Finance Sector in Eurasian Economies During and After the Global Crisis in 2008

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As in the other countries around the world, banking systems in Eurasian economies, comprised of Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan, were adversely affected by the 2008 global crisis. A common challenge across most economies is to revive private-sector credit growth. Compared with the high increases of 80 percent in the period immediately prior to the crisis, credit growth has slowed sharply and even turned negative in real terms in a number of economies. Governments in many countries have taken measures to address banking sector stress. The measures for restoring credit growth and thus a high economic growth will be discussed in a part of our work. In the short run, such measures include aiding banks to repair balance sheets and also providing liquidity. In the medium term, measures should promote de-dollarization and the development of local debt markets.

Keywords: global crisis, Eurasian economies, finance sector, banking, the Caucasus and Central Asia

The Reviving in Eurasian Region After the Global Crisis

Big external shocks created by the global crisis adversely affected the Caucasus and Central Asia (CCA) region in 2009, but their negative impact on economic growth was limited by some measures taken by the governments. A recovery across the region, and in particular Russia, is expected as the global economy starts growing up in 2010.

Growth has been the strongest in the energy exporters such as Turkmenistan and Uzbekistan, where governments start leaving from their supportive policies as growth gains speed (Yılmaz & Selçuk, 2010). In Kazakhstan, which needs continued policy support, is being seen a slower recovery in 2010. Energy importers such as Armenia, Georgia, and Tajikistan target modest tightening fiscal stance in 2010, while the recovery has yet to gain firm traction. Fiscal constraints curtail governments’ room to maneuver, and additional donor support would provide needed fiscal room.

Exports of goods and services fell across the Eurasian region in 2009. In addition, remittance inflows into the region dropped up to a third. The crisis in international financial markets affected Kazakhstan most markedly, which is more integrated with global financial markets and to a lesser degree of Armenia and

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Georgia (Mukhammedev & Kairbekova, 2010). In Kazakhstan, there has been a big volume of outflow in private portfolio capital since the beginning of the crisis until end 2009. The negative impact of the external shocks created by the global crisis on growth was limited by the same policies and donor support. Countercyclical fiscal and monetary policies helped moderate the impact of the external shocks. In the energy importers, donor support and imposed new taxes helped finance the fiscal stimulus, whereas the energy exporters relied on savings. Besides, depreciating exchange rates against the dollar and the ruble during the first half of 2009 helped redirect demand toward domestic supplies, with imports of goods and services decreasing in most the Eurasian countries by 14-30 percent in 2009. The fall in imports also reflected lower oil prices. But, growth in the energy importers declined: Armenia saw the largest decline in growth to -14 percent and Georgia’s growth fell to -4 percent. In the Kyrgyz Republic and Tajikistan, growth remained positive in the range of 2 to 3 percent (see Table 1). However, most energy exporters fared even better (IMF, 2010a).

Table 1

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<th>Real GDP Growth (%) in Eurasian Countries</th>
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Note. Source: IMF, 2010b.

The latest developments point to a speedy recovery across the region. Export started to increase in most countries during the second half of 2009. Likewise, the decline in remittances is slowing and also they are increasing again during the first months of 2010. Capital inflows also have turned positive again, though they remain lower than before the crisis. However, these trends are not the same in the region. In a number of countries, stress in the banking sector is keeping back credit growth and slowing economic activity.

Energy exporters consider exiting from accommodative policies as growth gains traction. Turkmenistan and Uzbekistan are expected to grow by 12 percent and 8 percent, respectively, in 2010. In both countries, fiscal policy remains expansionary, and tighter policies would help prevent a rise in inflationary pressures. In Azerbaijan, non-oil growth is expected to increase, and the authorities target a narrowing of the non-oil deficit, given the scope to improve expenditure efficiency and the need to ensure medium-term fiscal sustainability. Growth in Kazakhstan is projected to be slower at slightly more than 2 percent, and mildly expansionary fiscal stance implied by the 2010 budget is appropriate (Özer, Karaağaç, & Önden, 2010). A key challenge for CCA energy exporters over the medium term is to sustain growth and achieve sustained employment gains. In Turkmenistan, production volumes are expected to increase for some years to come. Similarly, Uzbekistan has a diversified export base, with oil and gas accounting for only one quarter of all exports. However, both countries have business environments that are less friendly than others in the region (IMF, 2010a).
Energy importers have limited fiscal room and are mostly aiming for modest fiscal adjustment in 2010. In Armenia and Georgia, overall fiscal deficits are likely to increase by up to 2 percent of GDP in 2010. In the Kyrgyz Republic, the recent political events are expected to slow in revenues, but the government can provide assistance to overcome any stress on the budget. With the recovery still weak and growth likely to remain below the rates achieved prior to the global financial crisis, governments should stand ready to provide continued fiscal stimulus if the expected growth does not materialize. However, governments are running out of fiscal room, as donor support is expected to decline in most countries compared to 2009, and public debt as a percent of GDP has increased sharply. As such, additional donor support would provide room for countercyclical spending and public investment to enhance the region’s medium-term growth potential. Current account deficits remain high in the energy importers, ranging from 8-15 percent of GDP. While financing appears secured in the short term, such large deficits constitute external vulnerabilities. In Armenia and Georgia, foreign direct investment currently finances 50 percent of the countries’ current account deficits, and central banks are expected to accumulate gross reserves. Tajikistan can rely less on foreign direct investment but benefits from donor support including concessional lending, even if it is declining.

In these countries, external debt is increasing as percent of GDP. While the region recovering, policies should be implemented to reduce current account deficits and to put external debt into limited levels. Inflation could increase again in 2010, though inflation rates are estimated to stay below 10 percent—similar to those in Russia, but higher than in advanced economies. Depending on the exchange rate regime, these inflation differentials could lead to a reversal of competitiveness gains realized in some countries since early 2009, which would weigh on external demand as a driver of growth. Exchange-rate regimes differ across the region and are changing. During the crisis, most countries abandoned their de facto exchange-rate pegs and allowed currencies to depreciate against the dollar and the ruble. Armenia and Georgia maintain a flexible exchange-rate regime, only smoothing excess volatility, and nominal exchange rates have depreciated recently, which should help maintain competitiveness. Azerbaijan and Turkmenistan follow a de facto peg against the dollar, which has helped anchor inflation differentials, and competitiveness thus will depend on the dollar’s movements against the exchange rates of these countries’ trading partners. Kazakhstan has announced a move toward wider bands, which would allow the central bank to more effectively pursue domestic objectives while preserving competitiveness. Uzbekistan pursues a crawling exchange-rate depreciation in support of its export industries.

**Eurasian Banking System During and After the Crisis**

Eurasian banking systems were adversely affected by the global crisis as in other countries around the world and credit growth has slowed sharply (Nanto, 2009). Policymakers in many countries have taken measures to solve banking sector stress. In short run, these measures include aiding banks to repair their balance sheets and providing liquidity/capital injections under specific circumstances. In the medium term, policies should promote de-dollarization and the development of local debt markets.

**Restoring Credit Growth**

After a period of high credit growth prior to the crisis, credit growth has slowed significantly across all the countries (see Figure 1). As a result of the global financial crisis, banks have seen non-performing loans (NLP) rise and funding decline sharply. Banks are now focusing on repairing their balance sheets and are reluctant to extend new credit. Because in the medium term, credit-financed investment is an important driver of high and
sustained growth, policy makers in the region are thus seeking to restore credit growth. In the region, three transmission channels concerning the global crisis were dominant: First, intense balance-of-payments pressures led to depreciation in several countries. With high levels of de-dollarization and exposure to currency risk, the depreciation contributed to a significant weakening of balance sheets of banks and unhedged borrowers. Second, the crisis subjected banks to a sharp reduction in funding—deposits, remittances, and external borrowing which had been fueling rapid and high credit growth in previous years. And third, the slowdown in economic activity may have resulted in a tightening of credit supply as well as a contraction in demand for credit due to increasing macroeconomic uncertainty.

As countries recover from the crisis, these things should be done: (1) While countries recovering from the crisis, improvements in macroeconomic conditions should create a recovery in credit, both from the supply side—as funding sources reemerge and macroeconomic uncertainty declines, and from the demand side, as the economy begins to work and private agents are more willing to start investment projects. Therefore, fiscal and monetary policies to strengthen growth should help restore credit; (2) As recovery happens, policies should aid banks in the process of repairing their balance sheets by recognizing losses and supplementing bank capital if needed; (3) Where banks are fundamentally healthy and mainly affected by a lack of funding, temporary central bank liquidity/capital injections may help restore credit growth; (4) Over the medium term, policies should promote de-dollarization to reduce vulnerabilities to sudden exchange-rate movements, and thus currency risks. De-dollarization would also enhance the effectiveness of monetary policy. Pre-crisis trends in the region have shown that macroeconomic stability is the most successful factor for sustained de-dollarization. In addition, the regulatory framework should encourage a proper pricing of currency risk, for example, by requiring higher capital charges for foreign exchange loans to unhedged borrowers, thus addressing the indirect currency risk; (5) In some countries, allowing greater exchange-rate flexibility also may help banks and the corporate and household sectors to better internalize the risks of dollarization; (6) Developing local debt markets can contribute to de-dollarization by giving domestic agents access to a wide range of domestic-currency financial instruments. Moreover, local debt markets allow banks to diversify their funding base and thus become less vulnerable to swings in individual funding sources.

In April 2010, the International Monetary Fund (IMF) along with the European Bank for Reconstruction and Development (EBRD) and the National Bank of Georgia (NBG) hosted “Conference on Sustainable Credit
Growth in the Caucasus and the EU’s Eastern Neighbors” in Tbilisi, Georgia with the participation of the region’s private and public representatives. The conference’s key findings were: (1) All countries in the region experienced a boom-bust credit cycle. The sharp credit decline was seen to reflect shifts in both supply and demand; (2) Conference participants discussed a range of options to revive credit in the short term, noting that the effectiveness of conventional monetary policy was limited due to weakness in the monetary transmission mechanism, related to the thinness of domestic capital markets, high levels of dollarization, and banks’ heightened risk aversion (Glodniuk, 2005); (3) For the medium term, there was broad agreement on the need to avoid boom-bust cycles and achieve de-dollarization (IMF, 2010a). All countries in the region experienced a rapid and prolonged expansion in credit, a credit boom, prior to 2008, in the sense that not only credit was growing at a high rate, but well beyond its historical trend. But, this process came to an abrupt end as the global financial crisis hit the region. Since end 2007, real credit growth has fallen sharply, by about 63 percentage points on average. The credit cycle in the region followed similar trends as that in the Baltics and other countries in the Commonwealth of Independent States (IMF, 2010b).

A Channel of the Global Crisis: Dollarization

Before the crisis, dollarization has been relatively high in the region. Between 2002 and 2007, the average percentage of both deposits and loans denominated in foreign currency ranged from 40 percent in Kazakhstan to 80 percent in Georgia. Also during this period, some countries experienced a de-dollarization process, affected by improving macroeconomic performance and stability, and by sustained and large currency appreciation in some countries, such as Armenia and Georgia. While going into the crisis, the de-dollarization process in the region wasn’t completed, and this made their banking systems vulnerable to possible sudden movements in the exchange rate. Two main types of vulnerabilities arose: (1) A direct currency risk arising from a mismatch between foreign-currency liabilities and assets, that is, banks with a negative (short) net foreign-currency position would suffer an immediate loss in the event of currency depreciation; and (2) An indirect currency risk, resulting from lending in foreign currency not to be hedged domestic borrowers. In this case, it is the mismatch on the part of borrowers that would result in an inability to repay their foreign-currency loans, and would ultimately weaken bank balance sheets through a deterioration of asset quality. Immediately prior to the crisis, only Armenia’s banks had a short net foreign-currency position, and were therefore exposed to direct currency risk in the event of depreciation. This short position was the result of sharp increase in deposit dollarization in the run-up to crisis, which banks were unable to match by extending foreign-currency loans before the depreciation occurred. The remaining countries, on the other hand, exhibited a long net foreign-currency position. However, all six CCA countries, by virtue of substantial lending in foreign currency, were vulnerable to indirect currency risk. This risk is also related to the extent to which bank borrowers receive income flows denominated in foreign currency. A comparison of foreign-currency loans with a measure of these income flows also indicates the pre-crisis exposure to indirect currency risk was substantial (IMF, 2010b).

Countries in the region, except for Azerbaijan, also devalued their currencies by 18-25 percent after the ruble’s depreciation against the dollar between July 2008 and February 2009. These depreciations created primarily by exposures to indirect currency risk together with the deterioration in macro-economic activity weakened bank balance sheets. Most of the countries experienced reductions in their capital-asset ratios by more than 2 percent and increases in their NLP ratios by more than 4 percent. Kazakhstan and Tajikistan were particularly hard hit: the NLP ratio increased by 14-16 percent (see Figure 2). Tajikistan managed to escape an
immediate decline in the aggregate capital-asset ratio, partly reflecting a large capital injection from an international financial institution into its banks. In Azerbaijan, the exchange rate was maintained in stability and therefore an immediate capital loss was avoided, although a rise in NPLs occurred (IMF, 2010c).

Figure 2. Exchange rates, capital-asset ratio, change in NPL. Source: IMF, 2010b.

With a negative impact on their lending, the crisis also created important cuts in banks’ funds. Historically, shocks to funding had a significant impact on credit tightening. Domestic deposits accounted for about 20 percent of short-run tightening of credit throughout the entire cycle, while external funding accounted for less than 5 percent. Thus, continued reliance on domestic deposits in the region as the main source of funds may have dampened the credit bust, despite its increasing access to foreign savings in the last ten years. Output movements strongly influenced credit in the region. This reflects a tightening of credit supply in response to worsening macroeconomic conditions and subdued confidence, and a contraction in demand for credit, both of which have contributed to credit stagnation following the crisis, despite policy measures to revive it.

**Measures After the Global Crisis**

Many countries in the region undertook countercyclical monetary policies in response to the credit bust. Central banks aggressively lowered policy rates as well as required-reserve ratios, and introduced unconventional measures, such as direct liquidity support and enhancements to existing deposit insurance schemes. It is notable that private-sector credit has remained sluggish, and lending interest rates have not fallen to the same extent as policy rates. In fact, in some cases, lending rates increased, for example, by 78 basis points in Georgia and 232 basis points in Azerbaijan. In addition, policies were also undertaken in several countries to reduce direct and indirect foreign-currency risks. These policy actions also serve to illustrate the trade-offs that may arise between mitigating risk and stimulating credit growth. As recovery happens, the governments in the region should implement policies to aid banks repairing their balance sheets by recognizing losses, supplementing bank capital if needed, and solving bad loans. Where banks are fundamentally healthy and mainly affected by a lack of funding, temporary central bank liquidity/capital injections may help restore credit growth. Over the medium term, policies should promote de-dollarization to reduce vulnerabilities to sudden exchange-rate movements, and thus currency risks. De-dollarization would also maintain macro-economic stability in the long term. In addition, the regulatory framework should encourage a proper pricing of currency risk, for example, by requiring higher capital charges for foreign exchange loans to unhedged borrowers, thus addressing the indirect currency risk (IMF, 2009).
Conclusion

All countries in the region experienced a boom-bust credit cycle after the crisis. The abrupt credit decline was caused by the shifts in both supply and demand. In order to revive credit in the short term, it should be noted that the effectiveness of conventional monetary policy is limited due to weakness in the monetary transmission mechanism, related to the thinness of domestic capital markets, high levels of dollarization, and banks’ higher risk aversion. The current account deficits of some countries in the region should be managed better than before in order to avoid the external shocks. After the crisis, increasing financial stress which has limited credit growth in the region has adversely affected the economic view of the region. Priority should be given to banks repairing their balance sheets as the precondition for restoring sustainable credit growth. Moreover, the region should seek to return to their pre-crisis paths of de-dollarization by maintaining macroeconomic stability and supportive regulatory measures. In the short run, unconventional measures, including liquidity injections, as well as expansionary fiscal and monetary policies to support growth, also can help revive the secure in private sector.

References


