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**DMITRY PANKIN, DEPUTY MINISTER OF FINANCE, RUSSIA**

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**MEDET SARTBAYEV, DEPUTY GOVERNOR, NATIONAL BANK OF  
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**OLEKSANDR SAVCHENKO, DEPUTY GOVERNOR, NATIONAL BANK  
OF UKRAINE**

**HERBERT STEPIC, CHIEF EXECUTIVE OFFICER, RAIFFEISEN  
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THE MODERATOR: Thank you all very much for joining us. Hopefully, you have all been able to find a seat and you can squeeze in. Following from last year's session, which was obviously timed nicely ahead of the current market environment, the topic is very similar. We are looking at financial instruments in the region that need to be further developed to improve the resilience of the region. Obviously, the last nine months have more than demonstrated how important the resilience of financial markets is.

Our panellists will help provide a lot more insight and guidance for the future. First is Herbert Stepic, the Chief Executive of Raiffaisen International, one of the leading banks across the whole region, who has years and years of experience. Cristian Popa is Deputy Governor of the National Bank of Romania. Dmitri Pankin is the Deputy Minister of Finance for the Russian Federation. Oleksander Savchenko is from the National Bank of Ukraine. Medet Sartbayev is Deputy Governor of the National Bank of Kazakhstan. George Handjinicolaou is Chief Executive of the International Swaps and Derivatives Association (ISDA) in Europe.

Obviously, since we had our Annual Meeting in Kazan, we have seen a marked change in the financial markets. The credit crisis, which obviously started a long way away from the region, has had a significant impact on Western banking systems. It has had a relatively modest impact on the economies in the region. Nevertheless, the banking system itself is feeling the shockwaves of the impact, but itself it has not had any exposure to the losses incurred by the Western banks.

Nevertheless, it has highlighted a couple of key issues. It has highlighted the role of liquidity within the banking system, which is very varied across the region, country by country. It has also demonstrated the vulnerability of the region, in terms of its current account deficits, which are inherent in the growth we are seeing, but also in terms of the reliance of the foreign exchange capital markets, again which is part of history and part of building the financial markets. That, again, has highlighted some of the vulnerabilities.

At the same time, the impact on the real economy and on the credit environment is still very modest, and only the future will tell whether the real economy we are

beginning to experience in the Western economies will trickle into the countries of operations.

The same applies to the direct impact on the credit markets. We have obviously seen movements in the way credit spreads have moved in the Western markets and emerging markets and the banking system; but the impairment of loss of credit portfolios has been remarkably modest in the Western markets and here in the region.

However, again, things are very dynamic and moving month by month.

At the same time, we have seen inflation cross the paths of the banking system and the central banks. In many cases, the inflation has nothing to do with the sub-prime crisis or the financial crisis, and it is causing severe policy dilemmas, not only in Washington and New York and Frankfurt, but also in the region where severe inflationary pressures come from the increase in energy and food prices. This is causing a dilemma for the central bank in terms of policy instruments. In the US and the European markets policy instruments are relatively abundant, but in the region they are still under development. At the same time, the financial institutions that participate in the region, in terms of needing to develop activities in the local financial system, are lacking the instruments to be able to manage and grow their portfolios and balance sheets in the way that is needed to support the growth of the region.

The theme today is to look back over the past nine months to see what we have learnt and look at what the banking system, the central banks and the governments have done to guide the economies through a rather turbulent time. We can draw lessons from that as to which sections of the financial market we need to focus on in order to improve resilience and long-term sustainability to support the long-term growth in the region.

I will ask Mr Stepic to give us an assessment of how Raiffaisen Bank has coped in ensuring that the credit growth is supported with an internationally connected bank, and to draw some lessons. It is not a homogenous region; there are different factors and different pressures in different countries.

MR STEPIC: Good morning. I feel very sorry for all of you who have to stand while we have the comfort of sitting here - but that is part of crisis management! We will do better next year, I hope.

I think, in front of this audience, to talk about Eastern Europe - and that it is not Eastern Europe any more is a fact - so let us talk about different regions. The results are these. The capital markets are heavily affected not only in Western Europe, but as a consequence in all three regions, and that means Central Europe and South-Eastern Europe as well as the CIS countries. That means that the non-governmental bond market is still literally dead.

On the other side, as a consequence of the liquidity crisis, there is much higher risk consciousness on the part of market participants. Despite the fact that the economies of the emerging markets are still running high - which I will come to - nevertheless the readiness to grant liquidity is reduced. We are talking about a reduced influx of funds to most of the regions.

As a consequence of supply and demand and the increasing consequent risk - just look at the CDS markets as they have developed over the last eight months - funding became not only scarcer but more expensive. We are talking about higher funding costs, in central Europe of 30 or 40 basis points; in south-eastern Europe, 60 or 70 basis points; and in CIS countries 100 basis points and over. There are specific countries where the risk pattern is more significant; that is countries where, in addition to the global banking crisis, there are political issues, as we have seen, due to the election situation in Serbia. Consequently the CDS market was even above 200 basis points.

We are still experiencing a specific situation, although at a reduced level, thank God, due to the extraordinary loan-to-deposit ratio, a widening of the credit spreads and CDS spreads in Kazakhstan. Kazakhstan is affected most, and this country, with a loan deposit ratio of 150 is the next country where I believe that funding will flow in on a much reduced level as before.

How are the banks affected and how are they counteracting it? The countries of the first transition phase that have invited international banks to a large degree are doing best. Large international banks are funding their subsidiaries so far entirely. That is, I would say, not a guarantee but a solid back-up for coming months when we see a continuation or even an increase of the crisis, because we might see a fraction of the real economy that has not been seen so far to have had an additional impact. Liquidity will become even more important during the next 12 months - it is not over yet.

Having said that, I should emphasise that the consequences on the real economy cannot be felt so far - for there is very little direct involvement with the US trade-wise.. There is a strong relationship with EU countries, but the EU itself is not very much affected as far as the real economy is concerned.

In a nutshell, the real economy is not affected yet. That might come. What we have seen, due to the fact that money became scarce, is the fact that economies and projections and forecasts for this year for GDP growth have come down, I would say on average for all three regions by approximately 1.5 to 2 per cent. That is a positive message on a very high level. The average for all three regions is around 5.5 per cent, which is in multiples of what we forecast for the EU region.

The second positive message for the economies as well as the banks involved is that we see a cooling down of the very much over-heated lending processes. Romania had 80 per cent plus credit growth; here 70 per cent - I am talking year over year, not the last five years - and Russia had 54 per cent credit growth. It is very much fuelled by private consumption, by the way, in most of the countries. That will come down. There is less availability of funds. We guess that the growth rates that I have just mentioned will be down by 50 per cent in this year. The forecast for Ukraine still stands at 35 to 40 per cent plus, so that is still running high.

There is reduced GDP growth, but it is still at a very high level. Reduced lending activities give the banks time to breathe again, and that is the positive message that I definitely see.

As a consequence, the world has changed in terms of economies and the banks. As a consequence it will also have an impact on economies. Countries that have run a solid economic policy are less affected, specifically as far as the exchange rate is concerned, than others. Countries where the exchange rate is affected are Romania and Hungary, and others that have a very solid policy specifically on inflation, like the Czech Republic or Slovakia, are doing very well. We are even talking about increasing a very strong upward tendency as far as value of currency is concerned.

The situation in countries where foreign banks are active is usually much better than in others, and the risk that large banks will discontinue financing their subsidiaries is less. The consequence for the governments and central banks in being very prudent to fight inflation is higher than ever before, because we need specifically primary deposits from the local markets. The fact that this market was able to increase primary deposits over the last three years by over 50 per cent year on year tells you how much is still hidden under pillows or mattresses, hiding from the open economy! That is the cheapest source of financing.

I have been talking too much. I apologise and will shut up.

THE MODERATOR: I would like to ask how the central bank has been coping with the financial crisis, the changes in liquidity, the foreign exchange environment, and I would ask you to highlight the differences in various countries.

MR POPA: Just to give you a context of the environment in which we are operating, we have an inflation targeting regime, but this is very broadly defined and flexible. We are not interested in hitting isolated targets at a given point in time; we are interested in achieving a medium-run inflation path that is sustainable. That is key because you have to be aware of not increasing the equilibria present in the economy and not creating any others, and also managing financial stability because that, if not managed, could turn out to be a threat to the stability of inflation performance, apart from causing problems of its own.

In that context we have had an increasing inflation rate. Last year, at mid-year, it stood at about 3.8 or 3.9 per cent on a 12-month basis, and right now it is 8.6. We

undertook a series of measure to bring that under control, which also had to do with the fact that the exchange rate has registered a correction compared to the extremely unsustainable and nominally highly appreciated levels throughout the past two years or so, ending in August of last year. That brings into account a series of other problems.

The first thing you may be familiar with, but which I will mention anyway, is the fact that we have had five monetary policy rate hikes totalling 275 basis points.

Obviously, that does several things. First, it means that you have to manage demand in a very classical setting. You need to fine-tune it so that you do not stimulate a spill-over of demand for credit into foreign exchange, because that may prove to be, despite the changes in the exchange rate, more cheaply available, especially when the prospect of interest rate increases is fairly open-ended.

The second thing you need to do with that is show a reaction by maintaining the policy rate in positive territory, stimulate savings and therefore reduce consumption, and also stimulate a reduction or correction in the savings/investment balance so that the external disequilibrium, which worries a lot of investors, starts to peak and then gradually decrease. I think that is the right approach to gradually letting out the steam.

Then we looked at the fact that credit is growing very fast. I am sorry to have to brag, Mr Stepic - it is not 80 per cent - real-term 12-month credit growth in January, if I remember correctly, was about 52 or 53. I may be off by a number of percentage points, but anyway it was very fast.

We have long spoken about the fact that despite the need for credit to grow, the inevitability of catching up needs to be done in a fairly gradual fashion so that nothing untoward arises in the economy in that catch-up process. Therefore, we would be very happy to see a deceleration.

We are now contemplating two scenarios. If things continue, even in these troubled times of persistent turbulence in financial markets, exposure to emerging markets, and especially to new European Member States, will still be profitable for European

banks, especially for those that have large domestic presences anyway, because of incomplete saturation and interest rate spreads that are profitable for these banks to operate with.

Growth in these countries being on the high side, despite some corrections, is still very promising for anybody wishing to expand their business, and that is the more likely scenario. In case the unlikely scenario, which is that turbulences worsen and the pressure for liquidity in banks in parent countries increases, you would see an outflow from their operations, but we discount that quite significantly. We still think that even with a slower pace of growth, exposure will continue to be significant. We will be very happy to see growth go down from fifty something into twenties and thirties territory, because we think that is more manageable and more in synch with the disinflation work we need to do right now.

We have also looked at the balance of risks in the financial sector, and found that for example in Romania, with about 55 per cent of total stock of credit in forex, more needs to be done from the central bank to manage this kind of risk - the asset liability mismatch.

Recently we adopted an increase in provisioning regulations even for standard credits, in terms of banks' exposure to unhedged borrowers, and with a special focus on households. We have also upped our financial stability assessments and stress tests, and we urge banks to proceed and do the same thing themselves, because the risk assessment they carried out when deciding on credit scoring before the turbulences arose may be significantly different than the risk assessment they can do right now. We urge them to do that and we want them to maintain a dialogue on this process with the commercial bank community and the Romanian Banking Association.

We have been highlighting the fact that people need to be aware of not only credit risks but exchange risks when undertaking borrowing in foreign exchange. That is why we have been vocal on the entire exposure to foreign exchange borrowing, but especially so in terms of exotic currencies. Some business models that are prevalent elsewhere have started to catch on in Romania, and that is exposure to Swiss franc borrowing, especially for longer dated loans.

We think that those can be expensive over time and are more difficult to balance because people naturally in Romania tend to have savings in euros or dollars, very seldom in Swiss francs. Therefore the ability of non-corporate debtors to hedge these risks is quite limited, and they should be extremely prudent when they engage in such borrowing.

That is the kind of environment we are working in. We are also exchanging information constantly with other regulators and supervisors in other areas of the financial sector, be it capital markets, insurance, private pensions and so on, in the context of the wider exercise within the scope of the European Union. I think this is very valuable right now, because there may be developments that are germane to the banking sector arising elsewhere. So far we have not seen a great impact on liquidity. What we have seen is that compared to the generalised excess liquidity that we had to deal with during the summer and which was prevalent over last years, the situation is beginning to get into more reasonable territory, in the sense that not all banks are in excess liquidity positions all the time. We expect this to move to the point where we will become a net creditor, as is normal for a central bank, rather than a net debtor as is the case for banks in emerging markets with extremely strong catching-up processes.

We have recently also made improvements to the framework of monetary policy in the sense of creating a symmetric corridor for the deposit facility and the Lombard facility of the central bank that moved together with changes in the monetary policy rate. We have also changed the penalty rate in relation to the monetary policy rate, in a way that is straightforward and can have an index, so to speak, in case any changes occur in the future in regard to the policy rate.

So far, so good. Our balance is of contained risks in the system. We think that policies - and I refer not just to monetary policy but to fiscal and wage policy as well - need to work together to contain the imbalances in the economy and therefore put the country on an even more sustainable footing as it goes forward.

THE MODERATOR: The Russian market has been remarkably resilient during this crisis, so can you give your assessment of it?

MR PANKIN: Last year we had an expectation that the Russian banking system would have some problems and that we needed to cope with the world financial crisis, and needed to prepare. Some very important measures were taken. The central bank had a much improved scheme of intervention. We have now serious capacity from the central bank to lend money to commercial banks. Many assets could be used as collateral for such loans, and the potential volume of short loans from the central bank to commercial banks is now about 1,500 billion roubles.

Our Minister of Finance took some measures and we introduced a system to sell liquidity to commercial banks, because typically we have a huge amount of liquidity locked in our central bank accounts. This is not used by commercial banks, and the volume could be up to \$100 billion. I do not mean a reserve fund or a stabilisation fund; it is only just the current account of the federal budget.

We introduced a system so that part of this money could be sold through the auction system to commercial banks when we have a demand for liquidity.

We had some expectation, but real life was not so bad, I would say. This is the same as most banking systems in eastern Europe. Basically, our banks were not involved in complicated structured products; it is a simpler banking system - just loans for consumers, loans for the corporate sector. The corporate sectors are not going badly, and in Russia there are not many consumer laws. They are rising, but there is not a large volume (interference on tape recording).

Our bank did not deduct any losses from its balance sheet, and all assets were more or less good. Another problem for the Russian banking system was in connection with refinancing foreign loans, because many banks used borrowing from foreign markets in order to develop domestic activity. The question was how to refinance the foreign loans, especially in the first quarter of this year when foreign capital inflows practically stopped. We expected that the US \$500 billion reserve with the central

bank would be enough to cover a repayment of \$10 billion or \$15 billion repayment of foreign loans.

I can say that this expectation was too optimistic. Now we can see that in the second quarter we will have inflows of foreign capital, and it is the same problem for the central bank in knowing how to materialise the inflows of foreign capital and how to cope with inflation.

Did we have any impact on activity? It was a rather small impact. To some extent, there was an impact on interest rate growth for private consumers for the commercial sector, but it was not a great amount. Many companies had to postpone external borrowing and also foreign bonds - the issue of cross-border back home perhaps - in the middle of this year or third quarter.

As I said, the Minister of Finance introduced a special system of budget auctions to provide liquidity for commercial banks. We expected that there would be enough demand and put the limit up to US \$12 billion that could be sold through this auction; but the demand was only \$1 billion. However, the Ministry of Finance was very happy because it meant that the real market had enough liquidity and it was not necessary to put in additional liquidity. Therefore, the banks could work on their own without help from the federal budget.

The biggest worry in Russia now is inflation. We could not cope with the inflation target last year, when inflation was about 12 per cent. This year, the same first months did not show a positive result, and inflation is still a real problem. We understand the situation, and it is very difficult to fight it, because there are huge capital inflows and a huge rise in budget expenditure. With such currency inflows it is very difficult to explain to other ministries and the population that we cannot increase budget expenditure. Rising budget expenditure would mean that inflation would increase and investment would decrease because the investment climate would be poor and would lose in the long term; but if the short-term requirement for roads, for health, for pensions is very high and there is a lot of demand, it is very difficult in such an environment to cope with budget expenditure. The result is of course

inflation. Last year, if our budget expenditure grew by 40 per cent you could imagine the effect of that on the economy.

We are not worried about some turbulence in the world financial market, due to the huge currency reserve, but our biggest worry is inflation in such an environment.

MR SAVCHENKO: Thank you for the opportunity to speak to you in regard to Ukraine. In my view, Ukraine prepared very well for crises. Last year the Central Bank introduced some very efficient measures. One of them incorporated banking liquidity risk and currency risk in the capital adequacy ratio. It connected with all Ukrainian banks and they started to think much more about capital. Compared to other countries in the international markets the liability of our banking system is quite small, at about 22 or 23 per cent. It is much less than in Russia or Kazakhstan and other countries. More than half of this figure belonged to banks with 100 per cent foreign capital, as Mr Stepic represented.

That is why we do not care about such risks because they have a very solid mother institution.

The rest, 10 billion to 15 billion, is easily financed through the domestic market; basically it is a basic deposit scheme of individual cooperation as well.

As a result, we see a shortage not of foreign currency, but of local currency, hryvnia. It is a common problem for Europe and the world - acceleration of inflation - not inflation, but acceleration of inflation.

What are the reasons for inflation in Ukraine? We calculate that the food basket inflation is 52 per cent. You can see the influence of rising food prices on inflation. Energy is responsible for 11 or 12 per cent. Nevertheless, we think that the contribution of local banks to inflation is also substantial. Last year credit growth for individuals was 200 per cent. We believe that 45 to 50 for this year will be the figure for the banking system.

That is why approximately a month ago we introduce a tighter monetary policy. The era of cheap local currency finished in Ukraine, and a tighter monetary policy began. As a result, soon you will see much greater flexibility of the exchange rate in Ukraine. The key aim of the central bank is stability of local currency. We have to keep inflation internally stable, and keep external stability via the exchange rate. That is why, as our Chairman said in his statement yesterday, there will be greater flexibility in coming days. The expectation of the market is that there will be appreciation of local currency for the time being.

How has this crisis impacted on the real economy? I believe that it has not impacted greatly. GNP growth we expect this year to be between 6 and 7 per cent. We now have 6.3 per cent, but because we expect very good growth, there will be an acceleration, which will very much affect the world market for food, because we expect a 50 per cent higher growth in Ukraine than in previous years. We have tried to eliminate export of our grain and other products over the year, and that is Ukraine's contribution in the food price crisis.

THE MODERATOR: Medet, in Kazakhstan it has been an interesting nine months.

MR SARTBAYEV: I thank the organisers for giving me the opportunity to speak. I will focus your attention first on measures we took before August, before the crisis. Starting from the second quarter of 2006 we introduced a tighter monetary policy. It included the introduction of new rules for minimum reserve requirements, as a result of which all the [liabilities were] included in the calculation base, and it resulted in a positive increase of more than four and a half times.

The Central Bank also accepted a couple of measures, including the liquidity ratio, which required 100 per cent coverage of ... efforts .... and also decreased the open position limit from 30 per cent to 25 per cent. In April 2007 everything was reduced ... of the capital ... which is required from the banks' increase of the capital in case they are going to increase their ...

The year 2006 also featured new measures like the new FSA weighting of the risk for collateral for mortgage lending; and they introduced more requirements for evaluation of collateral lending.

The macroeconomic figures: we closed the year 2006 with inflation at 8.4 per cent, which was one or two basis points more than the forecasted level for this year. The external debt has grown from 70 per cent to 90 per cent in 2006. Of course, that created concern to the monetary authorities because the inflows of capital from export of commodities and borrowing activities of the commercial banks pushed us to a tight monetary policy.

In August 2007, when the [selling started from] hedge funds, we started to react immediately to the situation. I would say that we did not neglect the problem. We understood that it would be a new cycle and would not end in one month. We immediately called on the shareholders of the banks, asking them to preserve the liquidity they had obtained for the previous years. Some banks, like Allianz Bank were supposed to buy [other assets] such as a bank in Russia – [valued at] \$2 billion still. BTA was supposed to buy the oil refinery in Turkey, also a \$2 billion deal. We told them that if they were going to [buy assets] abroad and to create longer positions in subsidiaries abroad, we would not support them in that case. We asked them to secure liquidity to withstand all the challenges we would be facing in the future.

The second message that we delivered to the commercial banks was that in the event of a shortage of liquidity for financing [their] debt, the central bank was committed to support them,..

We also organised a couple of conference calls with international investment funds and commercial financial institutions during August - more than 15 conference calls. More than 150 institutions were on the other side of the conference calls.

We wanted to deliver the main message that we would be committed, like many other central banks, to supporting our commercial banking system, so that when the commercial environment is tightened it would make it easier to inject liquidity into

the system. Financial stability issues are a priority for us, and inflation issues were [of less concern] at the time.

When we talked to the investment banks and financial institutions, we committed to support those with an exposure in money market instruments in Kazakhstan.

Actually, it was quite an active development in 2006 and at the beginning 2007 we had around \$7 billion invested in money market instruments in Kazakhstan. Over the first half of the year, before the crisis, around \$2 billion was closed just before the closing of the positions. In August, around \$2 billion was withdrawn from the system.

Our commitments were working, and, as a result, more than 50 per cent, more than \$3 billion was left in the system. We took a long view on cooperation with our partners in Kazakhstan. We have long-term views for development of the stock market in Kazakhstan, while the government and central bank, together, executed a new project for creation of the Regional Financial Centre in Almaty, which has created tax incentives and raw material incentives for market participants to develop the stock market in Kazakhstan.

Bearing in mind these perceptions, we tried not to create barriers for institutional investors; we tried to bring comfort to those investors who already had confidence and some exposure in Kazakhstan.

In regard to the operational part of our activity, we injected liquidity from August until now and the turnover was more than \$40 billion. In terms of the monthly distribution or allocation of this amount, in August we injected around \$8 billion and September around \$8 billion. That substantially decreased, beginning in October - around \$4 billion; and we closed in 2007 with a position of not more than \$1 billion.

We opened two windows. One was a purchase agreement in public securities. In the second window we set the limit for 50 per cent out of the reserve deposit for the banks, allowing them to swap one currency with another. They needed to meet their liquidity ratio requirements.

In terms of the acceptance of other instruments as collateral, we did not start accepting corporate debt in August. We supposed that those windows which we provided in liquidity was enough, and there was no demand for the banks. The dynamic was that by the end of the year we had a substantial decrease in injection of liquidity.

As a result of the liquidity injection, it helped the banks to withstand some challenges at the beginning, when they did not want to borrow at a higher price on the international market through syndicated facilities. Starting from the second half of the year the banking system repaid more than \$50 million in debt. There was no default and still our banks are solvent.

It was very important to focus on the foreign exchange market at this stage. By the end of August there was general volatility of the exchange rate linked with the amendments to the customs law, which required any importer to present certificates. It was done especially for upgrading of customs statistics, but no-one knew that they would have an impact on the exchange rate and inflation in Kazakhstan.

Before the holidays at the end of August, we received information from the banks that they cannot withdraw bank notes in hard currency that were imported into the country from exchange offices in the customs docks. We asked the Ministry of Finance and Customs authorities asking them to release all notes otherwise we would not have any other external shock but would have a crisis without external shocks.

As a result of this suggestion the banks were able to ... (break in tape recording) ... to 140. A panic arose in Kazakhstan. The population does not evaluate the situation of economic categories with any models; if they think that something will happen, they just add to the price. Many merchants who imported commodities to Kazakhstan had additional operational expenses. That was one of the reasons for the surge in inflation.

In October 2007 we had inflation of 4.4 per cent instead of the forecasted level 0.7 per cent. At the end of the year inflation was much higher than forecast. December to December was 18.8 per cent and average inflation for 2007 was 10.2 per cent.

Next year, we think that average inflation will be 16 per cent, and month-to-month inflation will be in the region of 10 per cent. For the first quarter the inflation level is 2.5 per cent, which is much less than forecast.

In the foreign exchange market it is important to mention that in August and September there were \$6 billion out of the reserves of the Central Bank. This injection helped us to keep the financial situation stable, and perhaps ten days after the situation I explained to you - until the end of the year we had a flattened period in terms of the exchange rate.

There was some speculation about the exchange rate. Some market participants of foreign hedge funds started to build positions to short the tenge, thinking that there would be a devaluation; but that did not happen. Two or three months later some of them applied to the Central Bank asking it to provide them with tenge liquidity. We told them that we are not going to support speculators to make money out of that situation, and that it would be worse for us if we supported those who have an exposure in tenge money market instruments. Also, we do not have any formal method to provide liquidity in tenge to those market participants who are not registered in Kazakhstan, who have no deposits with the Central Bank.

There has been speculation about the credit risk in Kazakhstan on the international market, the CDS market. First of all, it was the natural reaction of investors when they started to buy CDS protection when credit started to tighten in August. Later, in September and October there has been activity of some cash funds, which tried to get more protection than they actually needed. S&P, for example, and some other rating agencies, when they tried to evaluate credit risk in Kazakhstan, applied to the assessment spreads on the CDS market, which moved from 200 basis points to 800 basis points in two or three months. We cannot agree with the rating agencies while they wanted to downgrade the sovereign rating, because the sovereign rating had nothing to do with that because the sovereign position is a net exporter of capital: \$20 billion of liquid assets that the government has in the oil fund while the government debt was less than \$3 million.

If we considered a change in outlook or a downgrading of the rating, it should be about the banks that have a heavy debt position in terms of external debt ratios.

In terms of the CDS market we need to understand that the CDS market is a long-funded transition market; it exists between non-residents. At the moment, the particular Kazakhstan credit risk is not more than \$325 million. We told the market that if this kind of market hurts us, we do not exclude the possibility that the central bank can intervene in this market also. It is very easy for us because while we are committed to supporting our banks by providing liquidity on the domestic market, it is very easy for us to sell serious protection on the international market. However, we did not do that; we assumed that with the initial redemption of the external debt the need for serious protection would decrease. We advised the banks not to borrow money at this point and to think about substituting external debt by internal medium-term funding. We recommended to the government that it should use different channels for providing medium-term funding to the banking system, including development institutions, and the government committed last year to release about \$4 billion from the budget. They just reallocated some funds from those projects where disbursement had not started and reallocated this money to the banking system. The banks and the construction sector received this money.

The problem was that it was thought that development institutions should do some kind of securitisation, but usually this process takes time, and the negotiation process used to be a help in agreeing prices. Development institutions put deposits through the banks in exchange for the obligation that they will be lending to the construction companies that have advance payments from the population, to secure the demand in the country.

We could not neglect the problem. There is a problem. Most important is how adequate we are and how reactive we are and what kind of instruments we use for withstanding the situation. We think that Kazakhstan in general has enough capacity to withstand all the challenges for probably three years because Kazakhstan is not only exporting oil to the West, but it is the sixth biggest exporter of fer metals, the seventh biggest exporter in the world of wheat and fourth biggest exporter of uranium

and many, many other liquid commodities. We do not think that liquidity problems will hurt us substantially in the next two or three years.

We believe that the confidence of international investors will continue to be positive for Kazakhstan. If someone wants to withdraw money we would be happy because it would decrease inflation!

THE MODERATOR: George, it would be useful to move ahead in terms of looking at the experience of these countries and the banking system to know what progress has been made and needs to be made in the future in developing basic hedging instruments and risk management instruments.

MR HANDJINICOLOAU: I will take a slightly different tack in the sense that in representing ISDA, the International Swaps and Derivatives Association, derivatives in this context at this point might sound perhaps like a luxury, because we are dealing here with basic fundamental development issues, and in that context one might consider derivatives to be a luxury for discussion!

At ISDA we believe that that is not the case because it is an integral part of development of markets. That is because we are now seeing the emergence of a major economic bloc in the centre of Europe in the form of Russia, Ukraine, Kazakhstan, and there are important economies like Romania coming in to the global economy. As they come in, they offer a significant contribution to the global economy. Just look at the map and take into account the vast resources this region is bringing to the table, in the form of energy or other resources - as Medet mentioned, from Kazakhstan alone.

One has to think how this economic region can develop further. An integral part of that is to find ways to finance its activities in an efficient manner; and then to offer investors alternative opportunities. That means markets. This is what ISDA is all about. In its basic form, it is all about creating better markets. That is even more important for this region in two respects. One is how this region integrates with the rest of the global economy, which means how we put in place the plumbing to plug in to the global financial system. That is the first challenge. The second challenge is

how to create domestic plumbing systems in the domestic economies so that we can link the investors with the borrowers.

We, at ISDA, can offer systems, because of our experience, and we have done that in many other countries, on both fronts. We obviously advocate derivative transactions, which are bilateral transactions, between two entities. For these transactions to be valid and legally binding, they have to have secure contracts. ISDA has developed its global master agreement, which is one of the most prevalent global legal instruments to be applied universally and ubiquitously. It is an agreement that transcends national borders. It supports a market that now amounts to US \$450 trillion in notional amounts outstanding. This, for us, forms the basis on which to go further.

How do we accomplish that? In order to do that we need to make sure that this agreement, which is now universally accepted in developed markets, is legally binding. That means that when it comes to local players engaging in these transactions and foreign players coming in to engage with local counter-parties, they have to have security and certainty that the agreements they are entering into are legally binding. That requires certain law reforms. We are in touch with the national authorities and are trying to implement those reforms, to ensure that these transactions are legally enforceable, particularly in relation to internal and external bankruptcy, which has to do with so-called netting and may sometimes involve protection of property laws, so that there is more security about collateral arrangements. In many of these transactions, when two parties are involved they want to be sure, because the transactions involve obligations that go back and forth for two, three, five or ten years, that the two parties are secure enough with each other to have collateral and that if something goes wrong the collateral is really enforceable. In several others, there are more minor technicalities that vary from case to case.

These are the basic ingredients that we need to put in place before the application of a contract is covered under the ISDA master agreement. I can assure you that the benefits from what we have learnt from our experience of the past 25 years can be significant. That is, as we have heard in the cases of Romania and Russia, for the management of internal finance, but also for the management of international finance, as in Kazakhstan. We know that these hedging instruments enable the players to

hedge risks that are peripheral to their businesses. For example, an importer or an exporter can focus one hundred per cent on their business and hedge away interest risks, foreign exchange risks, and increasingly other risks like energy risks and commodity risks. Apart from that, we also know that the derivative markets are fundamental in price formation. We all know that at the end of the day it is market signals, prices, that are the best indicators of efficient allocation of resources in an economy.

Finally, I would say that if we have learned something from the credit crunch in the developing markets, which thankfully have not affected the economies here, only indirectly, it is that the derivatives markets throughout this crisis have remained open and continued to provide market signals and also ability to people who want to hedge risks. We are here, in front of this audience, to declare that we are prepared to work with the various authorities and interested parties to see how we can bring to the fore this emerging part of the geographically in central Europe in the global market economy, which will lead to significant gains both for the global economy and also the central European economies.

THE MODERATOR: I thank the panellists; we now have a much deeper understanding of how they have coped with the crisis, in the variety of forms that have been exhibited. I thought that this was a good opportunity to use the rest of the time to hear from you what issues you would like us to highlight. I would like to hand it over to the audience to address questions uppermost in your minds.

A SPEAKER (ROMANIA): I would like to hear Mr Stepic's view about the Swiss franc lending strategy because Raiffeisen launched a Swiss franc mortgage campaign in Romania. Can he develop his view on this, bearing in mind the Vice Governor Popa's comments on this issue?

My second question is addressed to Vice Governor Popa: can he comment on EBRD's statement of yesterday that Romania could face a hard landing scenario?

MR STEPIC: This lending to private individuals in the short-term I would consider a nuisance. On the long end it is a question that as long as it is euro I would say it is

50 per cent a sin. When it gets to other currencies it is more of a sin. We have made several approaches, as have other large players, not only in Romania but in other countries, to stop consumer lending in foreign exchange, specifically in exotic currencies. Here, I would consider Swiss francs and Japanese yen as exotic currencies because the market is definitely not yet ready for that exercise. The same applies to the long end. Why are we doing it? It is for competition reasons. As long as the central bank does not get hold of it, we have to do it, when several large players are continuing to do it.

That is the only answer I can give to you: I would rather live without it, but I have to do it; otherwise I am out of the ballpark.

MR POPA: In regard to your question about yesterday's statement, apparently I consulted with Mr Berglof, the Chief Economist of the EBRD, and the statement apparently was not that Romania is not facing any risk of a hard landing; it was a simple reconsideration of the growth perspective of Romania by about 1.5 percentage points. This is now confirmed on the wires, and apparently this is attributed to a strengthening of macro policy, especially monetary policy in the country. Going from 6.5 to 5 per cent does not look like a hard landing at all. Not having been part of the discussion, I cannot confirm directly, but I can refer to my conversation with the Chief Economist as saying that.

We project a growth rate between five something and six something for the next two years, which is quite in line with potential GDP. Obviously, our model tends to historically under-shoot actual GDP performance, and last year it was 6 per cent with a very strong fourth quarter of 6.4 per cent, based especially on investments growth of 20 to 29 per cent, and some moderation in consumption down to about 10 per cent, so that does not look like a hard landing.

This year, based on expected mean reverting performance, in terms of agriculture, and a very strong first quarter, which is 7.5 per cent, it looks as though it will be even stronger than we thought. I do not think that that forecast will be correct, unfortunately. Ours may be quite moderate as well. At some point we need to see that monetary policy works, and we do not aim at making it work through a recession;

but we do aim to close the gap between actual and potential GDP growth at some point. It is now forecast to close during the first part of 2009.

Again, the way that that monetary policy and especially the interest rate hike works is complex; it has to deal with expectations, movement in the exchange rate, balance sheet and wealth effects, and the classic transmission into lending rates and then with a decrease of real rates. That will remain strong in any case, even if those stronger effects from monetary policy materialise as we hope. My final point is that there is no hard landing.

May I end with a response to Mr Stepic! That is very reassuring because the only interpretation I can make, apart from being competitive, is that one needs a sin to be redeemed at the end! For a variety of reasons, the kind of bank perspective I prefer - and of course we do not tell banks what to do because they have utmost freedom - we are regulators and supervisors - is that instead of maximising profit in a short run we have the kind of environment from other banks and their clients where profitability is maintained even in the face of smaller increases in market share on a yearly basis. It may be a problem of getting banks in a concerted action to renounce this, but increasing the domestic currency share of lending would be the way to go, especially as the local currency in Romania has left a period of unusually low volatility and very strong, unsustainable, as it turns out, appreciation; and then turning to something we have seen throughout the region in previous years, fairly large volatility and a corridor of stability in the past months, which looks as though it is moving between 3.5 and 3.7. There is a lot more volatility than was the case before.

I would think people tended to discount the exchange rate risk, maybe because they never saw it as being as large as it could be in the first place - but ultimately, given a push from the commercial banks, it will lead to lower exposure to foreign exchange borrowing and especially to exotic currency borrowing.

MS CUNNINGHAM (UBS): I have a question to George. I have seen in the past more and more SPVs being set up in Ukraine and in Russia for local banks to be able to sign the ISDA agreement and work with it. Can you update us on where we stand

from the local legal perspective in Ukraine and Russia on implementation of the ISDA agreement in the future and what work you do in order to process that?

MR HANDJINICOLAOU: We are currently in discussions with the Russian and Ukrainian authorities to perform the kind of law reforms that, particularly in the case of Russia, we are looking forward to seeing go through the next parliament. Once we get these basic reforms in place, then in parallel we will work in Russia with the local bankers' association to put in place a Russian version of the ISDA master agreement. Obviously, the size of the Russian market is such that it has attracted most of our attention; but at the same time there is Ukraine, Kazakhstan and Romania that are also markets of interest to us. At the end of the day we are not imposing it on anybody; we are responding to our members, which number 850 members around the world, representing major users of derivatives. If our members express an interest in doing business in particular countries, then we go along and try to assist them, working with the local authorities. It is not us who will take the initiative *per se*; our members will come to us, and we will form a group and draw on our experience, having done it repeatedly in a number of other countries.

A SPEAKER: Minister Pankin, Russian banks, the state-owned banks particularly, have been travelling the world in the last months, talking about expanding internationally. To what extent do you see the government supporting such moves, and in which directions do you think the Russian banks should expand into?

MR PANKIN: My feeling is that a lot of Russian companies are looking to expand abroad. It is a normal process when we are living in an open world. We welcome foreign investment into Russia and a lot of foreign banks are opening branches in Russia, which is very important. Many Russian companies are looking for growth, and the same for big Russian banks; it would be normal to have a presence abroad and start activity abroad. That is a positive move. The question is to find the right measure. Sberbank has a lot to do inside Russia, and if all of Sberbank's activity were to go abroad it would be ridiculous, but to some extent it is normal and it will help the big banks to become a player on the global market.

A SPEAKER: In the other meeting you mentioned that Russia's biggest problem is inflation and appreciation of the rouble. Just now you mentioned that inflation is again the problem. Do you think that appreciation of the rouble is still an efficient tool in the fight against inflation?

MR PANKIN: Traditionally, appreciation of the currency would be used as a tool against inflation. To some extent it is used in Russia, but at the same time rouble appreciation is very dangerous because it can have a very dramatic effect on manufacturing, production and exports, and generally production in Russia. We think that it is necessary to be very careful in the sense of rouble appreciation. It is better to use budgetary instruments. We think that the first priority is to have reasonable growth of our budget. We have to think what kind of measure could be taken in order to de-monopolise the economy, because in many cases the economy is monopolised, and in that environment each additional demand will lead not to a rise in output but a rise in price.

THE MODERATOR: What is coming out of the discussion is that the internal financial system needs to be strengthened in order to cope with external shocks. As Mr Popa said, external shocks will not go away and will be around for a long time. It is important for the audience in terms of their business development over the coming year to know what steps need to be taken to increase participation in domestic currencies and domestic capital markets, which are the ones that need to be strengthened in all the countries that are represented here?

MR POPA: We have encouraged banks to build up their capital base and look at different sources of risk. I think the Kazakhstan experience was illuminating, and it is thinking along the same lines. Of course, the application of Basel II brings all those risks into one melting pot. Insolvency has decreased in comparison with previous years, but it is higher than the minimum in Romania at around 12 per cent, so we are not doing too badly there.

We are also asking banks to secure a portfolio of adequate collateral for eventual participation not only in a liquid secondary market but also for their ability to secure

entry to the lending window of the central bank; and of course for a smooth participation in the payments system.

We find that the stock of securities, government paper held by the banks is dwindling. There is no liquid secondary market to speak of yet in Romania, and it turns out that the banks that are mostly likely to lose liquidity are those that do not have extensive portfolios, so this would be very good. As the government goes forward, banks should be ready to absorb and hold these securities for the purpose of entering into repo or other similar operations with the central bank.

I have mentioned the stepping-up of financial stability stress tests as well, undertaken very importantly not just by ourselves on a systemic level but by the banks themselves in a bottom-up fashion. That kind of work is extremely important.

MR PANKIN: We have a more or less universal approach. We need the right capital of the banking system and we need to understand how banks should cope with risk and grow risk management systems. As we are talking about authority, we need to continue to create instruments to provide liquidity to monitor the situation in regard to banks and the financial system. The Ministry of Finance is itself targeting to help in regard to the external position of banks in order to understand the situation.

MR SAVCHENKO: I would like to comment on the statement made by my colleague in regard to the Western financial crisis. There is a fundamental problem that a lot of central banks from developed countries, like the United States and England, started to support particular banks. Here, I have heard that this can be a key instrument in a crisis; there should be a lot of collateral in order to support local commercial banks.

As an economist I would like to say that this is a very wrong position. One month ago I wrote in a newspaper that one agency said that the Ukrainian Central Bank is not going to refinance its commercial banks. We should refinance, but in the last instance; but it should not be rapidly. That is why I do not appreciate a situation where central banks support commercial banks - other commercial banks, completely

independent of the central bank as a creditor; and this is a very good monetary policy, in my view.

In regard to development of capital markets, the fundamental problem of the Ukrainian capital market is liquidity. Capitalisation of our market is more than US \$100 billion, but daily trading is just like a joke - US \$20-30 million. That is why liquidity is a key problem. Dealing with this should be done step by step.

MR SARTBAYEV: I want to focus on the issues that have arisen. It was very important for Kazakhstan to develop the derivatives market and new instruments for pushing forward the development of the stock market. Three years ago, as I mentioned the government started to implement a project called Regional Financial Centre, Almaty. This environment was based on the experience of the ... financial markets, and we assumed it we have additional capitalisation through the market within two or three years of more than \$2 billion. The kinds of instruments we were supposed to see were - first of all a commitment from the government was to put government stakes in natural monopolies to public placements. We consider that this amount will be between 3 to 5 million in the first three years. The second commitment was from the central bank to develop hedging instruments for currency risk. To do that we started before the crisis to build the yield curve for up to one year and also the central bank issued bills with a longer maturity than one month.

In terms of the realty market, we have two working groups working with participation of the market, and representatives of the central bank. Already the package of amendments to the law is ready. It was difficult to introduce in one law complicated instruments that were to be subject of the agreement, and therefore we agreed to put through the securities law basic definitions. We agreed that an adjusted version of the tender agreement would be subject to approval of any market participants who will be working in Kazakhstan.

It is really important to cooperate on this issue because it is not only the regulation of these issues that is important. For example, looking at accounting problems, if you go ahead according to international standards of financial instruments, it is necessary to account mark-to-market or any derivative financial instrument - but if you see on the

domestic market, let us say, dollar/euro or euro/tenge instruments, for example ... you will not find more than two or three market-makers actually make markets. In such a situation you are not able to follow up the requirements of the international standards of accounting.

As for the other issues of development of the capital market in Kazakhstan, we are now seriously looking at the development and introduction of [Islamic finance] in Kazakhstan. Also the working group is working on the amendments to the legislation and we will probably open a window through a pilot project, which will be based on the regional financial centre.

That is also important because we have another way of funding out of Kazakhstan where we are more than one hundred nationalities and every religion is presented - it is possible to open any kind of instrument for capital markets.

As for the policy during the crisis, there is a lot of experience in Japan, in South Korea and countries that have experienced such a crisis; and the most important issue is cyclical support for the banking and financial system. It is evident and we cannot argue with them. Moreover, I would say that their monetary policy in such a situation, when the cycle goes down, is not efficient enough. It is necessary to use fiscal policy instruments, which will be concerned not only with tax incentives but with direct expenditure of the government.

I am surprised at the statement of my colleague from Ukraine, because how you act as a central bank, if you have a 50 per cent overnight interest rate in Ukraine without any support and regulation of this market will not withstand this situation. Therefore, you could have inflation of more than 20 per cent.

MR HANDJINICOLAOU: I think a lot of the countries here can have a quick win in development of markets by focusing on and establishing a domestic government market that focuses on few liquid issues. This is under their control because you are doing the regular issuing, so therefore focus on government bond issues that can recreate the benchmarks from many, many different things can be developed from. You can easily win.

THE MODERATOR: We have come to the end. I want to thank our panel for travelling here. It has been interesting. We look forward to seeing you in twelve months' time when, hopefully, the market conditions are better than today.

**(Applause)**