SOUTH CAUCASUS AND UKRAINE INITIATIVE
THE NEED TO ADDRESS FINANCIAL MARKETS DEVELOPMENT IN THE REGION

Working Group on Financial Markets Development and Impact of Central Banks

17 November 2009
Warsaw, Poland
The Need to Address Financial Markets Development Agenda

1. Financial Markets Development Challenges in the South Caucasus and Ukraine (SCU) region

2. The OECD South Caucasus and Ukraine Initiative and way forward
PART 1: Financial Markets Development Challenges in the South
Caucasus and Ukraine (SCU) region

- Challenging Economic Environment...
- ... and Financial Markets Environment
- A focus on Access to Finance for SMEs
GDP growth in the region is impacted by the financial crisis
Average GDP growth falling in 2009

Growth in BSEC-CA Countries
1998 - 2008

GDP Growth
2007-2009

Source: OECD Development Centre / IMF forecast; BSEC. Black Sea Economic Cooperation

Source: EBRD; e. estimate; p. projection
Reliance on external financing is increasing
On average 13% of GDP for BSEC region

External Financing - BSEC

Source: OECD Development Centre / IMF, BSEC. Black Sea Economic Cooperation
A measure of competitiveness: FDI growth is slowing down
How to support the quality and quantity of FDI?

How to improve both quantity and quality of FDI?

FDI in USD million

Central Europe
SEE
South Caucasus and Ukraine
Central Asia

Central Europe: First Wave of FDI
SEE: Second wave of FDI
SCU: Third wave?

Impact of the financial crisis

Source: EBRD Transition report 2008, OECD Analysis
A measure of private sector development: SME fragmented
Representing 95% of companies but 37% of GDP

Access to finance one of the key elements contributing to SME development

PART 1: Financial Markets Development Challenges in the South
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Relative high cost of borrowing
Lately declining after the impact of the financial crisis

Market interest rate
Weighted average across maturities

Armenia

Azerbaijan

Georgia

Republic of Moldova

Ukraine

Source: EBRD, Transition Assessment 2009. OECD analysis
Stock market capitalisation impacted by the financial crisis
However domestic credit to private sector increasing

On average, stock market capitalisation 30 percentage points lower in the SCU region.

On average, domestic credit to private sector 12 percentage points lower in the SCU region.

Source: EBRD, Transition Assessment 2009. OECD analysis
SCU. South Caucasus and Ukraine, SEE. South East Europe
High risk of not servicing external debt according to OECD export credits risk classification

OECD Country Risk Classification
under the arrangement on “Officially Supported Export Credits” (2008)

Measurement of likelihood that a country will service its external debt.

Source: OECD 2009
Liquidity (Broad money share of GDP) is increasing
However remains lower than in South East Europe

Broad Money M2
As percent of GDP, 2003-2008

M2 % of GDP

2003 2004 2005 2006 2007 2008

Armenia
Azerbaijan
Georgia
Republic of Moldova
Ukraine

In 2008 broad money is 23 percentage points lower than in the SEE region.

Broad money increase follows similar patterns throughout the SCU region.

Source: EBRD, Transition Assessment 2009, OECD Analysis
Note: SCU. South Caucasus and Ukraine, SEE. South East Europe

Broad money is the sum of money in circulation outside banks and demand deposits other than those of the central government. It also includes quasi-money (time, savings and foreign currency deposits of the resident sectors other than the central government). Data sourced from the IMF, International Financial Statistics, IMF country reports and monetary authorities.

SEE average based on data for Albania, Bosnia and Herzegovina, Bulgaria, Kosovo, Montenegro, Romania, Serbia
Level of reform improving for banking and non-banking sector although below SEE - according to EBRD Index

The values of EBRD index range from 1.0 to 4.0+, with 1.0 indicating a rigid centralized economy and 4.0+ implying the highest level of reform, which corresponds to a fully industrialized market economy.

SEE average based on data for Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Montenegro, Serbia

SCU and SEE regions follow similar patterns.

SCU is closely aligned with the SEE region.

Source: EBRD, Transition Assessment 2009, OECD analysis
PART 1: Financial Markets Development Challenges in the South Caucasus and Ukraine (SCU) region

- Challenging Economic Environment...
- ... and Financial Markets Environment
- A focus on Access to Finance for SMEs
Access to finance perceived as key obstacle to private sector development

Is access to finance an obstacle for firms?
SMEs represent 80% of respondents, 2007

- No obstacle: 26%
- Access to finance is an obstacle: 70%
- Do not know: 4%

Why did the firm not apply for a loan?
Percentage below includes only firms in need for a credit

- Interest rates are not favorable: 50%
- Collateral requirements for loans or line of credit are unattainable: 16%
- Application procedures for loans or line of credit are complex: 14%
- Size of loan and maturity are insufficient: 6%
- Did not think it would be approved: 3%
- It is necessary to make informal payment: 1.5%
- Other: 9%

70% of firms report access to finance as an obstacle to their business.

Interest rates and collateral requirements identified as the main barriers.

Higher barriers to access to credit than peers
Measured by collateral requirement and cost of borrowing

Sources of financing could be further diversified in the SCU region

Structure of financing for new investments
Percentage share, 2005, 2008

In the SCU region owner’s contribution is one of the major sources of financing.

* Leasing arrangement: a contract granting use or occupation of property during a specified period in exchange for a specified rent.

Data for SCU is from 2008 and data for OECD is from 2005.
The Need to Address Financial Markets Development Agenda

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OECD Initiative for the South Caucasus and Ukraine

Enhancing Regional Business Climate
- Prioritisation of policies to improve the business climate
- Policy Working Groups
- Competitiveness report on the South Caucasus and Ukraine

Improving National Competitiveness
- OECD Sector Competitiveness Strategy
- Surveys of investors and private sector perception
- Evaluation of policy reforms
- Supporting in implementing reforms

Building Capacity
- Training and coaching focused on policy makers and SME business intermediaries
Governance: Strong collaboration with regional bodies and the private sector

Policy Working Groups:
- Investment climate policy and promotion
- Financial Market Development and Impact of Central Banks
- Human capital for financial and business services

Country specific projects

Co-chairs: Poland and Sweden

Advisory Council

OECD Secretariat

Regional Offices and presence: Republic of Moldova

OECD donors and partners

SCU country economic teams

International Organisations and private sector representatives

Private Sector Council

Eurasia Expert Council

Working group on FMD co-chaired by the Czech Republic Collaboration with EU Eastern Partnership
Determining policy priorities across the region

PfC – SCU results overall

Which policy dimensions are of priority to improve investment, competitiveness and private sector development in the South Caucasus and Ukraine region?

Financial Markets Development identified as one of the key policy priorities to support competitiveness

Source: OECD Policies for Competitiveness Assessment Framework
Financial markets development
Four pillars to address policy reforms

PfC – Financial Markets Development
Level 2 and 4

Institutional Framework
- Coordination of supervisory responsibilities
- Central Bank independence
- Capital Market Authority
- Off-shore Financial centres
- Financial sector openness
- Financial education

The Banking Sector
- Competition
- Foreign entry and ownership
- Basel capital adequacy requirements
- Domestic credit to Private Sector (as % of GDP)
- Non-Performing Loans
- Transaction technology infrastructure

The Capital Markets
- Stock market depth and liquidity
- Sophistication of financial instruments
- Technical Infrastructure
- Development of the Corporate Bond Market
- Government benchmark curve

Access to Finance
- Credit guarantee schemes
- Collateral and provisioning requirements
- Cadastre
- Availability of risk capital
- Registration systems for movable assets
- Micro-finance facilities

Source: OECD PfC Assessment Framework
OECD Policies for Competitiveness Assessment Framework: Example for Access to Finance

Access to finance

**Effective Regulatory Framework**
- Collateral and Provisions Requirements
- Registration Systems for Movable Assets
- Cadastre

**Access to Bank Finance**
- Competition in the Banking System
  - Banking Sector Outreach
- Domestic Credit to Private Sector
  - Non-Performing Loans

**Access to Capital Markets**
- Capital Market Authority
  - Stock Market Depth and Liquidity
- Development of the Corporate Bond Market
- Sophistication of Financial Instruments
  - Corporate Disclosure requirements

**Early-Stage Finance**
- Availability of Risk Capital
  - Business Angels Network
- Micro-Finance Facilities

**Guarantee Schemes**
- Credit Guarantee Schemes
- Mutual Guarantee Schemes
- Export Guarantee Schemes
- Credit Information Services

**Improving Skills**
- Financial Literacy
- Entrepreneurial Training

Source: OECD PfC Assessment Framework
### PfC – Access to Finance

#### Level 3 and 4

<table>
<thead>
<tr>
<th>ACCESS to FINANCE</th>
<th>3.1 Effective Regulatory Framework</th>
<th>3.2 Access to Bank Finance</th>
<th>3.3 Access to Capital Markets</th>
<th>3.4 Early-Stage Finance</th>
<th>3.5 Guarantee Schemes</th>
<th>3.6 Improving Skills (Quality of Demand)</th>
</tr>
</thead>
</table>

#### 3.1 Effective Regulatory Framework

<table>
<thead>
<tr>
<th>3.1.1 Collateral and provisions requirements</th>
<th>3.1.2 Registration systems for movable assets</th>
<th>3.1.3 Cadastre</th>
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<table>
<thead>
<tr>
<th>Level 1</th>
<th>Level 2</th>
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<tbody>
<tr>
<td>Very high collateral requirements (more than 200%). Restrictive collateral definition and/or rigid provisioning requirements for uncollateralised loans.</td>
<td>Collateral requirement ranging 150-200% of loan amount. Restrictive collateral definition and/or rigid provisioning requirements for uncollateralised loans.</td>
<td>Flexible collateral definition and/or flexible provisioning requirements for loans under EUR 20 000.</td>
<td>Flexible collateral definition and/or flexible provisioning requirements for loans under EUR 20 000 and central collateral registry in place.</td>
<td>Flexible collateral definition and/or flexible provisioning requirements for loans under EUR 20 000 and central collateral registry covering most bank loans.</td>
</tr>
</tbody>
</table>

Source: OECD PfC Assessment Framework
PfC survey for SCU: Access to Finance identified as a key priority

Based on a sample of assessments completed by SCU countries, 2009

**Access to finance**

- Level 3

**Guarantee Schemes**

- Level 4

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**Guarantee schemes, improving skills and early-stage finance identified as top priorities.**

**Mutual guarantee schemes and export guarantee schemes identified as priority sub-sectors to address.**

Source: OECD Survey, 2009
Example of next steps: Monitoring the evolution of policy reforms for private and banking sectors

OECD SME Policy Index 2009: Access to Finance

<table>
<thead>
<tr>
<th>Scores for sub-dimension</th>
<th>ALB</th>
<th>BIH</th>
<th>HRV</th>
<th>XK</th>
<th>MK</th>
<th>MNE</th>
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