Expert Group Meeting on Financial Integration among the United Nations Special Programme for the Economies of Central Asia (SPECA)

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"Financial Integration Among SPECA Countries"

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Introduction

Why examine financial integration in the SPECA countries?

Short answer: ESCAP was requested to:

"In September 2018, the Governing Council of the United Nations Special Programme for the Economies of Central Asia (SPECA) adopted a request from Afghanistan to conduct a review of the members' banking systems, capital markets, and financial interlinkages, with a view to strengthening financial interlinkages among the members of the group"

Introduction

- Objective of the draft publication is to identify real ground conditions for financial integration and to provide policy recommendations on how SPECA countries can enhance financial interlinkages and why it is important for sustainable regional economic development.

Introduction

- The technical material will also provide a foundation for discussion on the 2019 SPECA Economic Forum on how to organize the regional policy dialogue on financial integration issues going forward.
- The SPECA countries have various similarities and specifics.

Introduction

The structure of the draft study:

- I. Review of economic and financial landscape of the SPECA countries
- II. Challenges, costs and opportunities of deeper regional financial integration
- III. Best relevant international experience
- IV. Conclusions and policy recommendations

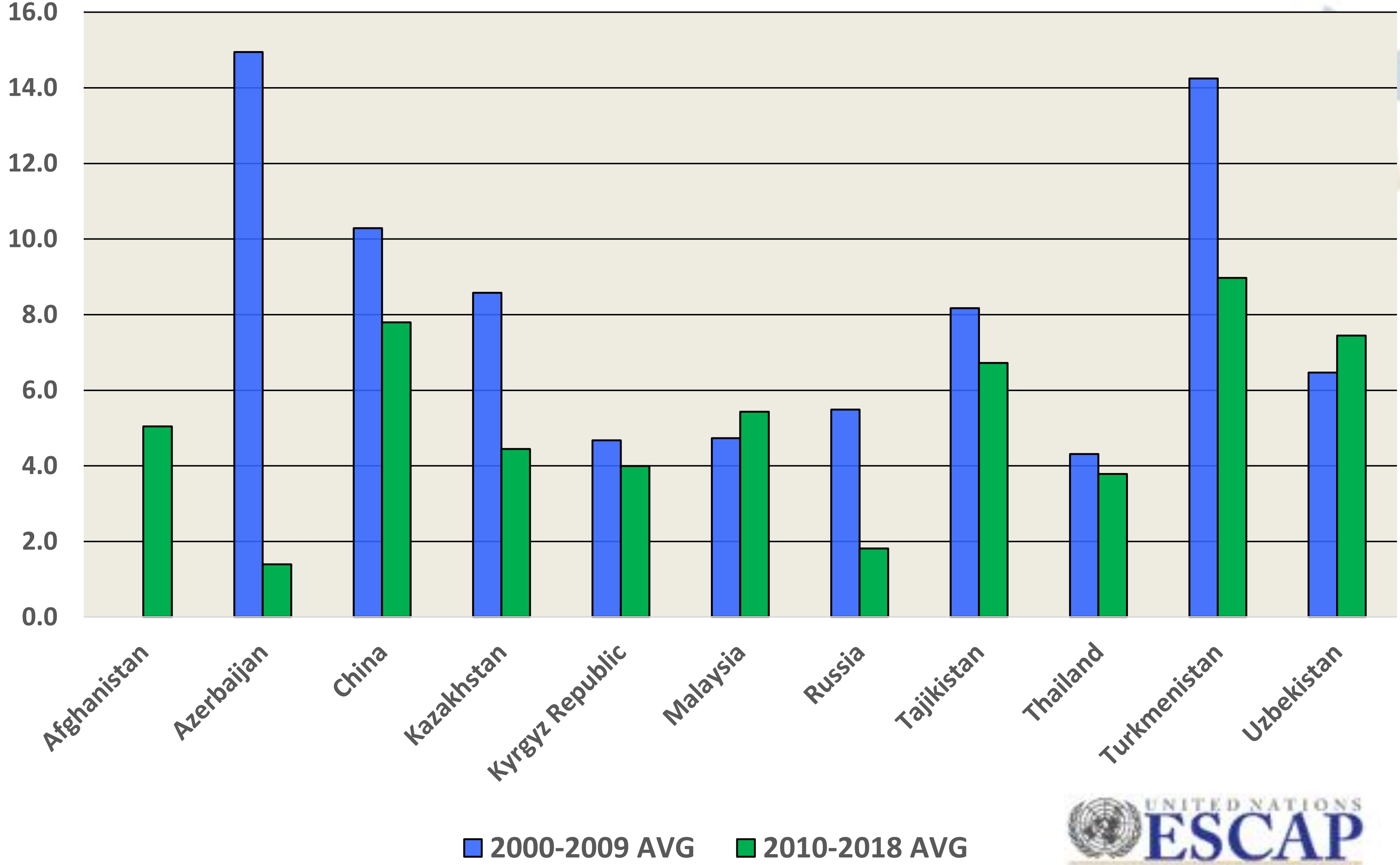
But the more substantive reason is that the SPECA countries are emerging from a period of slow growth that revealed important weakness in both their economies and their financial sectors

And it is important to understand how building international financial linkages can help reduce vulnerabilities and address those economic and financial weaknesses

Let’s take a closer look at recent economic and financial sector developments

Economic growth slowed in most SPECA countries in the 2010s, leaving per capita incomes in the non-resource rich countries falling behind Asian countries like China, Thailand, and Vietnam

Real GDP Growth in SPECA and other selected countries (period average annual rate)



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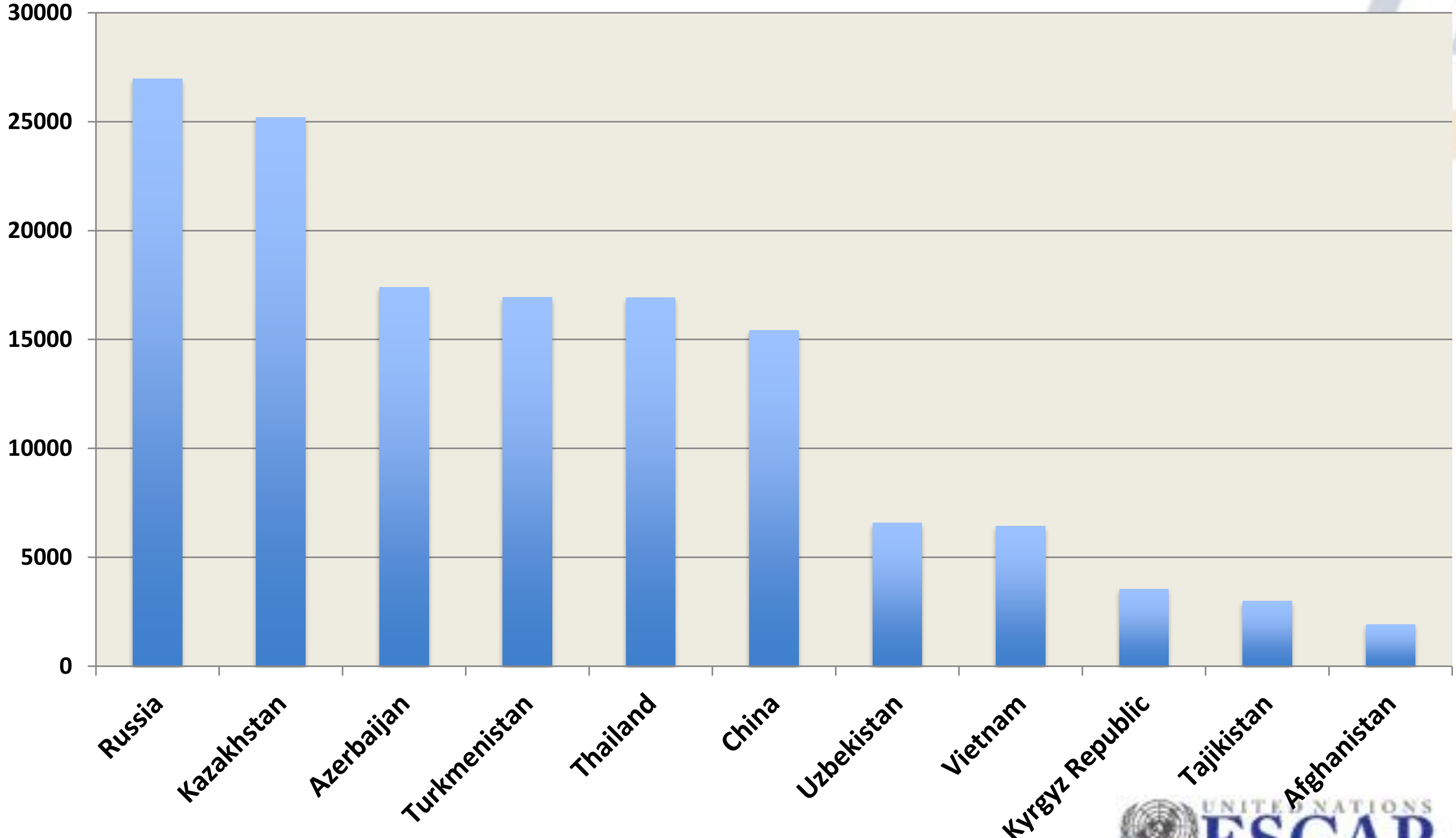
Source: IMF World Economic Outlook (October 2018)

Per Capita GDP, 2016
(at PPP current dollars)



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An important point to note about SPECA economies—Real sectors have few interlinkages and there is little trade among them

- Resource-rich economies (gas, oil, and minerals) and Kyrgyz Republic (gold) export mainly to Europe
- Others export mainly low value-added agricultural products

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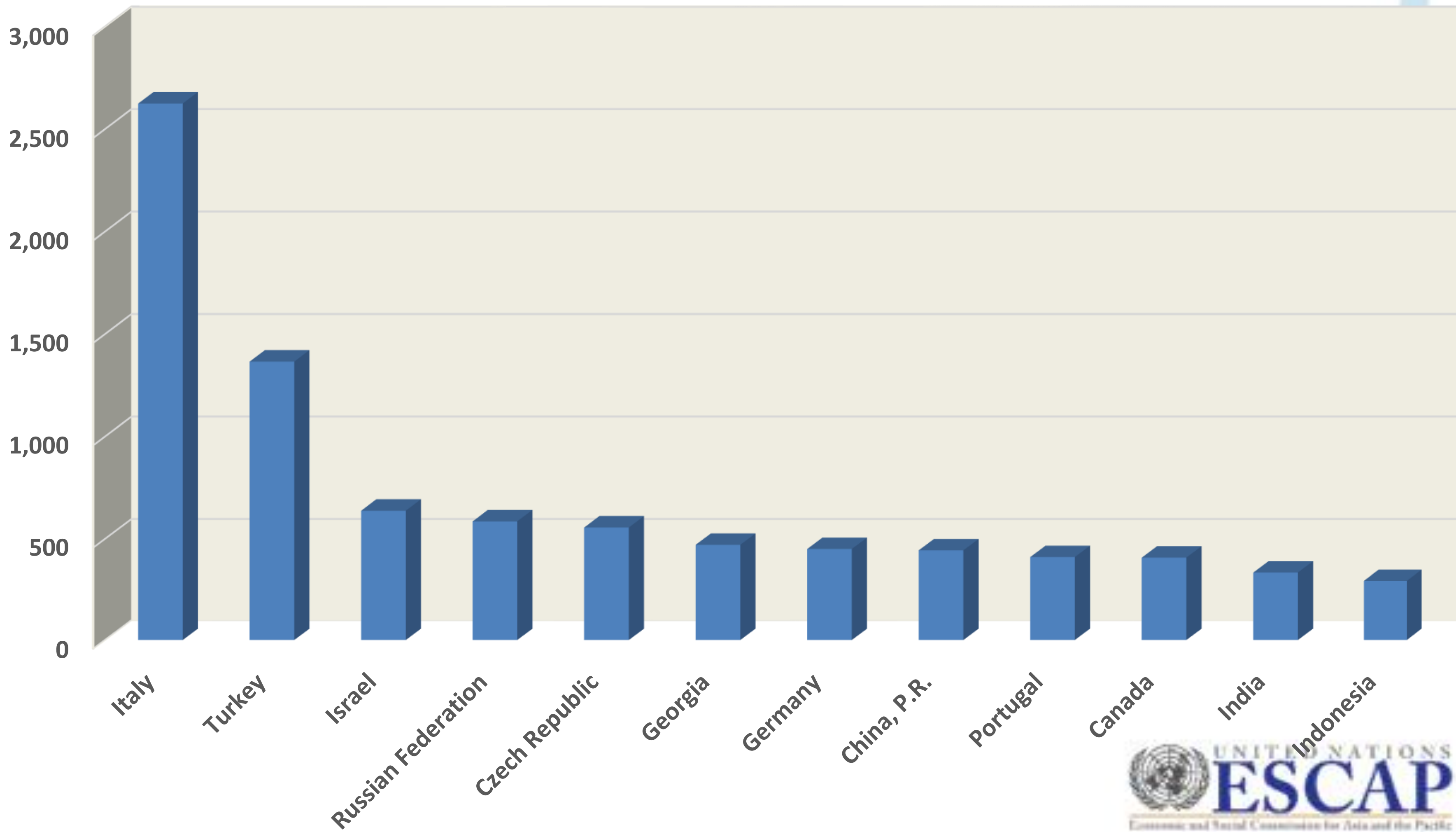
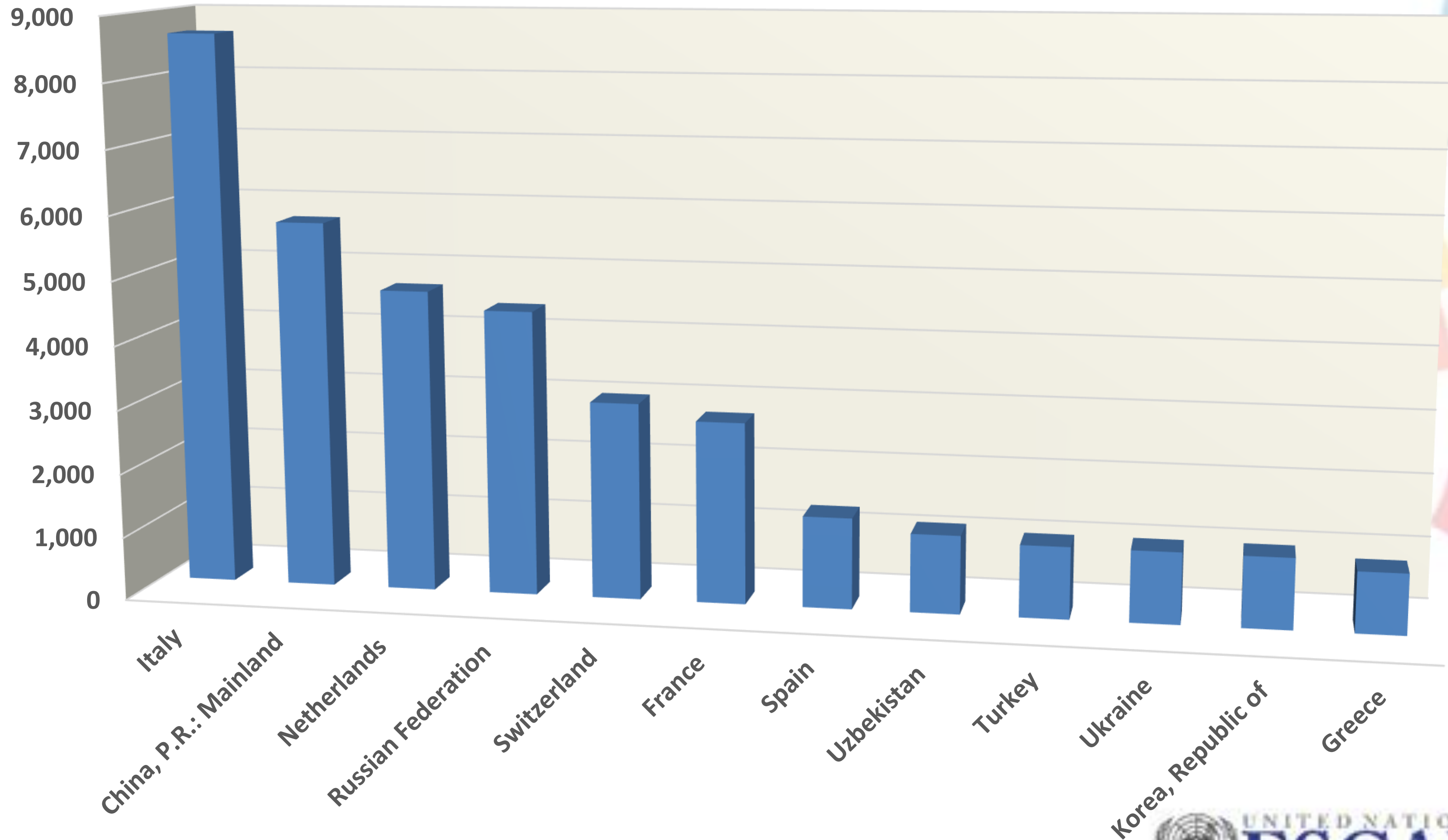
Azerbaijan: Exports to Main Trading Partners, 2017

(millions of U.S. dollars)



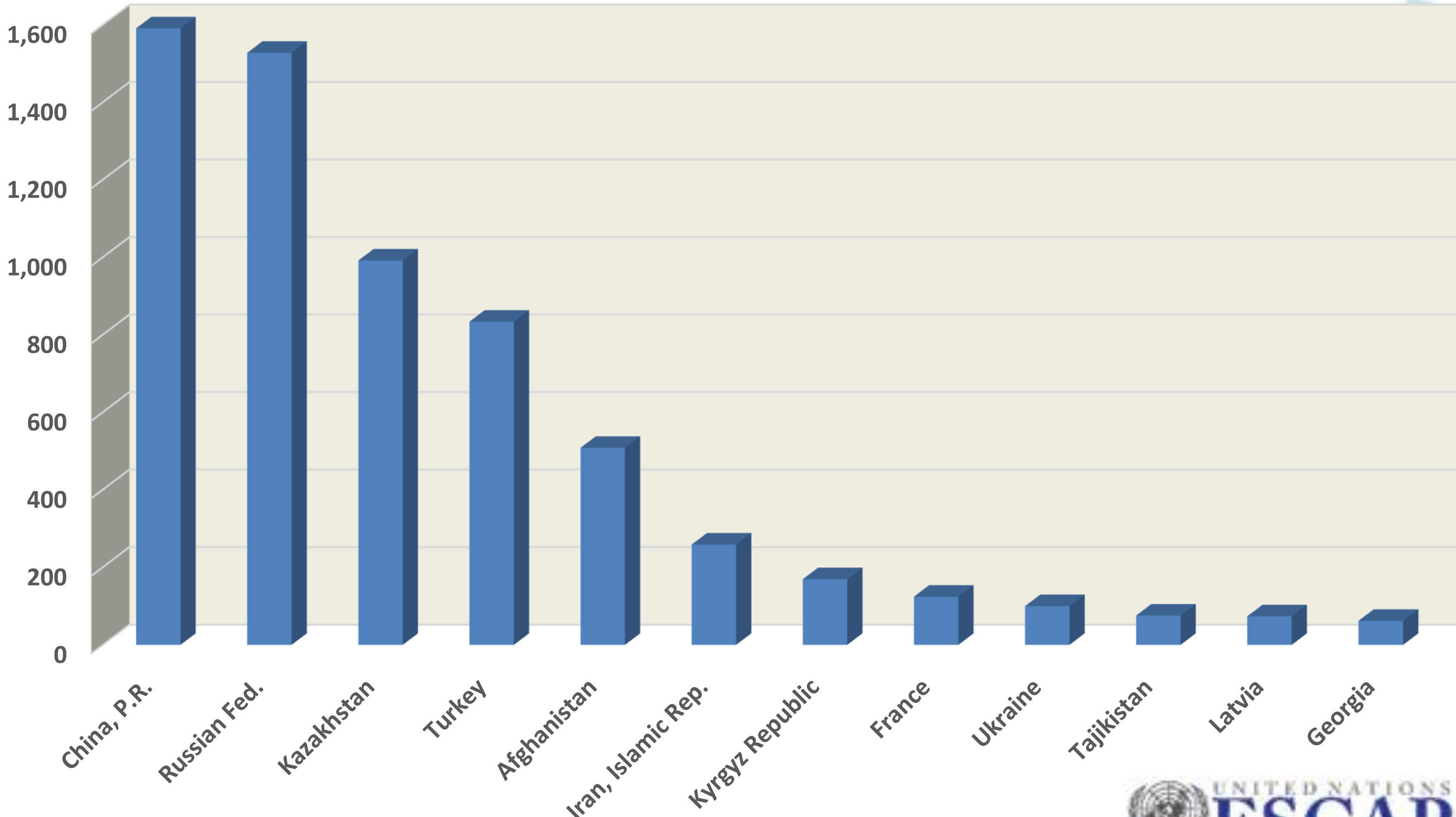
Kazakhstan: Direction of Exports, 2017

(millions of U.S. dollars)



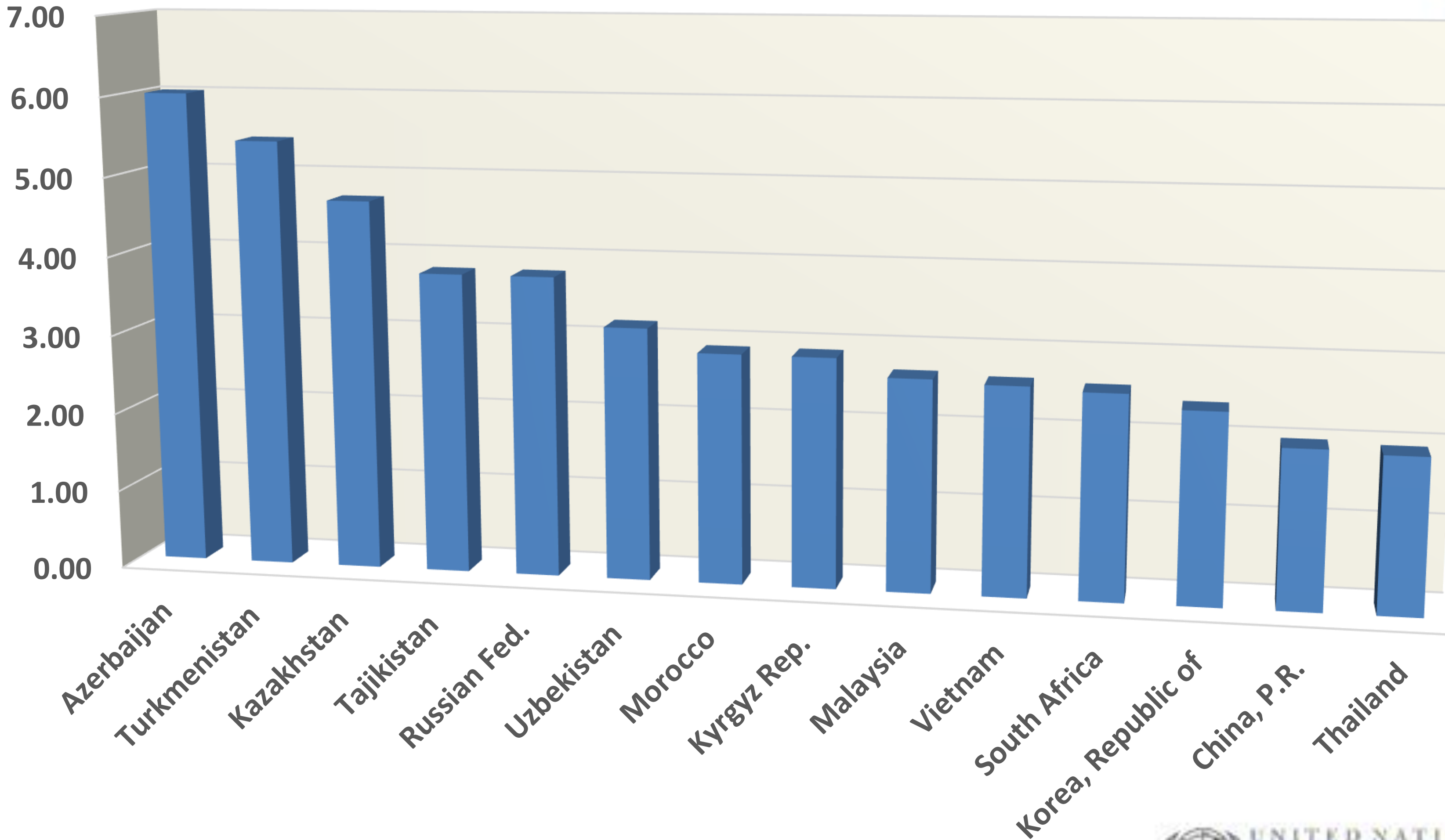
Uzbekistan: Direction of Exports, 2017

(millions of U.S. dollars)



Export Diversification Index

(lower number is more diversified)



Source: IMF calculations

What have we learned from the recent experience?

The first lesson is that the SPECA countries are highly vulnerable to various forms of spillovers from outside their borders, mostly from Russia.

The spillovers have taken four main—and often related--forms:

- Spillovers from slower growth in major trading partners
- Spillovers from weaker prices for SPECA countries' exports
- Spillovers in the form of lower remittances received from abroad and return migration
- Spillovers from financial flows

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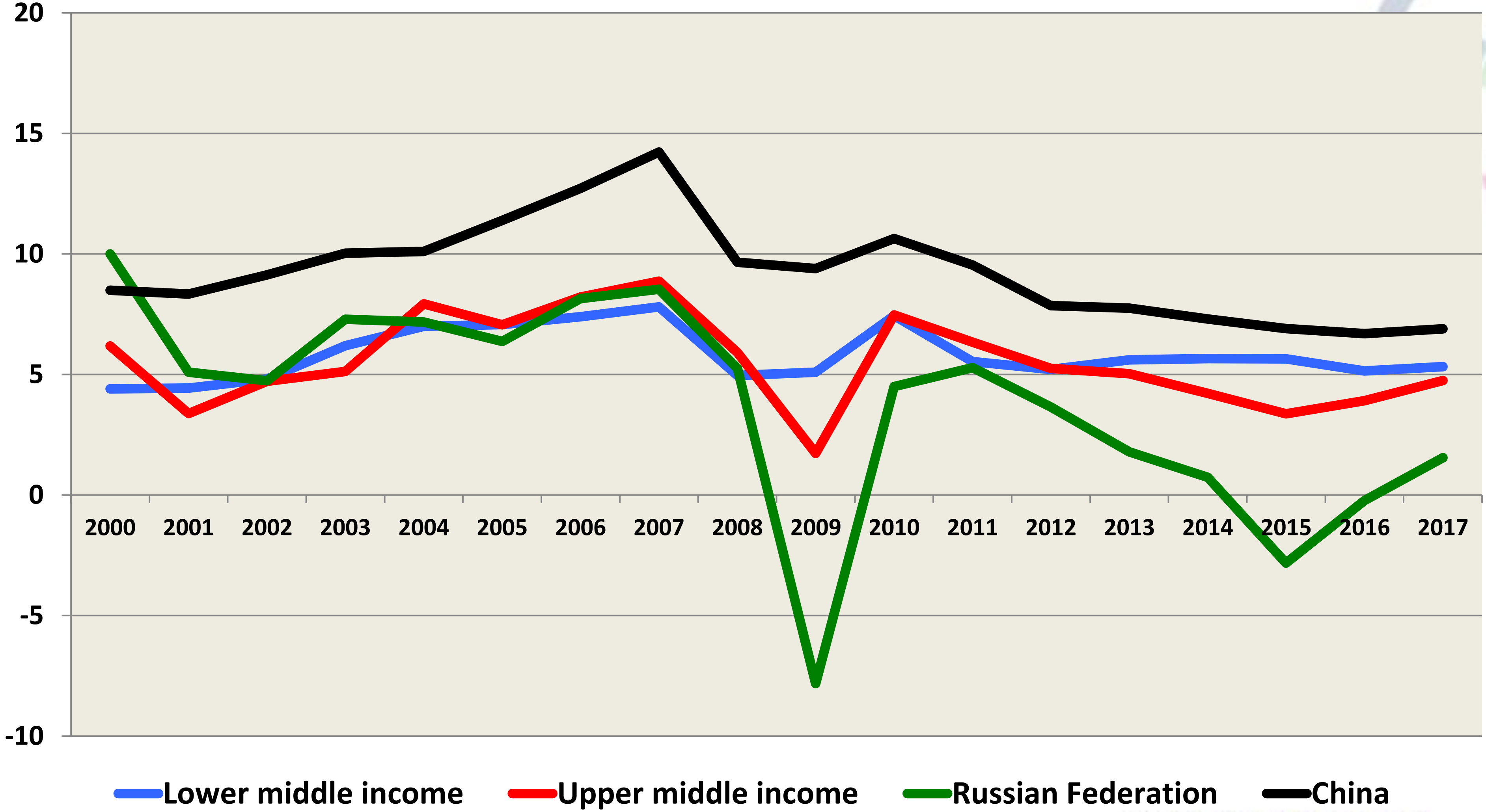
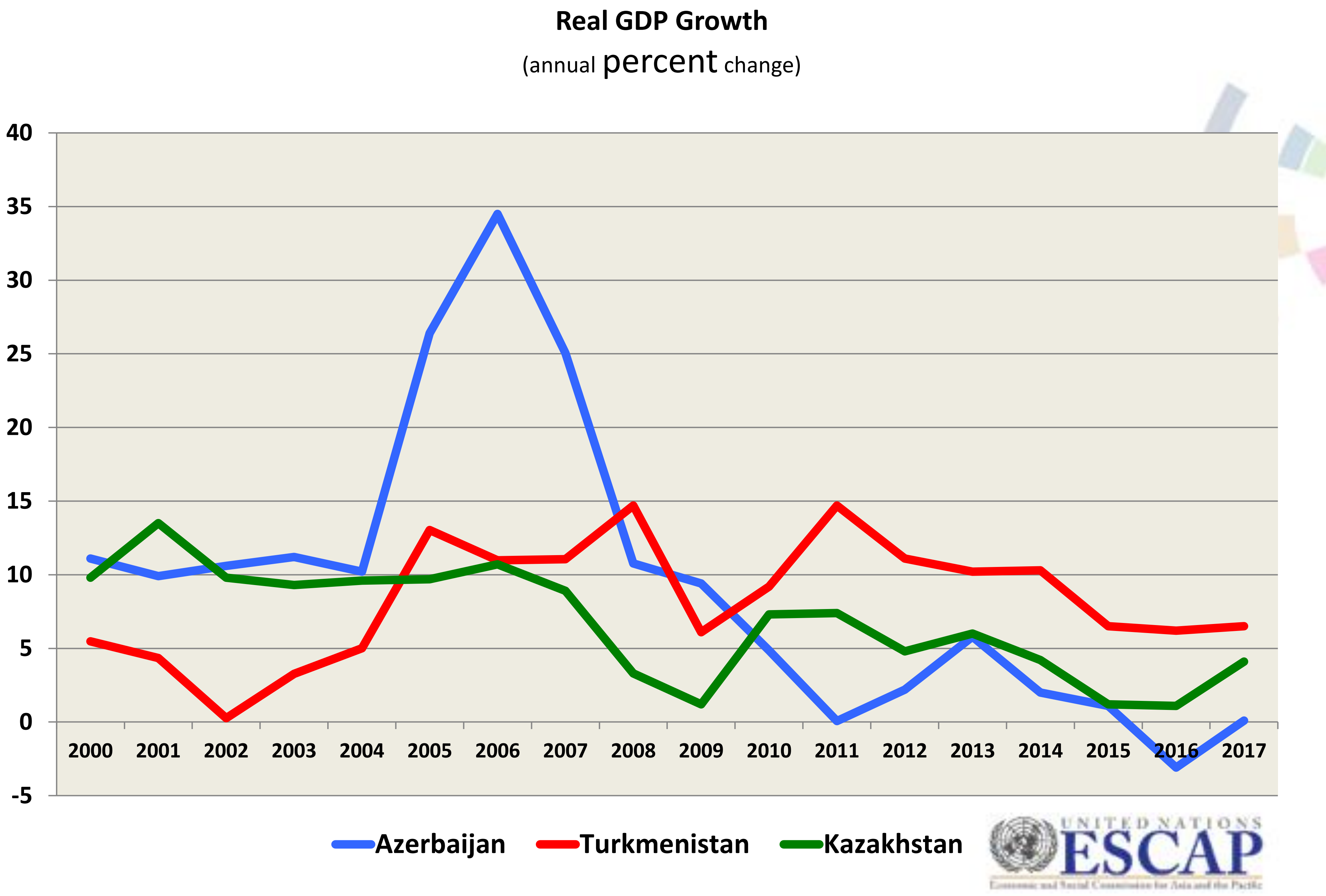
Real GDP Growth
(annual percent change)



Source: World Bank, WDIs


Real GDP Growth
(annual percent change)
40
35
30
25
20
15
10
5
0
-5
2000
2001
2002
2003
2004
2005
2006
2007
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2017
Azerbaijan
Turkmenistan
Kazakhstan
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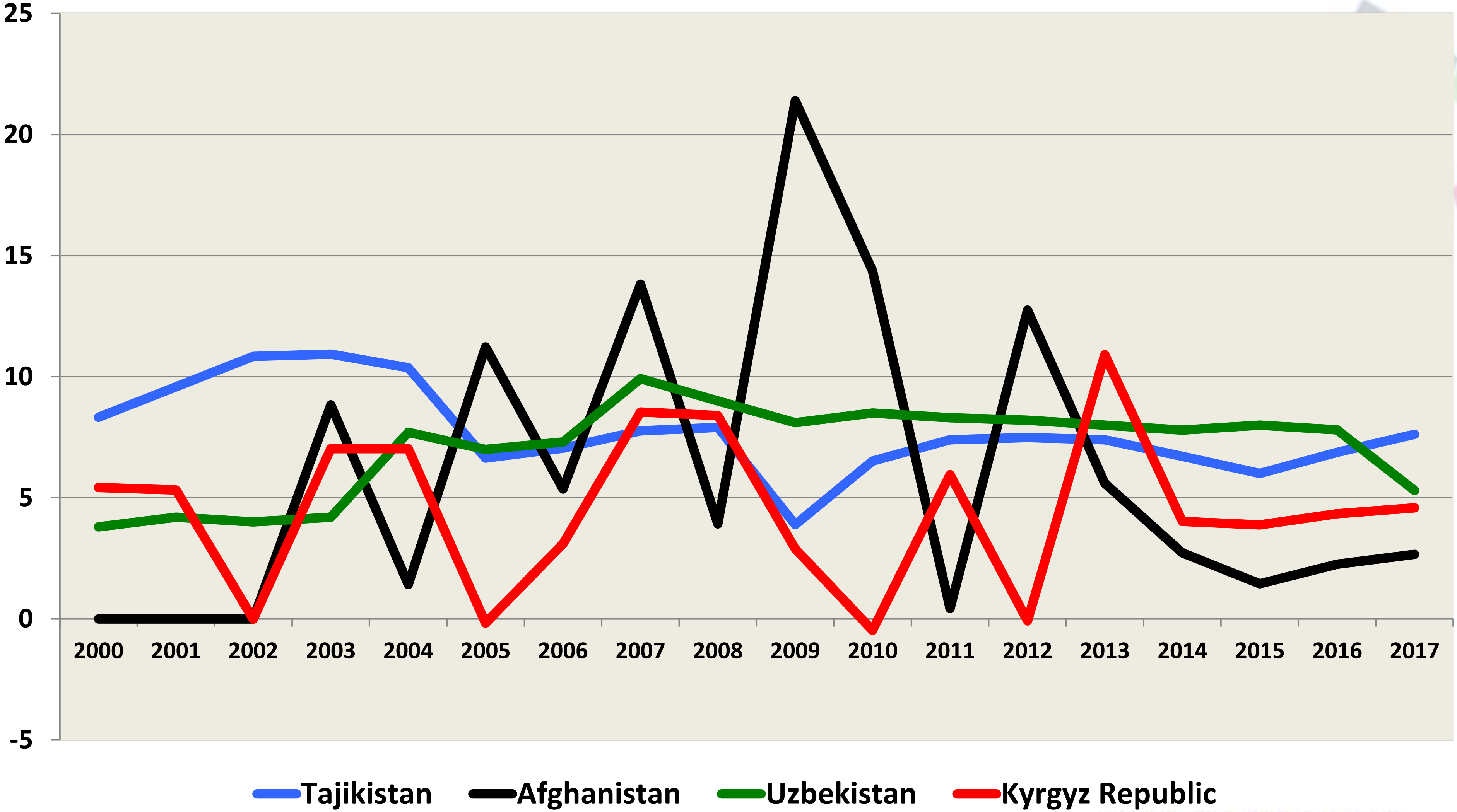
Real GDP Growth



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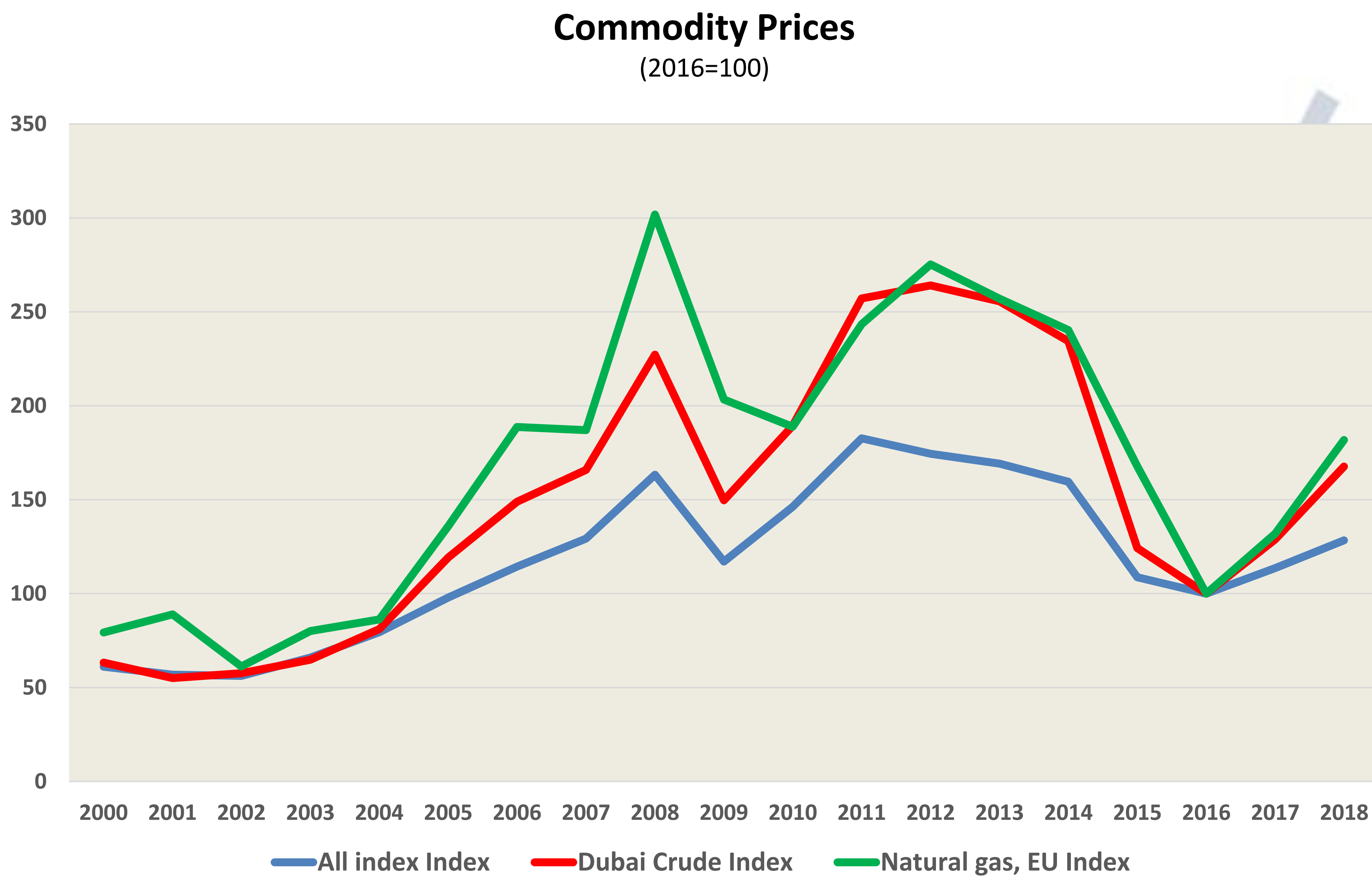
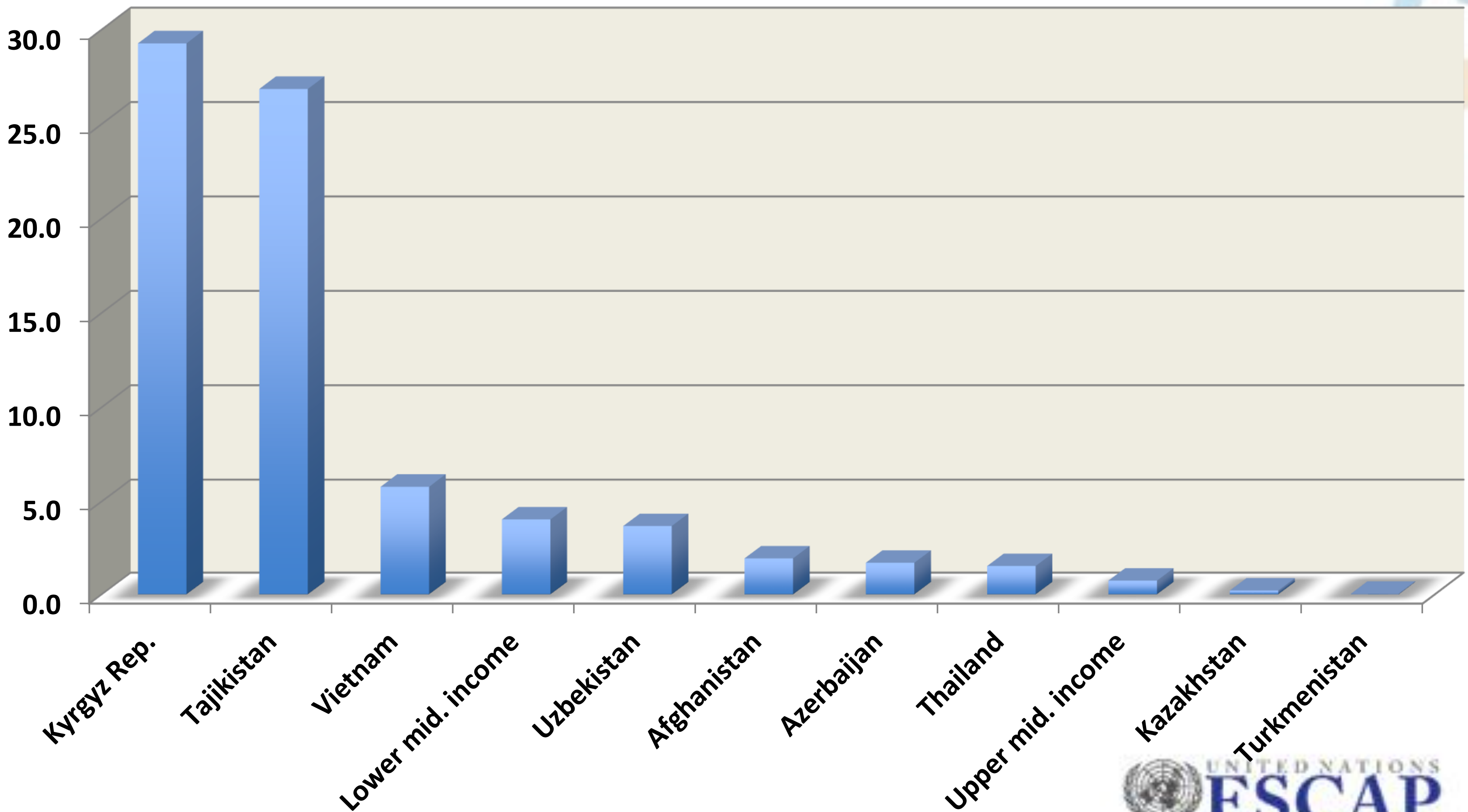
Source: World Bank, WDIs



Source: International Monetary Fund

Remittances, 2016
(percent of GDP)



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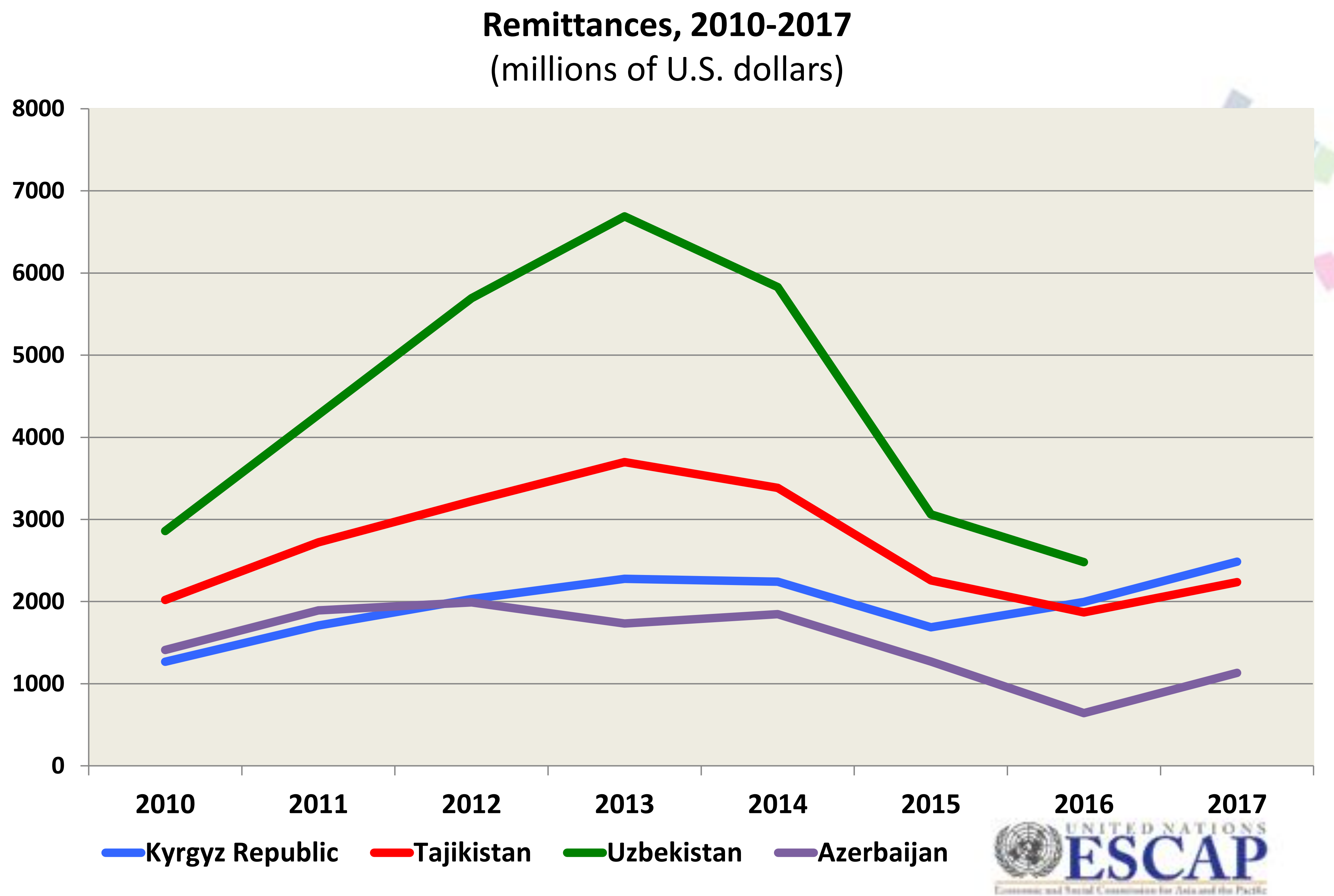
Source: World Bank, WDI



Source: World Bank World Development Indicators

Macroeconomic policies were relaxed in response to the crisis.

Budget deficits and public debt increased, reducing buffers and raising vulnerabilities

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Modest economic growth has now resumed in most of the region…

But the recent experience highlights vulnerabilities and the importance of moving away from traditional reliance on natural resources, remittances, and public spending and moving towards higher value-added production chains, taking greater advantage of region’s strategic location between China, Russian Federation, and Europe

Achieving such far-reaching structural transformation will require significant additional public and private investment spending in the years ahead, utilizing additional resources from both foreign and domestic sources.

What does this have to do with the financial sector? A lot.

Financial sectors play a key role in economic development by:

Mobilizing savings

Channeling resources to their most productive uses

Encouraging innovation, and well-conceived risk taking, and

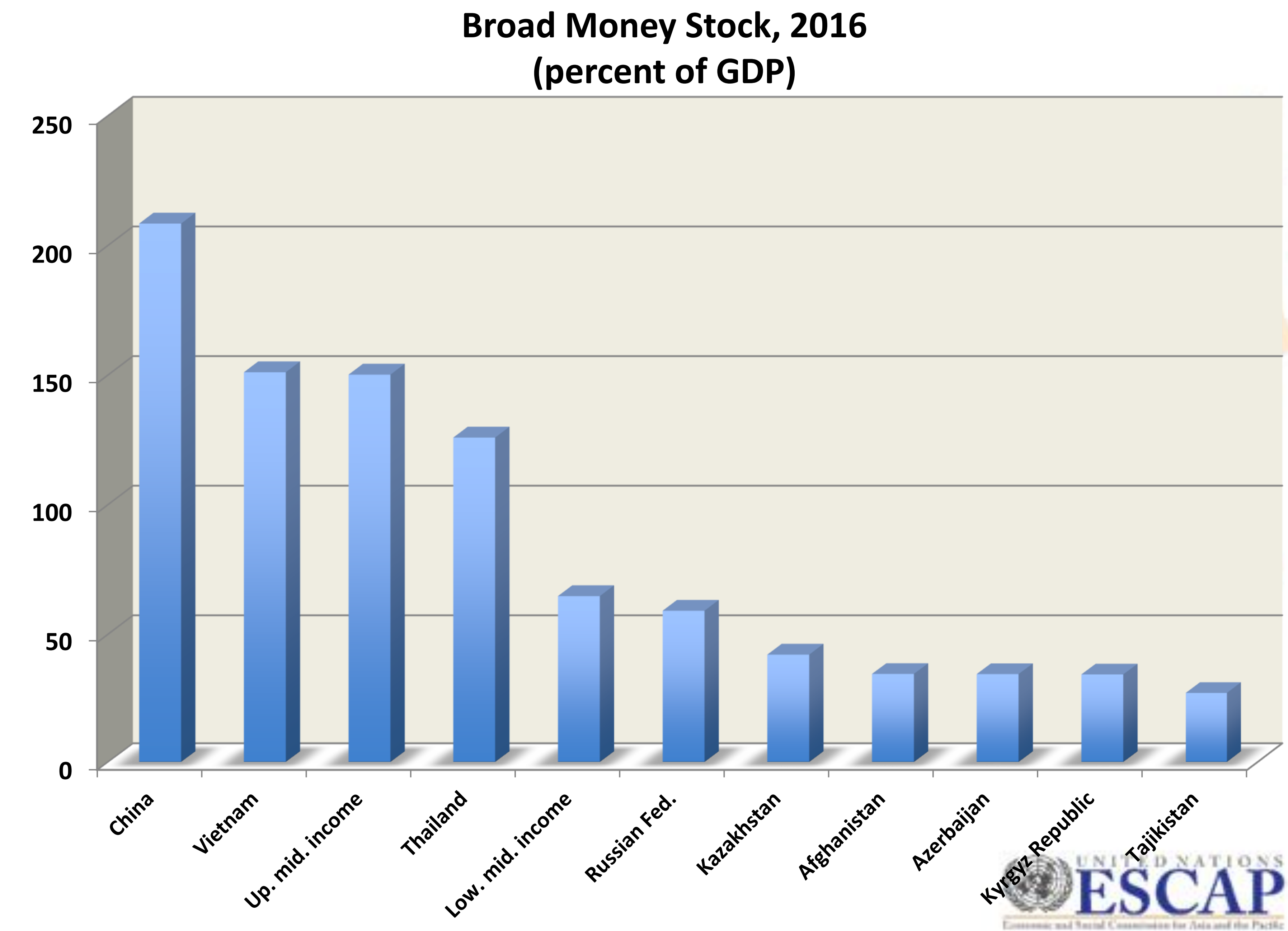
Smoothing life-cycle consumption

But SPECA financial sectors are not fully prepared for these tasks

- **The banking sectors are small and some were seriously weakened by the economic difficulties of the late 2000s and mid-2010s**
- **Capital markets are underdeveloped**
- **The financial sectors are not highly integrated with other countries in SPECA region and beyond**

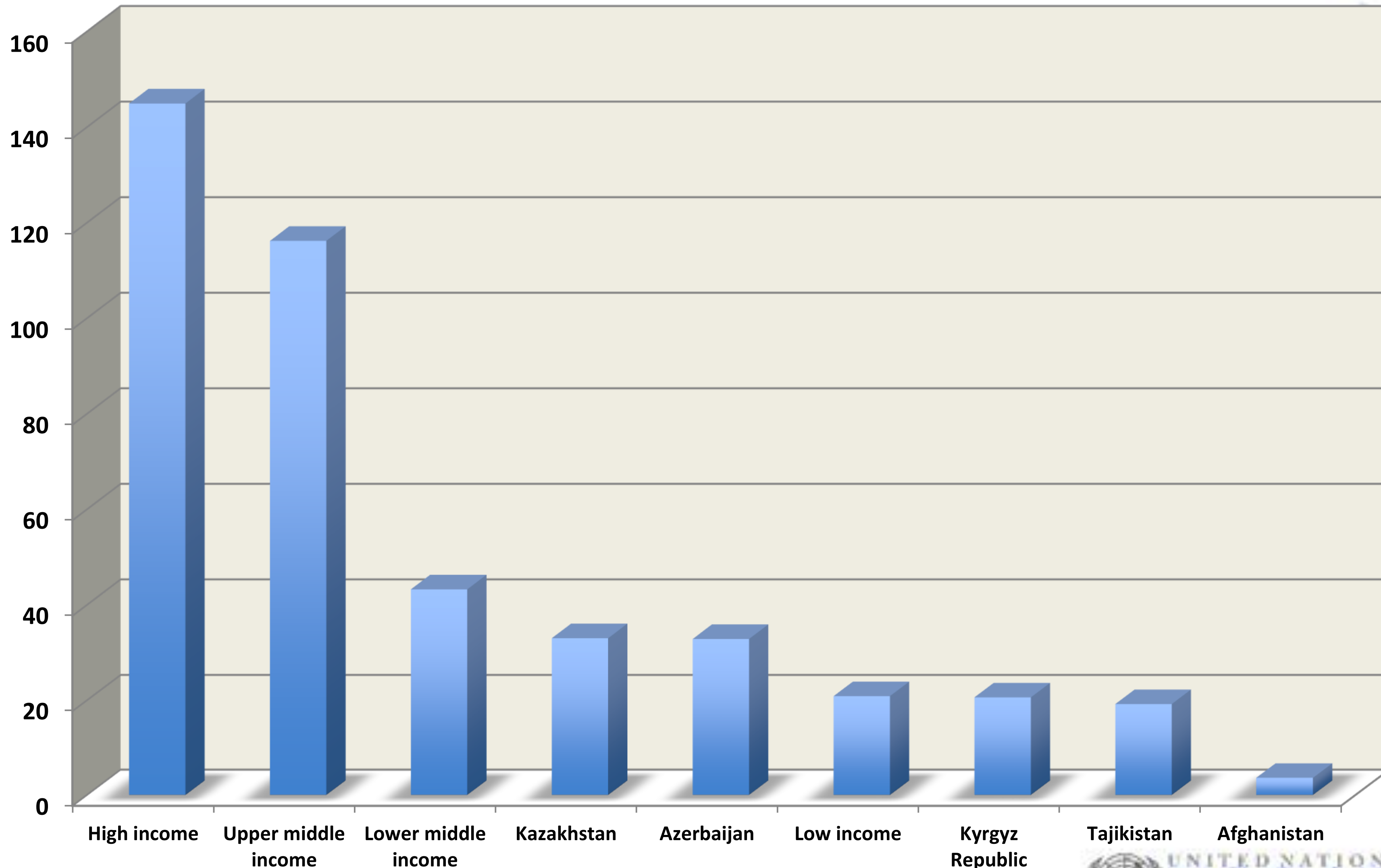
Some indicators of banking sector's small size

- Low level of broad money
- Low level of credit to private sector
- Low number of borrowers



Source: World Bank, World Development Indicators

Domestic Credit to Private Sector, 2016
(percent of GDP)



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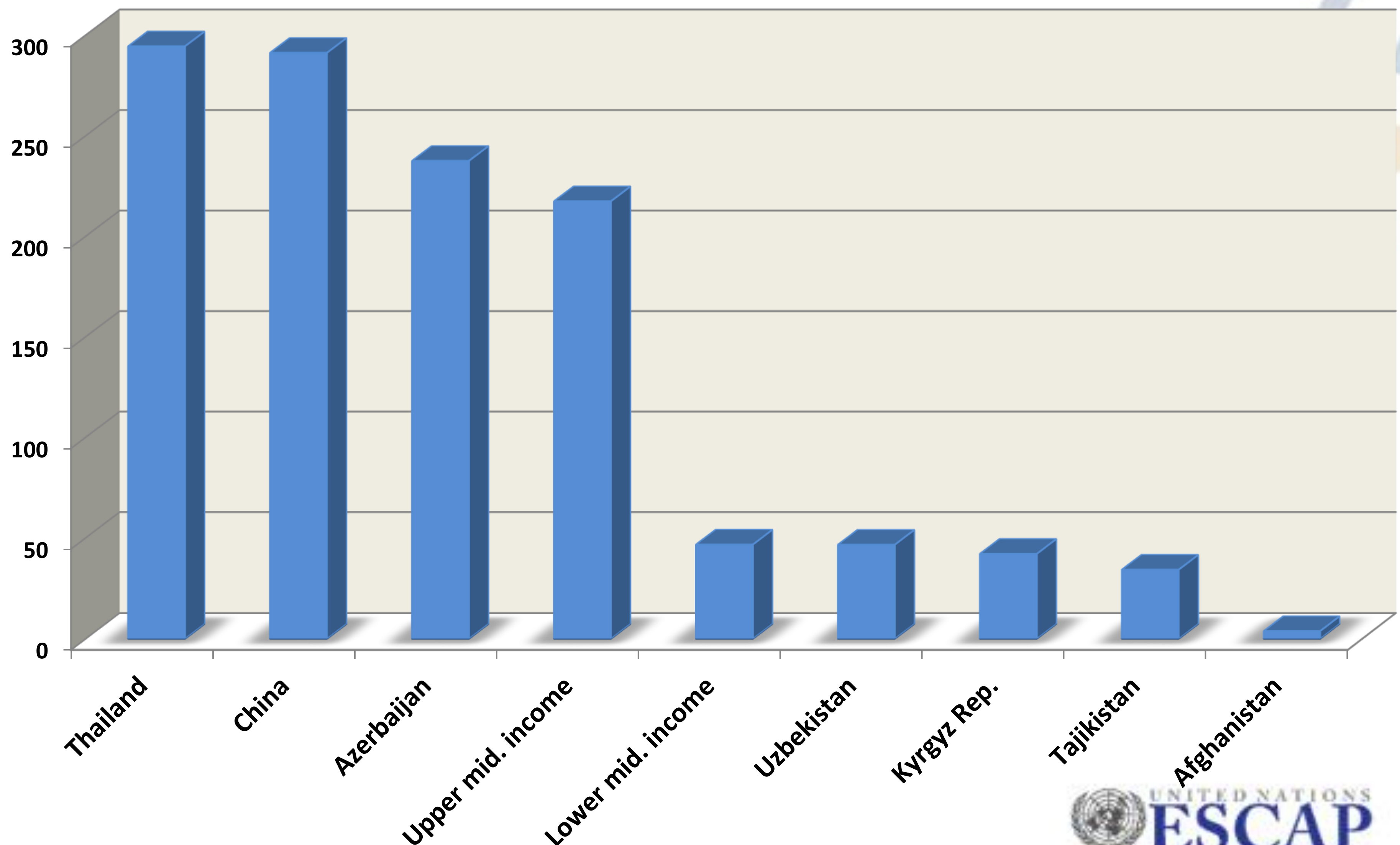
Source: World Bank, World Development Indicators

Commercial Bank Borrowers per 1,000 Adults



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Source: World Bank WDI and IMF Financial Access Survey

Even before Russian crisis, SPECA banking sectors had weaknesses

- Asset quality weak in some countries, owing to shortcomings in regulation and supervision, weak lending practices, loan monitoring and collecting

- Lack of competition by large state banks and connected lending

- In some countries, banks borrowed heavily in foreign currency to lend in domestic currency—large currency risks

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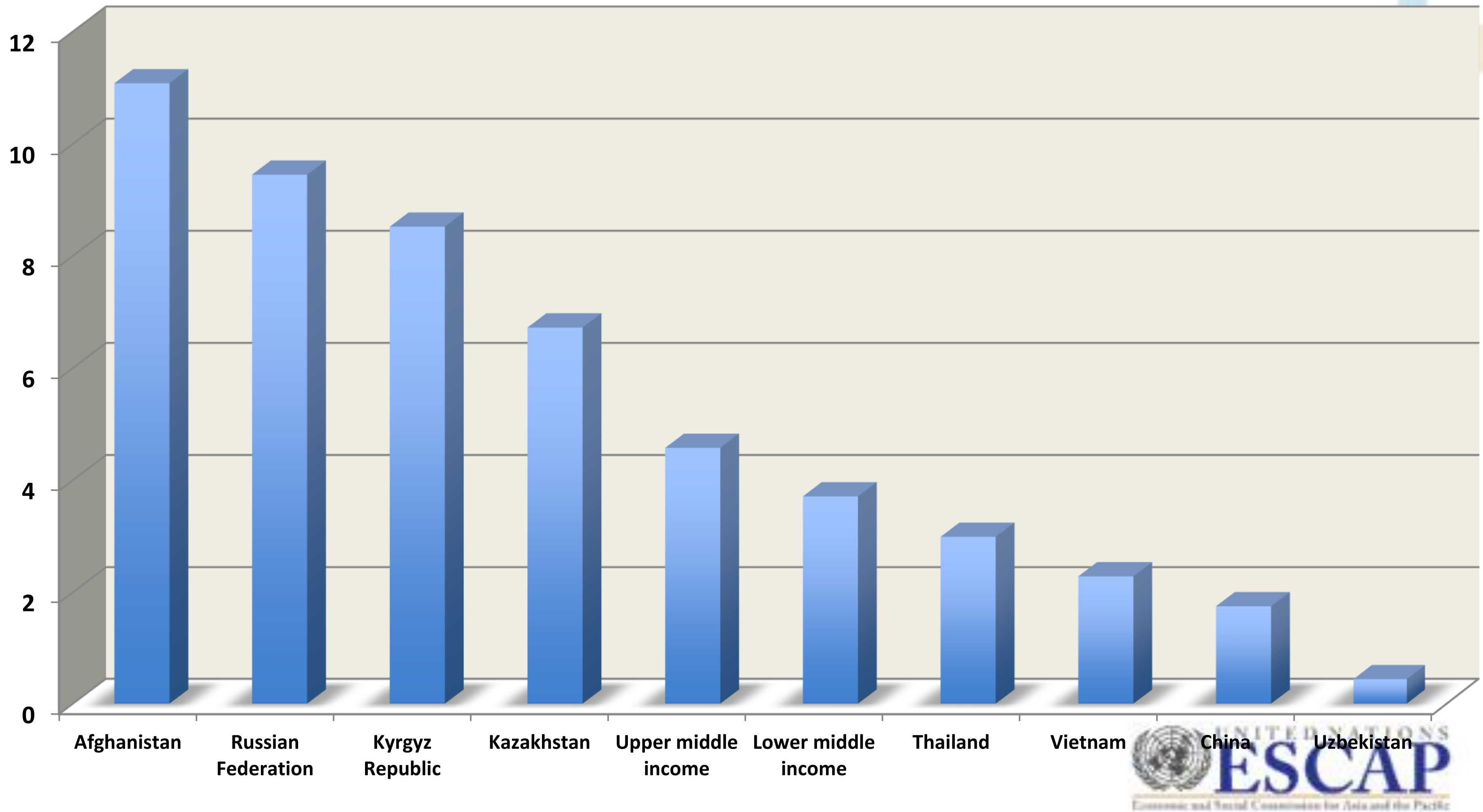
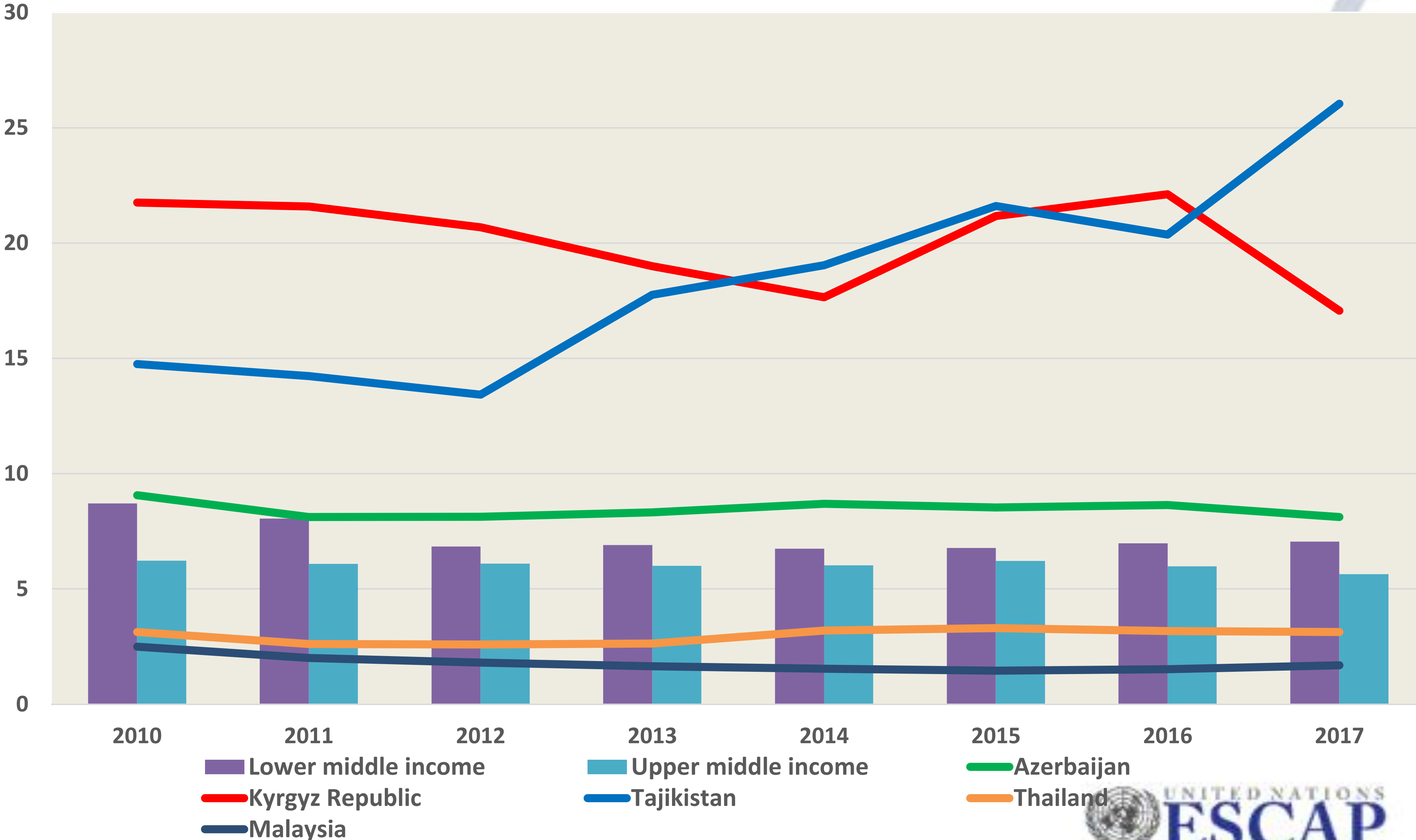
Nonperforming Loans, 2016

(as percent of total loans)



Bank Deposit-Lending Interest Rate Spread
(percentage points)



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Source: World Bank World Development Indicators

Financial condition of SPECA banking sectors deteriorated further during Russian crisis of mid-2010s

Exchange rate depreciations, which were needed in many countries to restore macroeconomic balance, resulted in large loan losses due to currency mismatches

The Challenges and Opportunities for Deeper Financial Linkages

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We see four levels of challenges to the development of greater financial linkages among the SPECA countries

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The first, overarching challenge is to maintain financial stability

Without it, financial systems cease to play their most basic roles. Although important steps have been taken, banking sectors still have fundamental vulnerabilities.

Second, the rehabilitation of banking sectors remains incomplete

- Insufficient recapitalization and inadequate bank intervention
- NPLs level is still an issue in some SPECA countries.
- Inadequate supervisory capacity and legislative framework

Third, countries have formidable development challenges

- Investment climate issues
- Limited financial infrastructure underdeveloped capital markets
- Small domestic markets
- Landlockedness
- Inadequate physical infrastructure
- Low economic diversification

Fourth, impediments to cross-border flows

- Low financial cross-border liberalization and relatively high levels of capital controls
- Weak economic interlinkages among SPECA countries

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Authorities in SPECA countries have responded with large capital injections and restructuring programs.

In Azerbaijan

- New bank resolution framework
- Liquidation of some small banks
- Increased capital requirements encouraged mergers
- Large debt restructuring and recapitalization of state-owned Bank of Azerbaijan

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In Kazakhstan, steps included

- Support for Halyk-KKB merger
- US$2 billion in capital support for five banks
- Withdrawal of licenses of several small/medium banks that were in violation of prudential requirements
- Implementation of legal changes adopted by Parliament to enhance supervisory powers

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But Kazakh authorities are still faced with challenges related to:

- Defining the magnitude of remaining problem loans at banks that received state support
- Determining whether further capital support is needed and how it can be raised
- Banks shifting NPLs to nonbank subsidiaries not subject to consolidated capital requirements
- Limiting liquidity support to nonviable banks

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In Kyrgyz Republic

- Implementation of prudential norms meeting Basel II and III international standards
- Implementation of risk-based supervision
- Establishment of higher capitalization requirements

But the central bank's acquisition of a troubled bank could represent a conflict of interest

In Tajikistan

- Government aided two largest banks at cost equivalent to 6 percent of GDP
- Authorities have initiated asset quality reviews of systemically important banks

But the banking sector still suffers from the legacy of directed lending, weak confidence of depositors, and remaining problems at two large banks

In Uzbekistan

- Directed credits are still often extended at highly negative real interest rates, resulting in a misallocation of credit and depressed bank profitability

- Credit market segmentation results in high degree of loan concentration in small number of SOEs

Capital markets in SPECA region are small and underdeveloped

Kazakhstan is currently the largest. Listed equities valued at 28 percent of GDP, compared with 71 percent in China 121 percent in Thailand

Domestic debt markets can play valuable role in

- Diversifying funding for governments and corporations
- Attracting funding for large infrastructure projects
- Broadening range of assets available for institutional and retail investors
- Provide additional channel for intermediation if banks come under stress

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Conclusions and Recommendations

Conclusion #1

- The very low existing level of financial integration among SPECA countries reflects the low level of underlying ***economic*** linkages among the SPECA countries, including low level of intraregional trade and investment.
- Simply stated, up until now, there hasn't been much demand for cross-border financial services within the region

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Conclusion #2

- There is some potential for that to change, particularly in connection with financing for regional infrastructure projects under the Belt and Road Initiative
- Those projects will likely include larger, non-SPECA countries

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Conclusion #3

- Financial sectors in most SPECA countries are relatively small. However, in Kazakhstan, Kyrgyzstan, Tajikistan and Azerbaijan they have been steadily growing
- Broader and deeper financial sectors could facilitate private sector development and inclusive growth
- Development of international linkages can contribute to broader and deeper domestic financial markets

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Conclusion #4

- However, it is not obvious that the SPECA region, itself, is currently the optimal country grouping for financial integration on economic grounds, nor is it clear whether leaders are prepared to invest the political capital necessary for such a major undertaking.
- We take this up in recommendations

Conclusion #5a

Real economies in SPECA countries have long had underlying structural weaknesses that were exacerbated and made more apparent by the Russian crisis:

- Lack of economic diversification
- Dependence on natural resources in resource-rich countries
- Regional spillovers in resource and non-resource rich countries

Conclusion #5b

Banking sectors in SPECA countries have long had underlying structural weaknesses that were exacerbated and made more apparent by the Russian crisis:

- Inadequate supervision
- Directed lending and lack of competitiveness by large state-owned banks
- Rising NPLs and inadequate capital due to poor lending decisions and currency mismatches

Conclusion #6

- Despite the weaknesses and Russian crisis, members' bank-dominated financial sectors were able to absorb the shocks and maintain financial stability (in some countries with substantial government support).
- In response to crisis, authorities in some countries have since taken a variety of measures to recapitalize weak banks, close some nonviable banks, and strengthen supervision
- But some of the underlying causes for the problems have not yet been fully addressed

Conclusion #7

The ASEAN experience demonstrates that developing strong financial linkages with foreign partners requires:

- Extensive planning, technical preparation, consultation, and harmonization and
- A very high degree of political commitment

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Conclusion #8

- The establishment of the Astana IFC is a major step forward for the region and it offers great potential for strengthening capital markets and fostering financial linkages among SPECA countries

Recommendation #1

- The highest priority for policymakers at the present juncture must be to complete the process of restructuring and restoring the financial health of their banking sectors.
- Countries needing further assistance should consult closely with the relevant international financial organizations to determine how to address the most urgent needs in areas such as legislative regulation, banking supervision and capital market development.

Recommendation #2

Supervisory agencies from SPECA countries are encouraged to:

- Ensure that effective mechanisms are in place to supervise branches and subsidiaries of foreign banks from other SPECA countries
- Establish mechanisms to enhance information sharing and exchange views on regional financial risks and vulnerabilities.
- Work over time to harmonize supervision practices

Recommendation #3

- Central banks and supervisory agencies in the region should be open to the licensing of financially strong foreign banks with reputations for providing innovative financial services and maintaining the highest standards in the areas of governance

Recommendation #4

- Regulators should also be open to the licensing of financially strong and highly reputable nonbank financial institutions specializing in the provision of financial services such as SME lending, agricultural financing, leasing and factoring, and private equity and venture capital

Recommendation #5

- Financial interlinkages should be enhanced beyond SPECA countries. Russia, China, and other Asian countries.

Recommendation #6

FinTech and financial literacy programs are key enablers to overcome obstacles related to financial access and inclusion and their continued development should be encouraged.

To address institutional constraints to sustainable SME financing. Further development of alternatives to bank finance, particularly expansion in leasing and factoring, private equity, venture capital, and the development of agricultural insurance systems could help increase access to finance for SMEs and ease funding constraints. The SME authorities should help companies fully understand the benefits of improved corporate governance practices, particularly in areas of risk management and audit.

The Astana IFC is encouraged to:

- Meet with regulators and business groups in SPECA countries to raise awareness of their products and services and
- Participate in the development of local currency bond markets

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Recommendation #7

- Central banks should review existing restrictions on international capital flows to assess whether they impair the development of international financial linkages
- Central banks should develop plans and appropriate timetables, in consultation with the IMF, to phase out capital controls that are no longer deemed needed on financial stability grounds

Recommendation #8

Senior management from member central banks and financial supervision authorities might wish to take up the issue of strengthening intra-regional financial linkages at the 2019 SPECA Economic Forum in order to evaluate the political support for further actions and to provide guidance to their officials on next steps.

Thank you!

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