and the results attained are thus conditional.*

**Despite losses, the banking sector maintains a capital ratio well above the regulatory threshold in both the baseline and moderate-stress scenarios.**[47] According to the baseline scenario, exchange rate stability, a reduction in unemployment, and the normalization of real economic growth over time improve the ability of households and companies to service their debts. Credit risk thereby declines. In addition, banks maintain solid profitability and the banking sector's Tier 1 capital ratio remains at around 22 percent over the three-year horizon, which is well above the regulatory minimum. Under the baseline scenario, each bank individually maintains an adequate level of the Tier 1 capital ratio. Under the moderate scenario, the exchange rate fluctuation and an increase in interest rates weaken households' and firms' abilities to service their debts, which increases credit risk. However, the operating profits of banks offset losses, and the capital adequacy ratio thus declines slightly to 20.7 percent.

**The realization of the severe-risk scenario would impose significant losses on the banking sector, but the sector's overall Tier 1 capital ratio would remain above the regulatory threshold**. Based on this scenario, in 2025, economic activity declines significantly, the country's risk premium increases, the exchange rate fluctuates considerably, and interest rates increase. Thereby, banks face sizeable credit losses and their net profit declines. The revenue generated over the first two years increases the capital coefficient by 5.6 percentage points, which is not enough to compensate for the -4.5 percentage points drop in the capital ratio caused by the credit losses (see Figure III.25). Therefore, under this scenario, the capital ratio significantly deteriorates, and the banking system has limited resources to provide loans to the economy. However, it should be noted that, even under the severe-risk scenario, the existing capital buffers would ensure a mitigation of potential losses. According to the scenario, at the end of 2026, some banks would need additional capital to maintain the minimum Tier 1 capital adequacy ratio. However, according to current estimates, the ownership structure of the banks would enable them to attract additional capital. Therefore, the capital losses identified under this scenario are not significant enough to constitute a risk to the sector's stability or resilience. It should also be noted that under this scenario, starting from 2027, the capital adequacy of banks starts to gradually recover as a result of improved asset quality and stable operating profits (see Figure III.26).

Figure III.25. Decomposition of the change in the Tier 1 capital ratio of the banking sector under the severe-risk scenario(%)[48]



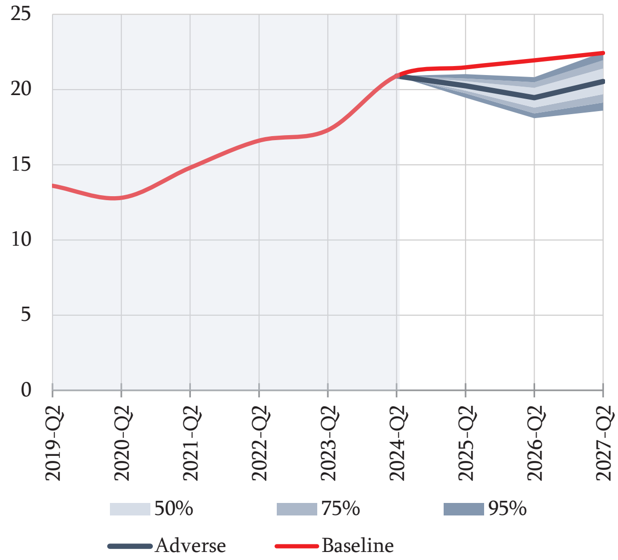

Source: NBG

47 The data for the stress test has been updated in accordance with IFRS 9. However, the old approach was still used to assess credit losses. Work is underway to implement a new IFRS 9-compliant methodology for calculating expected credit losses.

48 Other factors include the sum of the revaluation effects of assets and additional capital due to exchange rate volatility. Also, it should be noted that the total capital requirement for medium banks is in the 12.8-22.5% range, and for large banks is in the 13.5-16.6% range.

**According to reverse stress testing, the banking sector is able to mitigate an additional GEL 9.1 billion credit losses**. The goal of reverse stress testing is to assess the level of economic shocks and increased losses under which capital buffers, on top of the minimum capital requirements (the sum of minimal and combined requirements[49]), fully deplete. Considering the current level of capital adequacy, an 11.5 percent decline of capital buffers was analyzed, which equals credit losses of around GEL 9.1 billion. The non-performing loan ratio would need to increase 13-fold and exceed 30 percent to result in such losses. These losses could be incurred through different scenarios; however, in aggregate, real economic growth would need to decline by 6 percent in 2024 and by 13 percent in 2025. Additionally, there would need to be a significant depreciation of the exchange rate. It should be noted that reverse stress testing, as with the top-down stress test, does not assume any active response to the shocks from banks nor any change to their business models that might help them mitigate losses.

Figure III.26. Tier 1 ratio under the baseline and severe-risk scenarios (%)




Source: NBG

49 The combined buffer requirement includes the capital conservation, countercyclical and systemic risk buffers.

## Box 3. Climate Stress Test Exercise for the Georgian Financial System[50]

Climate-related risks, encompassing both physical and transition risks, could pose a significant threat to financial stability. Physical risks, such as extreme weather events (e.g., extreme precipitation and wind events) could cause an immediate and severe disruption of economic activity, while transition risks, associated with the shift towards a low-carbon economy, could result in long-term structural changes to the economy. Both types of risk have the potential to adversely impact asset values, increase credit risk, and disrupt the functioning of financial markets, thereby threatening the stability of the financial system.

Therefore, it is crucial for financial authorities to systematically assess climate-related risks to ensure that financial institutions are prepared for potential adverse impacts. Stress testing serves as a vital tool in this assessment process, enabling the evaluation of the resilience of banks and other financial entities to various climate-related scenarios. The National Bank of Georgia has developed a comprehensive Climate Stress Testing Framework that integrates multiple analytical modules to assess acute physical risks, as well as transition and chronic physical risks. The framework has been developed in accordance with international standards, which contributes to the reliability of the results derived from the stress tests.

The NBG's Climate Stress Testing Framework employs a top-down approach, utilizing its existing stress testing methodology and incorporating various satellite models and tools. In the assessment of climate-related vulnerability, this framework evaluates risks at the level of both household and corporate portfolios.

The framework includes four core modules:

- **The Acute Physical Climate Risk Module** aims to assess the immediate impacts of extreme weather events on the Georgian economy and its financial system. This module utilizes historical data, scenario construction, and advanced modeling techniques to project the economic damage associated with specific hazards such as extreme precipitation and wind events. These projections are then used to evaluate potential broader economic impacts, including changes in GDP and sectoral outputs.
- **The Transition Risk and Chronic Physical Risk Module** aims to evaluate risks associated with gradual climate change and the transition to a low-carbon economy for the Georgian economy and its financial system. By analyzing scenarios such as delayed transition pathways, this module examines how abrupt policy changes, technological shifts, and market dynamics might affect the financial sector.
- **The Stress Test Module for the Corporate Sector** aims to evaluate the potential impact of various climate change scenarios on the share of non-performing loans (NPLs) for corporate portfolios and, therefore, on the capital adequacy of the banking sector. The analysis utilizes the acute physical, transition and chronic physical risk scenarios to project sector-specific NPL ratios under the various climate scenarios. This module allows for a detailed analysis of how different industries might be affected by climate-related risks, particularly those that are more carbon-intensive or less able to pass on costs associated with climate policies to consumers.
- **The Stress Test Module for the Household Sector** aims to evaluate the impact of climate-related risks on household loans. By utilizing projections of key variables, such as real estate prices and loan-to-value ratios under different climate scenarios, it evaluates their potential impact on non-performing loans and capital adequacy ratios.

Each of these modules are interconnected and this unified framework serves

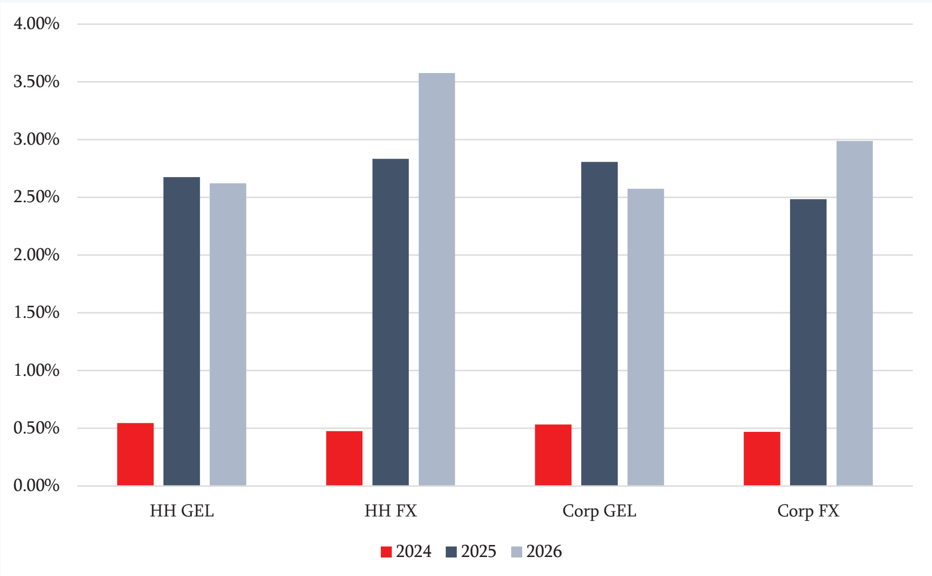
50 As the climate stress test is under development, the results described in this section may undergo slight changes.

to evaluate the potential economic disruption and financial stability challenges posed by climate change.

The results of the first climate stress test for Georgia's financial sector, presented as the change in the share of non-performing loans and capital adequacy ratios, are provided in the diagrams below.

The climate stress test evaluates the resilience of the financial system under three alternative scenarios compared to a baseline scenario. The forecasts of the macroeconomic variables in the baseline scenario are derived from the NBG's models and evaluations and are consistent with the forecasts published in the Monetary Policy and Financial Stability Reports. The alternative scenarios under the current stress test represent various climate change risk scenarios: a short-term disorderly (STD) scenario and two acute physical risk scenarios. The STD scenario is designed to simulate the economic consequences of a rapid and abrupt transition to a low-carbon economy compressed within a three-year period.[51] This scenario combines transition and chronic physical risks. Figure B3.1 presents the growth in NPL ratios under the STD alternative scenario compared to the baseline. Under that alternative scenario, the NPL ratios of both households and corporations increase significantly in both local and foreign currency.

Figure B3.1 Effect of transition and chronic physical risks on NPLs compared to the baseline (pp)




Source: NBG

The capital losses projected under the STD scenario are presented in Table B3.1. The results indicate lower capital adequacy ratios than under the baseline scenario, with the difference being most pronounced by the end of 2026. In this period, the Tier 1 capital ratio is 1.4 percentage points lower than the baseline value.

Table B3.1 Effect of transition and chronic physical risks on capital compared to the baseline (pp)

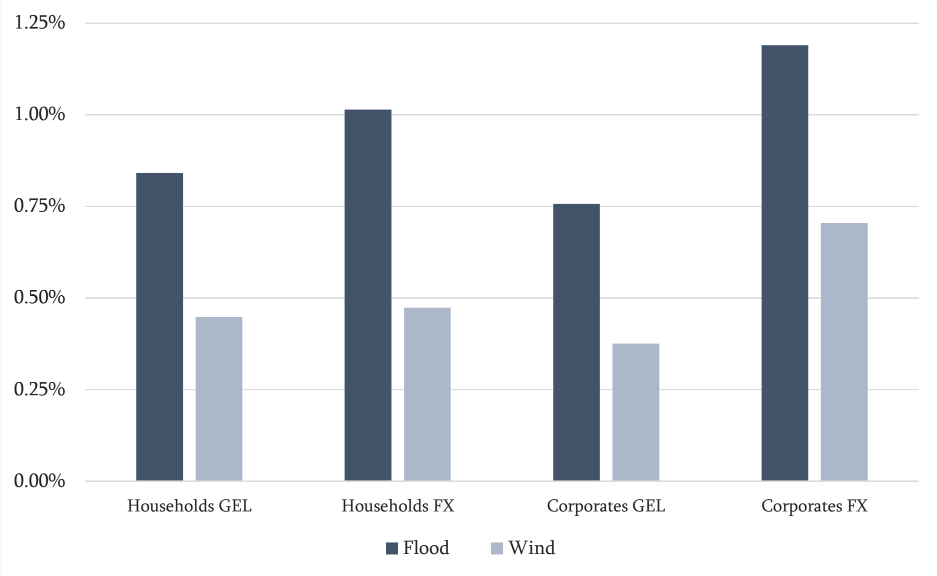
| | 2024 | 2025 | 2026 |
|---|---|---|---|
| Total capital adequacy ratio | -0.45% | -0.99% | -1.29% |
| Tier 1 capital ratio | -0.46% | -1.08% | -1.40% |
| Core tier 1 ratio | -0.48% | -1.15% | -1.50% |

Source: NBG

51 The forecast horizon for the climate stress test includes the years 2035, 2040 and 2045. However, to ensure consistency with the existing stress test model, the effect of climate risk on macroeconomic variables is translated to the years 2024, 2025 and 2026.

To examine the impact of acute physical risk, two scenarios related to extreme weather events are considered. One scenario evaluated risks related to extreme precipitation and the other evaluated the impact of extreme wind events. Unlike transition risks, the results of the physical risk scenarios are accumulated into one period. Figure B3.2 presents the change in the NPL ratio under the different physical risk scenarios compared to the baseline scenario. The analysis indicates that the banking sector's NPL ratios increase more in the case of extreme precipitation. Therefore, capital losses are also higher under this scenario as compared to the scenario with extreme wind events. A detailed description of the deviations of capital ratios compared to the baseline are presented in Table B3.2.

Figure B3.2 Effect of acute physical risks on NPLs, compared to the baseline (pp)




Source: NBG

Table B3.2 Effect of acute physical risks on capital, compared to the baseline (pp)

| | Flood | Wind |
|---|---|---|
| Total capital adequacy ratio | -0.94% | -0.86% |
| Tier 1 capital ratio | -0.95% | -0.87% |
| Core tier 1 ratio | -0.96% | -0.87% |

Source: NBG

Based on the results of the climate stress test, the potential losses related to a materialization of various climate risks are noteworthy. However, it should be noted that the banking sector is highly capitalized and remains resilient to such risks.

# IV. Financial Stability Policy Measures and Recommendations

*Ensuring the sustainable functioning of the financial sector in Georgia and fostering financial stability are among the key responsibilities of the National Bank of Georgia. To achieve this, the NBG has implemented a number of macroprudential and microprudential measures in previous years. As a result of the supervisory measures implemented by the NBG and the improvement in existing financial indicators, the financial sector is resilient and well prepared to withstand potential stress arising from the global geopolitical situation. Banks have fully restored the buffers that were released during the pandemic, and the banking sector has sufficient resources to provide credit to the economy. However, recently, the growth rate of loans has increased to exceed its sustainable long-term level. If this pace of loan growth continues, certain risks may emerge, potentially necessitating the implementation of appropriate measures. Despite the high loan growth, due to strong economic activity, the credit-to-GDP ratio remains below the trend. At this stage, there is no indication of a need to adjust the cyclical component of the countercyclical capital buffer. The National Bank of Georgia is continuously monitoring the situation and is actively continuing its efforts to support the resilience of the financial system.*

**As a result of the financial stability policies implemented by the National Bank of Georgia over time, the financial sector remains resilient and is prepared to withstand potential stress arising from the global geopolitical situation**. As of June 2024, banks maintained healthy capital and liquidity indicators, while asset quality improved compared to the previous year. The profitability indicators of the banking system remain stable, primarily being supported by low expected credit losses and increased net interest income due to heightened credit activity. The results of the top-down stress test also indicate the resilience of the financial sector; although credit losses increase significantly under the severe-risk scenario, the banking system maintains capital at an adequate level, thanks to solid capital buffers, and continues its lending activity.

**In order to mitigate the impact of globally tightened financial conditions on the local economy, the countercyclical capital buffer will be accumulated gradually, in alignment with the November 2023 decision of the Financial Stability Committee**. During the previous year, the Financial Stability Committee decided to set the cycle-neutral countercyclical capital buffer (base rate) at 1%. However, in order to mitigate the impact of globally tightened financial conditions on the local economy, the countercyclical capital buffer will be accumulated gradually. Banks will be required to accumulate a cycle-neutral buffer according to the following schedule: 0.25 percent by 15 March 2024, 0.5 percent by 15 March 2025, 0.75 percent by 15 March 2026, and 1 percent by 15 March 2027.

In June 2024, the growth rate of total loans amounted to 17.8 percent, which is above its long-term sustainable level. Amid global uncertainty, maintaining a high level of loan growth in the event of potentially tightened financial conditions poses risks. It should be mentioned that business loans made a contribution of 9.4 percentage points to total growth. However, from September 2023, the growth rate of consumer loans increased and, in June 2024, amounted to 25 percent. This was partially caused by the increase in the maximum maturity period from three to four years. Despite the high loan growth, amidst strong economic activity, the credit-to-GDP ratio remains below its trend, and there is currently no need to adjust the cyclical component of the countercyclical buffer. It is expected that, other things being equal, the credit-to-GDP ratio will gradually approach its trend by the end of 2024.

**The NBG continues to actively work on reducing structural risks arising from the high level of financial dollarization**. Despite the positive trend in recent years, dollarization and associated risks remain a significant challenge for the financial sector. Loans denominated in foreign currency, mostly with variable interest rates, carry interest rate and exchange rate risks, which are particularly concerning given the high share of unhedged borrowers with foreign currency loans, the increased exchange rate volatility of regional currencies, and the globally tightened financial conditions. To mitigate these risks, the NBG increased the limit on unhedged foreign currency loans from GEL 200,000 to GEL 300,000 on 1 January 2024. In April, considering the positive macroeconomic and macrofinancial environment, the Financial Stability Committee further raised that limit to GEL 400,000, which became effective as of 1 May 2024. The NBG continues to actively work on reducing the structural risks arising from the high level of dollarization.

**To promote financial stability, the National Bank of Georgia has implemented a Minimum Requirement for Own Funds and Eligible Liabilities (MREL) for systemic banks from 2024.** Within the scope of the joint Financial Sector Assessment Program (FSAP), conducted in Georgia in 2021 by the IMF and the World Bank, certain recommendations were made to the National Bank of Georgia. One of these was to establish the Minimum Requirement for Own Funds and Eligible Liabilities (MREL) for domestic systemically important banks within the resolution framework of the National Bank of Georgia. The requirement represents a percentage derived from the ratio of eligible liabilities and capital instruments to total liabilities and regulatory capital. The MREL for systemic commercial banks is determined under the following amounts and terms: 10 percent from 1 January 2024, 15 percent from December 2025, and 20 percent from December 2027. Moreover, banks are also required to submit a relevant MREL report to the National Bank of Georgia every month (see Box 4). Establishing this requirement ensures compliance with the recommendations issued by the joint mission of the IMF and the World Bank within the scope of the FSAP, and it also allows for closer approximation to the European Bank Recovery and Resolution Directive.

**The banking system's liquidity profile remains balanced for both short- and long-term maturities**. In recent years, the available stable funding of the banking system has significantly exceeded that required, resulting in a net stable funding ratio of around 130 percent. Additionally, the liquidity coverage ratio, in both foreign and local currencies, considerably exceeds the minimum requirement. It should be noted that the share of non-resident deposits has not changed compared to the previous year and remains around 18 percent. To mitigate liquidity risks, the NBG maintains higher liquidity requirements for deposits placed by non-resident individuals and legal entities compared to residents. In 2023, in order to mitigate the risks arising from the excessive growth of foreign currency deposits placed by Russian residents in Georgia, the NBG increased the liquidity requirement (outflow rate) to 80%. However, since then, the volume of accounts and deposits held by Russian residents has stabilized, and their share in total deposits has decreased. Additionally, banks have kept the majority of these resources as liquid assets, avoiding the replacement of long-term stable liabilities. According to certain assessments and considering the geopolitical situation, the immediate outflow of these deposits is less likely in the medium term. Accordingly, the Financial Stability Committee decided to alter the liquidity requirement for foreign currency deposits placed by Russian residents, establishing them similarly to those of other non-resident deposits (on average, 40%). However, banks are advised to regularly analyze the composition of their non-resident deposits and, if necessary, mitigate risks with an adequate internal liquidity buffer.

**The NBG continues its existing practice and has published the 2024 edition of its Supervisory Strategy for 2023-2025**. The new strategy document focuses on the action plan, related activities, and timelines for achieving the supervisory priorities set for the next 12-18 months. The supervisory regime and principles in place, as well as the NBG's vision regarding innovations within the framework of the 2023-2025 strategy, remain fundamentally unchanged compared to previous years. The activities of the NBG will remain unchanged from 2023 and will be based on the same priorities within the framework of the supervisory strategy document. However, additional activities to be carried out by the NBG have been added for each priority. The implementation of these activities will contribute to the improvement of the financial sector's risk management framework, the promotion of competition, the encouragement of innovations, alignment with international standards, the strengthening of supervisory functions, and increased transparency.

**The National Bank of Georgia continues to work to support the resilience of the financial system**, continuing its ongoing monitoring of the country's financial stability and assessing domestic and external risks, and, where necessary, the NBG will utilize all available instruments to minimize potential risks. Over the recent period, the quality and profitability indicators of the banking sector's assets have improved and are characterized by stability. Banks maintain capital at adequate levels and have healthy liquidity ratios. The banking system has fully restored the buffers that were released at the beginning of the pandemic and has sufficient resources to lend to the economy. However, in recent periods, the growth rate of loans has increased and exceeds its long-term sustainable level. If this growth rate of loans is maintained, certain risks may arise, and additional regulatory measures may become necessary. It should also be noted that uncertainty persists amid geopolitical tensions; however, based on the results of the stress test conducted, the banking system maintains resilience even under the severe-risk scenario. The National Bank of Georgia continues its ongoing monitoring of the country's financial stability, assessing domestic and external risks, and ensuring the resilience of the financial sector through use of a range of macroprudential and microprudential instruments (see Table IV.1). The non-banking sector is also resilient, and is also subject to established prudential requirements.

## Table IV.1. Macroprudential measures of the NBG

| Instrument | Rate | From |
|---|---|---|
| Counter-cyclical buffer[52] | 1% | 15.03.2027 |
| Systemic Buffers | | |
| JSC “TBC Bank” | 2.5% | 31.12.2021 |
| JSC “Bank of Georgia” | 2.5% | 31.12.2021 |
| JSC “Liberty Bank” | 1.0% | 23.01.2023 |
| Conservation buffer | 2.5% | 01.01.2024 |
| Pillar 2 buffers | | |
| CET1 Pillar 2 Requirement | | |
| Consolidated | 5% | As of 30.06.2024 |
| Range | 3.0% - 14.1% | As of 30.06.2024 |
| Tier 1 Pillar2 Requirement | | |
| Consolidated | 5.8% | As of 30.06.2024 |
| Range | 3.8% - 15.6% | As of 30.06.2024 |
| Regulatory capital Pillar 2 Requirement | | |
| Consolidated | 6.9% | As of 30.06.2024 |
| Range | 4.8% - 17.5% | As of 30.06.2024 |
| Total Regulatory Capital Requirements (including buffers) | 10.8% - 28.3% | As of 30.06.2024 |
| Common Equity Tier 1 (CET1) requirements (including buffers) | 7.3% - 21.3% | |
| Leverage ratio | 5% | 26.09.2018 |
| Payment-to-Income limit (PTI) | | |
| For loans in foreign currency (unless income is in the same currency) | | 01.04.2022 |
| Monthly net income<1500 GEL | 20% | |
| Monthly net income>=1500 GEL | 30% | |
| For loans in GEL (or in foreign currency if the borrower’s income is in the same currency) | | 01.04.2022 |
| Monthly net income<1500 GEL | 25% | |
| Monthly net income>=1500 GEL | 50% | |
| Loan-to-Value limit (LTV) | | |
| for GEL loans | 85% | 01.01.2019 |
| for foreign currency loans | 70% | 01.01.2019 |
| Liquidity coverage ratio (LCR) requirements in | | |
| All currencies (Cumulative) | 100% | 01.09.2017 |
| GEL | 75% | 01.09.2017 |
| Foreign currency | 100% | 01.09.2017 |
| Net Stable Funding Ratio (NSFR) | 100% | 01.09.2019 |
| Limits on open foreign exchange positions | 20% of regulatory capital | 20.07.2006 |
| Reserve requirements for | | |
| National currency | | |
| for liabilities with the remaining maturity up to 1 year | 5% | 25.07.2018 |
| Foreign currency | | |
| for liabilities with the remaining maturity up to one year | 10-20% | 05.08.2021 |
| for liabilities with the remaining maturity between 1-2 years | 10-15% | 05.08.2021 |
| Restrictions on foreign currency loans | Below 400,000 GEL | 01.05.2024 |

52 Banks will be required to accumulate a cycle-neutral capital buffer according to the following schedule: 0.25% by 15 March 2024, 0.5% by 15 March 2025, 0.75% by 15 March 2026, and 1% by 15 March 2027.

## Box 4. Minimum Requirement for Own Funds and Eligible Liabilities (MREL)

The MREL facilitates the ex-ante creation of a structure of balance sheets for systemic commercial banks that will allow the National Bank of Georgia, within its mandate, to effectively recapitalize a bank under resolution during a crisis by the write-off or conversion of liabilities.

**All capital instruments, or such bail-in-able instrument contracts that are fully or partially governed by foreign law, are considered MREL-eligible if, and only if, they include a contractual clause related to recapitalization by means of a write-down or conversion of a bank's liabilities (bail-in clause).** To this end, a requirement for commercial banks was put in place from December 2023 to include a bail-in clause for the contract for every capital instrument, while the requirement for remaining bail-in-able liabilities **was determined from 1 April 2024.**

**Methodology for calculation of the Minimum Requirement for Own Funds and Eligible Liabilities (MREL) adequacy ratio**

| | | | | |
|---|---|---|---|---|
| **MREL Indicator** | = | **MREL Target Amount** | / | **Total Capital/Own Funds + Total Liabilities** |

**Where**

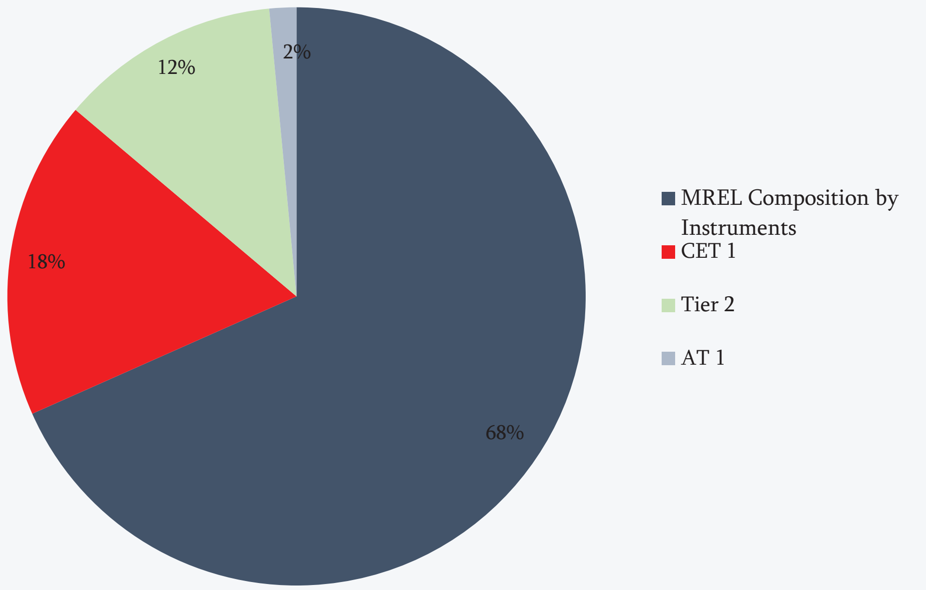
| | | | | |
|---|---|---|---|---|
| **Total Capital/Own Funds + Total Liabilities** | = | Regulatory Capital | + | Total Liabilities Excluding Regulatory Capital Instruments |

**MREL Adequacy of Commercial Banks:**

GEL

| | 30/06/2024 | 30/06/2024 | 30/06/2024 |
|---|---|---|---|
| | TBC | Bank of Georgia | Liberty Bank |
| **MREL resource** | 6,857,978,530 | 6,033,148,412 | 545,627,454 |
| **Total Liabilities and Own Funds** | 33,078,026,446 | 33,928,548,946 | 4,429,981,431 |
| **%** | 20.73% | 17.78% | 12.32% |

Figure B4.1. MREL composition by instrument as of June 2024




Source: NBG

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