



Promoting the Development of Domestic Capital Markets

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Causes and systemic risks of underdeveloped local capital markets



Weak macroeconomic policy frameworks

- high inflation volatility promotes saving in USD 
- incentives for FX lending/borrowing as a risk-minimizing strategy
- banking system vulnerability (liquidity, solvency) 
- limited traction of the monetary policy
- implicit government commitments helping FX borrowers

Underdeveloped local funding markets

- reliance on foreign funding
- volatile capital flows increase vulnerability

Abundant foreign financing

- may lead to under-pricing of FX loans

Why to develop local capital markets?

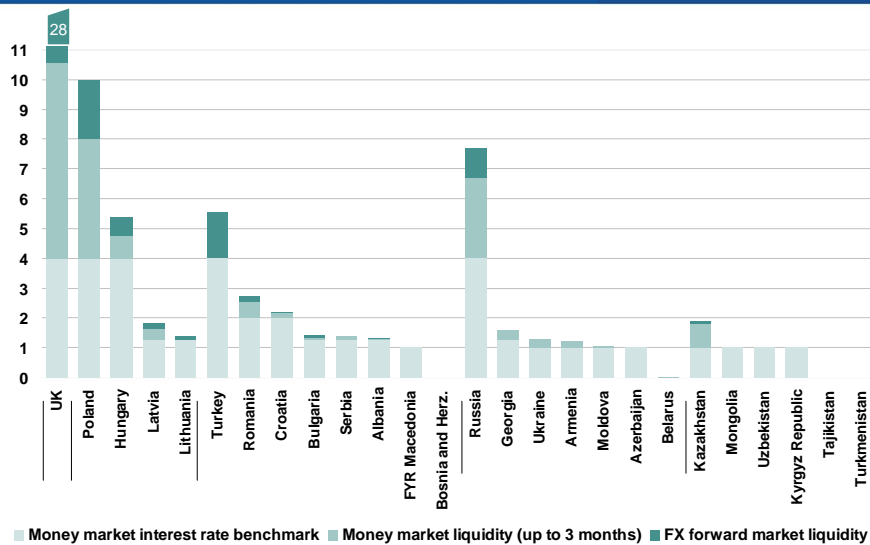
Promotes sound local currency (LCY) lending to unhedged borrowers by

- ✓ addressing systemic risks
- ✓ mitigating vulnerabilities from dollarisation
- ✓ enhancing monetary policy effectiveness

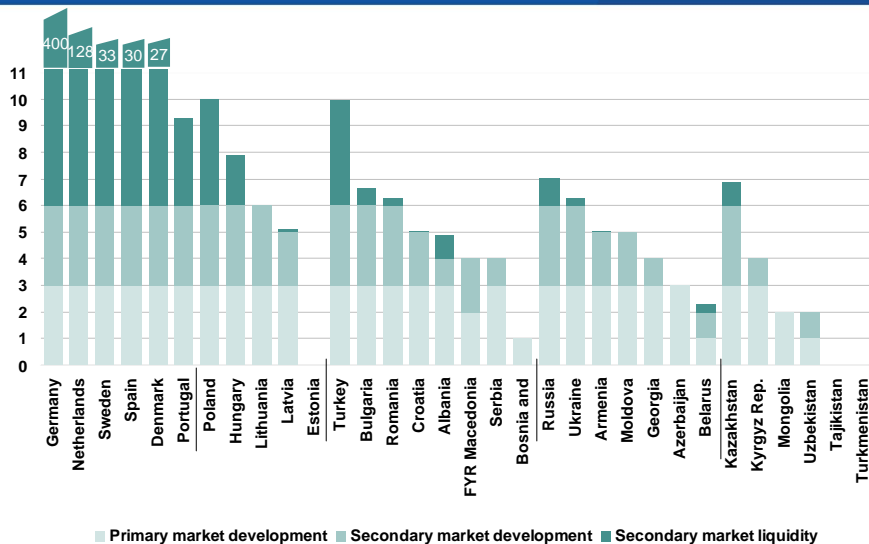
Encourages domestic saving and investment (“new growth model”)

- ✓ pre-requisite for sustainable growth
- ✓ necessary for external stability
 - less reliance on foreign funding
 - less external debt accumulation

In several emerging economies money markets and...



...government bond markets lack depth and liquidity



Potential areas to develop domestic capital markets

Strengthening policy frameworks

- ✓ policies mitigating economic fluctuations
- ✓ gradual move towards inflation targeting
- ✓ allowing more exchange rate flexibility
- ✓ prudent fiscal policies

Money and capital market institution building

- ✓ promoting the use of LC in interbank transactions through well-functioning interbank and FX swap market
- ✓ easing requirements for banks to close FX positions
- ✓ building a strong local currency government debt market
- ✓ strengthening the institutional investor base

Communication

- ✓ sharing information about agenda
- ✓ educating on risks of FX transactions

About the EBRD's Local Currency and Local Capital Markets Initiative



“Holistic” approach: focusing on all factors hindering local currency market development

- ✓ histories of inflation volatility and lack of macroeconomic credibility
- ✓ inconsistent regulation
- ✓ inadequate market infrastructure
- ✓ cheap availability of FX funding during boom
- ✓ causes can differ across countries

Coordinated approach

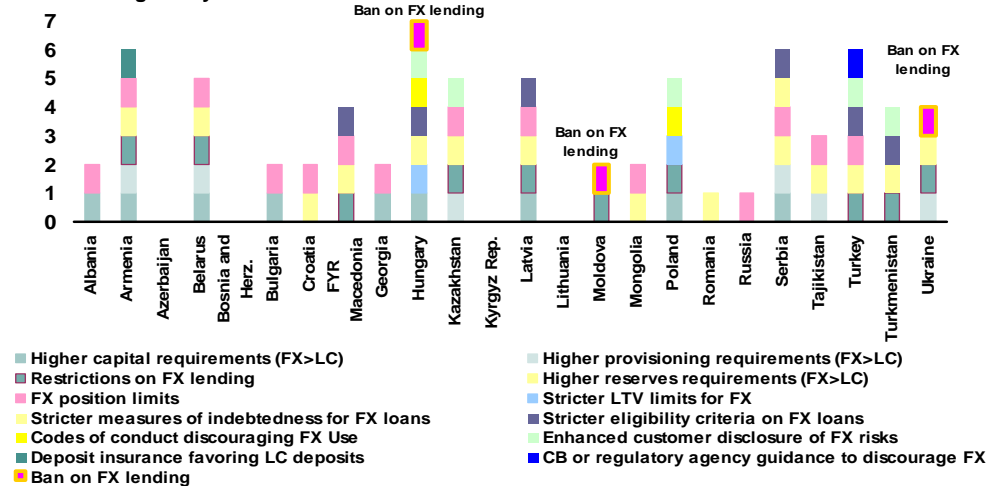
- ✓ country-by-country
- ✓ strong collaboration of IFIs, governments, financial institutions and private investors

It will take time: sequencing, communication and managing expectations

Regulation is not enough



Number of regulatory instruments



About the Initiative: the process



Discussions and engagement with authorities

- ✓ EBRD visit (under the ETC Lending Programme)
- ✓ MoU outlining further potential cooperation

Assessment

- ✓ joint EBRD-IMF-World Bank assessment mission

Policy recommendations/amendment of the MoU

- ✓ macroeconomic policies
- ✓ market development and instruments
- ✓ prudential, foreign currency and payments systems regulations
- ✓ communication

Technical assistance and lending programs

- ✓ developing effective monetary policy frameworks
- ✓ legal and institutional development of local currency markets

Monitoring

- ✓ annual EBRD monitoring report on market and legal developments

About the Initiative: achievements



Four assessment missions accomplished: Armenia, Georgia, Kazakhstan and Ukraine

- ✓ missions join the expertise of the EBRD, the IMF and the World Bank
- ✓ assessment reports with recommendations for the authorities

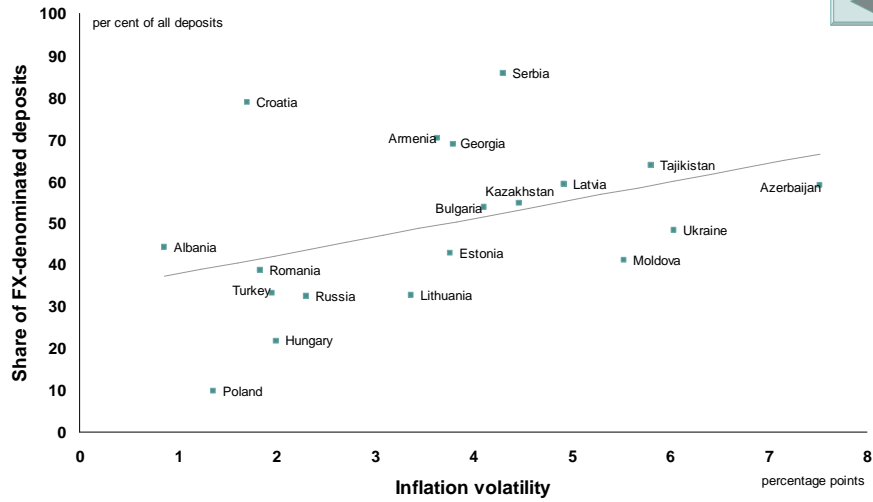
Further assessment missions planned

First stock taking: EBRD AGM in Astana (May 2011)

Long-term involvement

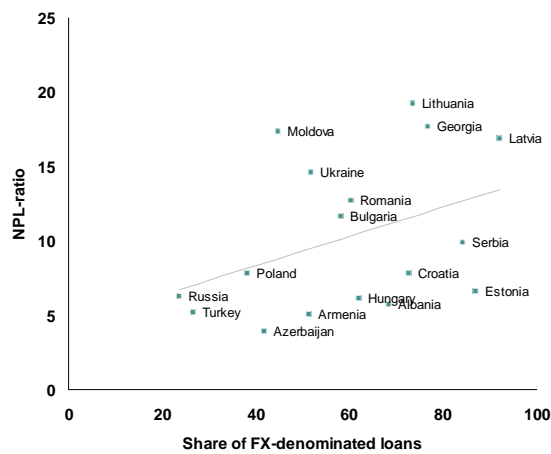
- ✓ technical assistance and joint outreach activities (IMF/WB, EBRD involvement)
- ✓ new LCY funding and lending program for ETC countries joining the Initiative

Inflation volatility promotes deposit dollarisation



Dollarisation contributes to portfolio worsening

Asset-side dollarisation and non-performing loans



Source: CEIC Data Company, IMF country reports, EBRD calculations and country authorities.
Note: Some extreme outliers had to be excluded (Tajikistan, Kazakhstan).