Local Currency Operations of the EBRD: Considerations on Country and Client Selection

1. Introduction

Several recent financial crises in emerging markets have underlined the importance of diversifying the funding of the private sector away from foreign currency sources, or from short term domestic bank finance that is equally prone to disruptions. Balance sheet risks – in terms of currency or maturity mismatches – have proven to be one of the most debilitating features of rapid financial development, with the potential to set growth and poverty reduction back by many years. Governments and monetary authorities in emerging markets have therefore devoted considerable resources to developing domestic capital markets.[1] In part as a result of such official efforts, but also due to much improved private sector credit quality, transparency and growth in domestic liquidity, local corporate bond issuance in emerging markets as a group increased nearly tenfold between the late 1990s and early 2003, growing from 4 to 27 per cent of total corporate funding.[2] Foreign investors increasingly participate in these markets and thereby alleviate the currency mismatch problem that had hitherto been inextricably linked with external capital flows.

The EBRD has already played an important role in this process in the transition region. To date, the Bank has made loans in eight local currencies. Given heightened perceptions of currency risks, and a more uncertain global funding environment, this work has lost none of its strategic value. A wide range of clients, in public, financial and corporate sectors, have expressed interest in local currency funding, and the Bank now seeks to move to other markets.

Since the first EBRD local currency bond in 1994 the objective has been to advance local bond markets so that they will ultimately be sustainable without IFI involvement, in line with the mandate of the Bank. Unless bond markets develop to become liquid and self-sustaining a client that is once funded in domestic currency may find that currency risk has been replaced by settlement and pricing risk. The experience has been that developing liquid local bond markets in transition countries is a process that requires lengthy and costly reform of financial regulations and institutions. Moreover, it is not clear that such markets will be viable in countries of operation that lack a liquid banking system or where financial transactions are to a large extent conducted in a foreign currency. The Bank will need to be selective in choosing new markets.

This paper sets out a number of considerations for the selection of countries of operation to which the future efforts of the Bank could be directed. Following a restatement of the logic behind local currency financing in Section 2, and a review of the experience to date in Section 3, Section 4 will set out considerations at the country level. Section 5 will present a number of developments in individual sectors that could raise demand for local currency. It will also be important to take into account the priorities set out by monetary authorities and in debt management strategies in transition countries (Section 6), and the work of other international financial institutions (Section 7). The concluding Section 8 presents a number of operational implications for the Bank.

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[1] Fitch Ratings (2004): "Local Currency Debt Capital Markets", Special Report, London: Fitch Ratings.
[2] L. Meddin: "Structured Finance in the Emerging Markets", Washington: International Finance Corporation.

2. The Rationale for Local Currency Financing

Since the second quarter of 2006, risk aversion in international capital markets has grown, and there is now a greater likelihood that instability in international capital markets could lead to exchange rate adjustments in those transition countries with large external financing needs. The ongoing tightening in the monetary policies of the key OECD central banks also contributed to a widening of spreads on emerging markets debt, though these spreads are still close to historic lows. Financing terms could deteriorate further and could become more volatile should negative news emerge in capital markets of industrialised countries. In this environment of tighter liquidity, markets have begun to discriminate against countries with perceived weak fundamentals, as is evident in the sell down of assets in Hungary, Turkey and South Africa.

Following a period of relative exchange rate stability, currency mismatches on the balance sheets of the corporate and household sectors in transition countries have grown. Evidence for the growth in unhedged currency exposures comes from the rise in gross external debt owed by banking and corporate sectors (emerging markets are typically unable to issue abroad in their own currencies). Moreover, banks in transition countries have rapidly expanded the stock of their loans denominated in foreign currency. Foreign currency loans in transition countries – typically in euro or dollar – have exceeded the funding needs of borrowers with natural hedges such as exporters, or households that receive foreign remittances. Recent financial crises, most notably in Uruguay in 2002, have underlined that currency mismatches can be an important vulnerability of the financial system. Currency mismatches will constrain the ability of policy makers to use the exchange rate to adjust to external shocks, and once the exchange rate does adjust this could have a contractionary rather than the intended expansionary impact. Recent experience with financial and currency crises has therefore resulted in a strengthening of prudential supervision of exposures in banking systems, and greater analytical scrutiny of exposures between sectors.[3]

Balance sheet mismatches, coupled with sharp exchange rate adjustments could have a debilitating effect on individual sectors, and on an economy as a whole. While the net open currency positions of banks are typically limited through prudential requirements, banks are now exposed to substantial credit risk from retail clients, and small and unhedged SMEs.[4] Credit quality of borrowers that in many countries have never experienced a full credit cycle remains hard to judge. Should the exchange rate adjust in response to an external shock, exposures between sectors can quickly spread liquidity problems throughout the economy. Unhedged foreign currency liabilities in the corporate sector, for instance, could undermine depositor confidence in banks with large exposures to that sector, and lead to rapid deposit withdrawals. This by itself could reinforce pressure on the exchange rate, leading to an overshooting beyond the level that would be consistent with restoring macroeconomic equilibrium.

The Bank's lending in local currency can play an important role in mitigating such currency exposures in transition countries. Local currency funding will also improve the creditworthiness of projects which solely generate local currency income, as this reduces foreign exchange risk. The Bank is able to lend to projects that are legally required to be

[3] Allen et al. (2002): "A Balance Sheet Approach to Financial Crises", IMF Working Paper no. 02/210, available at http://imf.org/external/pubs/ft/wp/2002/wp02210.pdf

[4] See Standard and Poor's (2006): "The Foreign Currency Gamble – Rising Risks For Banks in Central And Southeast Europe", August 2006.

funded in local currency, primarily in the municipal sector. EBRD's transformation of short-term domestic liquidity into longer term lending in domestic currency to carefully selected projects may have important demonstration effects in the local banking sector, further reducing roll-over risk in the economy.

By borrowing in local currency, the Bank can play an important role in stimulating the development of local capital markets, in line with Article 2 of the Charter of the Bank. As a financial obligation of the highest ('triple-A') credit quality, the Bank's bonds define an interest rate benchmark that may serve as an alternative to an often illiquid government bond market. Such benchmarks are needed to define the pricing of all other obligations in the financial market. Moreover, the development of money markets (of short maturity) has been shown to be a prerequisite for the evolution of a system of primary dealers that serves to develop a longer term corporate bond market.[5] In addition, by issuing floating rate bonds the EBRD introduces innovative and high standard procedures to the capital market that may help to foster its broader development. Introducing EBRD bonds is also likely to allow a more efficient allocation of risk within the local financial market. Existing local investors, such as pension funds, may diversify their credit risk beyond what is likely to be a narrowly defined set of local assets. The EBRD bonds will also provide a triple-A conduit through which *new* investors may gain exposure to the local currency without being exposed to local credit risk. This can be a precursor to new investors (which are often foreign) participating in the local government and corporate and bank debt market.

The prevalence of currency mismatches underlines the need for capital market development efforts by international financial institutions (IFIs), such as the EBRD. Yet, such financial risks need not put in doubt the merits of the continuing IFI lending in foreign currency. In most countries local currency funds will remain limited relative to funding needs for the foreseeable future. Foreign currency funding can still be extended where prudent risk management by individual borrowers mitigates currency risks. Moreover, IFI lending is normally at longer maturities than are available from private creditors, and is normally available throughout periods in which the country's access to private capital is impaired. Making foreign currency funding available will remain a careful judgement between furthering economy-wide currency mismatches and the associated externalities on the one hand and opening up additional funding and reducing rollover risk on the other.

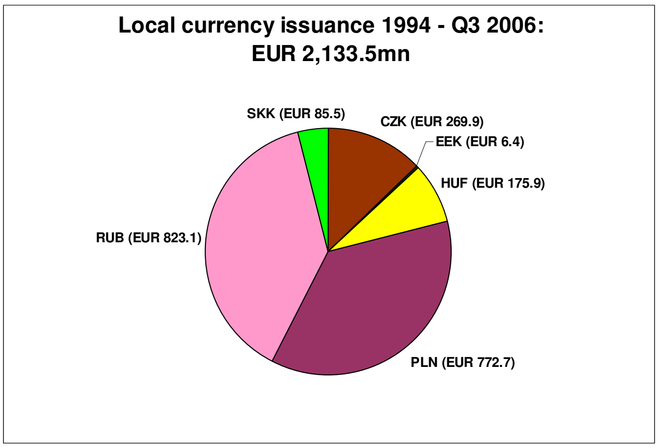
3. The Experience to Date

The local currency financing activities of the Bank have employed a range of instruments. In order to minimise mismatches in timing and structure between EBRD's local currency borrowings and loan disbursements the Bank has typically in the first instance negotiated credit facilities with local commercial banks, which would enable the Bank to borrow local currency funding for three month periods on a revolving basis. The Bank has used such short-term liquidity to extend medium term local currency project financing, thereby helping to channel the high levels of liquidity in the domestic banking system towards the real economy. While underdeveloped financial markets are, however, prone to periodic illiquidity in the interbank market for term funds, liquidity has typically remained available for overnight funding. During such periods the Bank needs to protect itself against the risk of not being

[5] Only where primary market dealers can borrow and deposit funds in a liquid and transparent market can longer term funds be raised; see G. Schinasi and T. Smith (1998): "Fixed Income Markets in the United States, Europe and Japan: Some Lessons for Emerging Markets", IMF Working Paper no. 98/173, available at http://www.imf.org/external/pubs/ft/wp/wp98173.pdf.

able to access sufficient funds to finance loans or cover repayments due on its local currency borrowings. It does so through clauses that allow for the re-indexation of an interest period from typically a 3-month rate to a compounded overnight rate during a period of market illiquidity or turbulence. As the Bank always has access to long term liquidity in US dollars and euro, the Bank has addressed the risk of being unable to access local currency even in the overnight market through clauses that allow the loan to be indexed to US dollars or euro in the case of a defined 'Market Disruption Event', which would be triggered if the Bank could either not establish an interest rate for the relevant period, or could not obtain funding for the period, or saw the cost of funding rise too high. Where the Bank's local currency lending became sizeable, the Bank has sought to minimise the mismatch between its borrowing and loan maturities by extending the maturity of its local currency borrowings through the cross-currency interest rate swaps market or through local currency-denominated bond issuance. Bonds would be executed either through the Eurobond market, or through the domestic public or private-placement markets.

To date the Bank has issued bond financing in the currencies of six countries of operation. These activities date back to 1994 when the EBRD issued a 5-year Hungarian forint inflation-linked bond in the domestic market to finance a project. Since then, the EBRD has been a frequent issuer of bonds denominated in the Czech, Estonian, Hungarian, Polish, Russian and Slovak currencies. Many of these transactions have been targeted at international investors and have therefore been documented and settled as Eurobonds, and many have also been listed on the London stock exchange. This has the advantage that associated costs, documentation requirements and procedures are minimal, and that the level at which funding is achieved is commensurate both with the Bank's triple-A rating and with the other funding activities in the international capital markets.



Where the Bank has issued predominantly to a domestic investor base, as in Hungary and Russia, all associated costs and procedures are significant, and the funding levels tend to reflect the pricing of government issuance, as such issuance is deemed the benchmark, and treated as the domestic equivalent of triple-A rated paper, despite its lower international rating. The Bank has also accessed local currency funding through the establishment of revolving credit facilities with banks in Bulgaria, Kazakhstan, Romania, and Russia allowing the EBRD to extend loans in their local currencies. The EBRD launched a promissory note programme in Russia in 2001, which offered the Bank short-term rouble financing while pursuing legal and regulatory changes to allow the Bank to issue bonds in the Russian domestic market in 2004. The Bank has used the cross-currency and interest rate swaps market to establish pools of liquidity in Czech koruna, Hungarian forint and Polish zloty to extend loans in these currencies.

The EBRD's three domestic rouble bond issues have been instructive with regard to the potential for developing local capital markets, but at the same time underlined the extensive regulatory dialogue that is required. These 5-year Floating Rate Notes, which were issued in

May 2005 (RUB 5 billion), April 2006 (RUB 5 billion) and September 2006 (RUB 7.5 billion), represent an important step in the development of the Russian capital market, as they introduce a new asset class to Russia, as well as being the first international triple-A issue in the Russian market. In preparing these issues the Bank worked closely with the Russian authorities since 1999 and provided technical and legal expertise to develop the framework for the issuance of long-term local currency bonds. Regulatory adjustments included:

- the Securities Market Law, which reflects input from the EBRD and was passed by the Duma in December 2003;
- disclosure regulations for International Financial Institutions which were registered with the Federal Financial Markets Service (FFMS) in 2004;
- listing regulations for bonds issued by foreign issuers were established in 2005 in agreement with Moscow Interbank Currency Exchange (MICEX) and the FFMS;
- inclusion of the Bank's issues in the Central Bank of Russia's Lombard list, making them eligible for repurchase transactions with the CBR;
- the establishment of a new money-market index, the Moscow Prime Offered Rate (MosPrime) which was the result of extended coordination between EBRD and the National Currency Association (NCA).[6]

Substantial benefits are expected from the newly established MosPrime, as a transparent, credible and accurate money-market interest rate benchmark. This benchmark for the local market for bank loans could contribute to greater pricing transparency and consistency, and serve as an index for the pricing of derivatives (including futures, which were introduced by MICEX in June 2006, and swaps). Transparency of pricing and establishment of derivative contracts have become more important since Russia's capital account was fully liberalised in July 2006. The development of a new and credible money-market index should allow the interbank market to develop greater liquidity in short maturities of more than one week. This should increase the efficiency of the interbank system which hitherto has seen trading heavily concentrated in the overnight market. The MosPrime rate has been used by a number of banks in their corporate loan programmes, and by two banks for long term mortgage lending.

The syndication of two rouble loans this year to Mosenergo (RUB 7.2 billion) and HydroOGK (RUB 6.3 billion) has demonstrated the potential for leveraging the Bank's local currency funds through the participation of private creditors. These were the first transactions in the power sector where all financing was provided in roubles, at maturities of up to 10 years in the B tranches. Both transactions will promote MosPrime as a benchmark for commercial loans in the currency, and create a precedent for private western institutions which may in future access the rouble loan market without IFI involvement. The syndications underlined the keen interest of western banks to participate in loans to highly rated state-owned institutions. Nevertheless, this is an as yet immature market in which pricing and maturities are difficult to establish upfront, and reliance on market-based syndication procedures will be important to establish these variables.

Since the 1994 Hungarian forint loan, the Bank has extended 80 loans in local currencies, totalling about EUR 1.8 billion. Table 1 underlines that local currency lending has been concentrated in the Polish zloty and the Russian rouble which together account for 80 per cent of lending. Clients have been primarily in the FI sector (28 per cent of total local currency

[6] MosPrime is the reference rate fixed by NCA based on the indicative offer rates on Russian rouble deposits as quoted by the leading participants of the Russian money market for first class financial institutions.

disbursements), and in the key service sectors, such as power and energy, telecommunications, and municipal and environmental infrastructure (together about 46 per cent). This distribution across sectors is in line with the absence of currency revenues in these sectors. The Bank's local currency funds also extended the maturity of what would be available in the local financial market to a median of about 5.7 years (Figure 1). Nevertheless, local currency disbursements are only a small fraction of total Bank lending to countries in which such funding was available.

Table 1: Distribution of the Bank's local currency lending by currency and sector

a. by currency

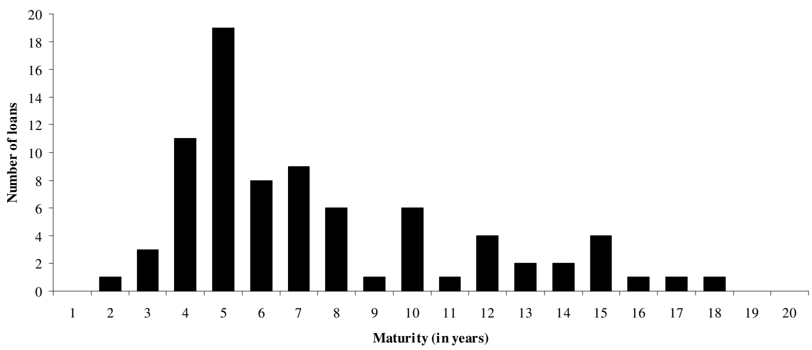
	EUR m amount	% of total	number of loans	period of signings
PLN	793	44	28	1999-2006
RUB	648	36	22	2001-2006
HUF	94	5	5	1993-2005
RON	99	5	4	2005
CZK	93	5	10	2000-06
BGN	30	2	4	2005-06
SKK	30	2	4	2003-06
KZT	14	1	3	2005

b. by sector of client

	EUR m. amount	% of total
Financial Institutions	404	22
Non Bank Financial Institutions	105	6
Municipal & Env. Inf.	282	16
Power & Energy	321	18
Telecoms Informatics & Media	212	12
Transport	128	7
Agribusiness	130	7
Other	218	12

Source: Treasury, Client Risk Management.

Figure 1: Maturity distribution of the Bank's local currency loans



The availability of domestic currency funding has had important microeconomic effects, which in many projects have enhanced the intended transition impact.

- In the financial sector access to local currency has allowed banks to on-lend to riskier sub-borrowers, such as small regional SMEs without foreign currency revenues; or expand into long term retail lending, such as mortgages.[7]
- Mitigating currency mismatches for corporate borrowers has reduced balance sheet risk and funding costs, thereby stimulating investment plans.[8]

[7] Recent FI projects in local currency include mortgage credit lines in Russia (to Delta Credit and Rosbank), and general consumer lending (RSB and Rusfinance Bank). There were also rouble credit lines to small regional SME-oriented banks such Spurt Bank, Primsotsbank, and Promsvyazbank. There has been only one KZT loan in the Kazakh FI sector.

- Public sector utilities in several countries are legally barred from borrowing in foreign currency. Furthermore, availability of local currency funding has widened the scope for the Bank's engagement in the municipal infrastructure sector, as demonstrated in the Mosenergo and HydroOGK projects.

Nevertheless, in several cases Banking teams have found that where both foreign and domestic currency funding were made available, higher nominal domestic interest rates and strengthening domestic currencies meant that clients were either unconcerned about the currency risk, or found local currency funding costs uncompetitive, or both.
Experience with clients has shown that, even where currency risk was fully understood, continued foreign currency borrowing was often regarded as a rational funding decision. Potential borrowers were concerned about volatile market rates that could reflect frequent liquidity squeezes, arising for instance out of end-month tax dynamics or political instability. Instruments to hedge risks and costs were generally unavailable and clients were concerned about higher overall transaction costs and wider bid/offer spreads upon cancelling a loan. Also pricing was in many cases seen as less transparent than in larger more liquid markets, and indeed, where no credible floating rate benchmark exists, the base rate the Bank uses in its loans is the EBRD's "Cost of Funds".

4. Prerequisites for Bond Market Development

In selecting new markets for future local currency borrowing and on-lending, the Bank will need to judge the sustainability of the capital market development process that it initiates. Only where a liquid money and bond market takes hold and proves to be viable subsequent to IFI involvement will the considerable resource requirements on the side of both EBRD and regulators be justified, and will funding structures of private parties adjust. In the absence of such a viable market, clients that have once been funded in local currency may find that in place of foreign exchange risk their funding structure is subject to pricing risk and rollover risk if no transparent benchmark and yield curve has been created and no market pricing consensus has been developed, or settlement risk, where the market infrastructure is insufficiently developed. If the Bank were to extend local currency loans by accessing the currency through an unhedged position in the foreign-exchange market, the desired development process would not be served.

There is hence no presumption that local currency financing is superior in all countries. EBRD local currency operations in countries not previously accessed will need to meet key criteria in terms of the macroeconomic environment, the structure of the financial sector, and the willingness of regulators to facilitate capital market development.

A. The Macroeconomic Context

Macroeconomic stability and a transparent and credible policy framework are critical for investors to have confidence in local currency denominated instruments. Beyond this basic prerequisite, two interlinked aspects of the macroeconomic environment will need to be supportive of capital market development. Official policy towards the exchange regime, and endogenous trends in the use of the domestic currency in the financial system determine the viability of efforts to create local currency money and bond markets.

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[8] Local currency loans to the corporate sector were mainly in the CEB countries, for instance in the Polish Kaufland project.

(i) Monetary authorities need to credibly signal that exchange rate policy will remain independent in future.

In a large number of transition countries perceptions of exchange rate risk are low – due to either a successful record in running a fixed exchange rate regime or the authorities' record in maintaining exchange rate stability within an adjustable peg. Current macroeconomic trends have also contributed to expectations of further exchange rate appreciation, most notably in the resource rich countries of the CIS. Costs of funding in foreign currency that are adjusted for expected exchange rate variations are therefore generally low compared to funding in domestic currency.[9] Rollover or refinancing risk of generally short dated foreign currency liabilities are not normally perceived as an obstacle.

The closer a country moves to fully adopting a foreign currency the less likely it is that domestic currency money and bond markets will grow in the interim. Current exchange rate policies in transition countries range from the highly rigid to the semi-flexible (see a schematic summary of de-facto exchange rate regimes in Figure 2), and provide a first filter for the Bank's future funding strategy.

- At one extreme, two countries have irrevocably surrendered an independent national monetary and exchange rate policy. Slovenia will be the 13th country to accede to the Euro area in January 2007, and Montenegro in 2000 unilaterally adopted the Deutsche mark (now the euro) as official legal tender.
- Four countries (Bulgaria, Bosnia and Herzegovina, Estonia and Lithuania) have adopted currency board arrangements, in which the supply of the national currency is fully backed by euro assets held by the central bank, and exchange between the two occurs at a fixed parity.[10] Estonia and Lithuania have entered the European Exchange Rate Mechanism (ERM II), and expressed their intention to accede to the euro zone at the current parities. Prospects for speedy euro adoption by Lithuania and Estonia have been set back by their failure to meet the Maastricht inflation criteria. Despite substantial current account deficits, their currency boards are generally judged to be sustainable, and their eventual accession to the euro zone at the current parities is not in doubt. Bulgaria will seek ERM II membership and euro adoption soon after its accession to the EU in 2007. Again, risks to a speedy adoption could stem from the failure to meet the inflation criterion. Given expectations for euro accession foreign exchange exposures and euro-substitution are large throughout the economy. However, current account imbalances are generally judged to be sustainable and risks to a revision of the parity consequently very small.
- All new EU members are obligated to seek ERM II membership, and adopt the euro, though this target continues to slip for several countries. Latvia and the Slovak Republic have entered ERM II, under which they are committed to comply with the Maastricht convergence criteria and have announced official targets for euro adoption in 2008 and 2009 respectively. This looks credible for the Slovak Republic, though may slip for Latvia. Poland, Hungary and the Czech Republic are yet to take this step.

[9] Such intermediate exchange rate regimes are therefore the most dangerous in terms of building up mistaken expectations of exchange rate stability and contributing to unhedged currency exposures.

[10] Exchange rate crises are unlikely, given the central bank reserves normally cover more than the narrow money in circulation, and political parties and fiscal policies in all four countries are geared towards supporting these arrangements. Nevertheless, in the absence of exchange rate adjustments, adverse external shocks may require prolonged periods of demand retrenchment – possibly recessions – that could put these arrangements to a test.

Official target dates have repeatedly been pushed back and are increasingly put in question by capital market participants, given the lack of political will for sustained fiscal reform. In all five countries large currency mismatches in the economy are coupled with uncertainty about timing and parity of euro accession.

- For the other aspirants for EU membership among the SEE countries, euro adoption remains a distant prospect. Macedonia is the only country to shadow the euro closely, while Albania, Croatia, Romania, and Serbia conduct relatively independent exchange rate policies. In all five countries the use of the euro in the financial system is widespread and currency mismatches are pervasive. Given the uncertainty around the timing of EU accession – and of economic convergence with the euro zone – these countries may warrant consideration for local currency funding.
- The final group of countries – essentially the CIS countries and Mongolia – are likely to retain an independent exchange rate policy for the foreseeable future.[11] These countries maintain either exchange rate pegs (to the US dollar or the rouble) or a so-called managed float. In the latter case the exchange rate shows more flexibility than in other countries, though the central bank would still intervene in the foreign exchange markets to limit currency volatility.[12] Closer economic and political integration with Russia may bring about a gradual shift towards more aligned exchange rate policies. Still, for the foreseeable future the CIS and Mongolia are likely to be exposed to considerable exchange rate risk, and hence warrant consideration for local currency funding.

[11] Only Belarus has announced its intention to adopt the rouble as official currency. The close peg of the Ukrainian hryvnia to the US dollar is likely to become more flexible.

[12] This so-called 'fear of floating' is explained by concerns over excessive volatility in domestic prices following exchange rate swings, and the risk to existing foreign currency exposures.

Figure 2: De-facto exchange rate regimes in the transition countries [13]

Fixed exchange rate regimes	irrevocable parity: Montenegro (euro) Slovenia (Euro in 2007)	currency boards backed by the euro: Bulgaria Bosnia and Herzegovina Estonia Lithuania	
Converging to euro membership	other ERMII members: Slovakia Latvia 1/	Distant or uncertain prospects for EMU membership: pegged to euro Hungary Macedonia 1/	 floating Albania Croatia Czech Rep. Poland Romania Serbia
Other exchange rate pegs	Belarus (RUB) 2/ Turkmenistan (USD)	Ukraine (USD)	
Managed or independent float	Armenia Azerbaijan Georgia Kazakhstan	Kyrgyz Republic Moldova Mongolia	Russia 3/ Tajikistan Uzbekistan

1/ fixed peg, with +/- 1 per cent variation around the central parity.
2/ Belarus has announced its intention of adopting the ruble as official currency.
3/ The parity to a basket of the euro and US dollar is subject to occasional revaluation.

Source: IMF and authors' assessments.

(ii) Trends in the use of foreign currency denominated assets and liabilities in the financial system (so-called 'financial dollarisation') also need to be supportive of liquid financial markets in domestic currency products.

In a large number of transition countries, bank lending is to a significant extent conducted in foreign currency – mainly the euro in the CEB and SEE countries, and the US dollar in the CIS. The ratios in Table 2 suggest that the level of deposit and loan dollarisation varies widely between 30 and 80 per cent, with ETC countries showing the highest ratios.

Widespread dollarisation will limit the liquidity in domestic currency funds in the banking sector, incline banks toward offering foreign currency denomination for standard products in order not to incur fixed costs for setting up alternative local currency products, and incline financial supervisors toward adopting a more lenient stance with regard to currency exposures. Besides aggravating foreign exchange mismatches in the economy, financial dollarisation has been shown to make economic growth more volatile, make the achievement of inflation objectives more difficult, and raise the likelihood of banking crises.[14]

[13] Observed or 'de-facto' exchange rate regimes often differ from what has been officially announced, and reflect the actual variation in exchange rates and reserve levels.
[14] Levy-Yeyati (2005): "Financial Dollarization: Evaluating the Consequences", *Economic Policy.*

The root cause of financial dollarisation is a lack of monetary policy credibility – typically due to a history of high and volatile inflation.[15] Figure 3 below illustrates that increases in deposit dollarisation coincided with periods of political uncertainty in Ukraine (in December 2004, and January/February 2006), when stability of monetary policy and of the banking system was most at risk. Dollarisation has proven persistent and possibly self-reinforcing. Even when earlier macroeconomic volatility has been overcome the credibility of institutions is hard to re-establish and large stocks of currency exposures will dispose the central bank towards seeking to stabilize the exchange rate, further reinforcing previous trends.

Table 2: Share of foreign currencies in total deposits and loans of selected transition countries, 2005 (per cent)

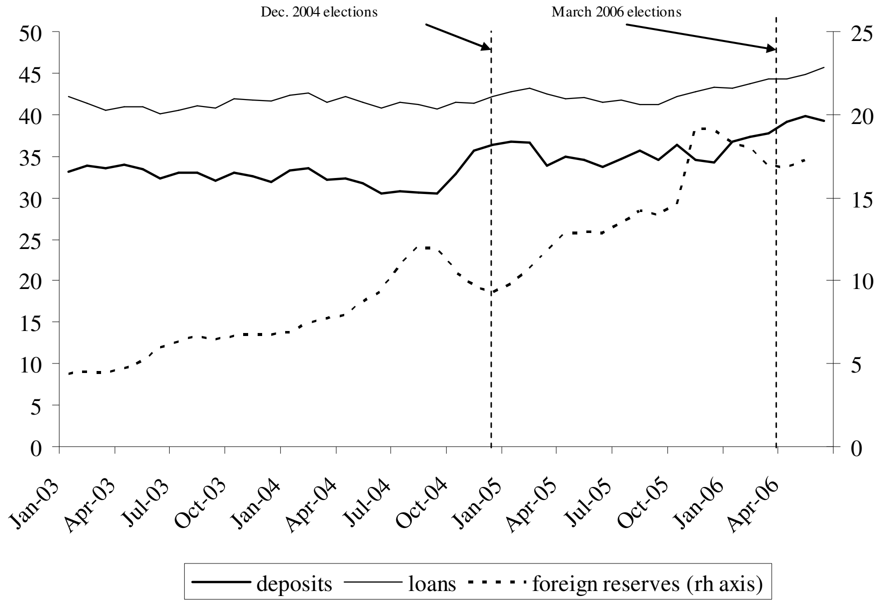
	deposits	loans
SEE		
Albania	31	77
Bulgaria	47	47
Croatia 1/	85	78
Romania	34	54
Serbia	67	70
CIS		
Armenia	64	..
Belarus	45	..
Georgia	72	76
Kazakhstan	42	52
Kyrgyz Rep.	83	73
Moldova	42	..
Russia	29	26
Ukraine	34	38
Tajikistan	68	..
Mongolia 2/	34	46

1/ includes positions indexed to the euro.
2/ deposit dollarisation refers to total liabilities.

Source: IMF staff reports.

[15] Essentially dollarisation can be understood as the portfolio allocation of risk averse depositors. Even where differences in expected returns on deposits are arbitraged away, a risk averse individual will seek to reduce variability in real returns on deposits, and hence deposit savings in the foreign currency if the expected variability in the real exchange rate is lower than that of inflation. Given the policy of several central banks to preserve the real value of the currency following a history of high and volatile inflation, observed variations across countries and over time appear to be consistent with this assumption.

Figure 3: Share of foreign currencies in total deposits and loans in the Ukrainian banking sector (per cent), and official foreign reserves (rhs, USD billion)



Source: National Bank of Ukraine.

B. The Structure of Financial Markets

The local banking system will be the first port of call for seeking an investor base for EBRD bonds. Key prerequisites for counterparties would be integrity and ownership transparency, and usual prudential standards, such as liquidity and capital adequacy. These standards are likely to be met in most CEB and SEE banking systems which have a substantial presence of foreign, or majority foreign-owned institutions. However, in many of the small CIS countries, banking systems are as yet poorly regulated, capitalisation of domestic banks is low and few, if any, international banks have established a local presence (Table 3). Those banks that are sufficiently transparent and well-run to be a potential partner for EBRD tend to be those in whom the Bank already holds an equity stake. Their ability to lend any excess liquidity to the Bank (either through revolving credit facilities or the bond market) is not only constrained by their limited capital base, but further by prudential limits on related party lending.

Institutional investors, such as pension funds, could be alternative investors in EBRD bonds. Many countries have made progress through the establishment of second pillar pension funds that have by now accumulated modest assets (Table 4). While in some cases a substantial proportion of assets is allocated to domestic bond markets, with few exceptions only sovereign bonds would be invested in.[16] This is often a function of the asset allocation restrictions that were imposed on these funds at a time when government borrowing was higher and demand from investors was less certain. While both restricted government borrowing requirements and the growth of pension funds are conducive to a widening of the investment criteria, it may also be possible to negotiate government-equivalent status for EBRD paper, and that of other IFIs with the relevant sovereign membership. Thus asset allocation restrictions may support bond market development in the immediate instance,

[16] Nickel and Almenberg (2006): "Ageing, pension reforms and capital market developments in transition countries", EBRD Working Paper (forthcoming).

though such restrictions are likely to be lifted over the long term.[17] Funds managed by other institutional investors – notably professional asset managers – are typically limited, though the growth of the middle class and return of flight capital to transition countries may support growth in privately managed assets. Institutional investors of any kind are rare in the Early Transition Countries.

A liquid supply of government bonds has supported private bond markets in many emerging countries, though this is not a precondition. As the highest credit quality within any country, sovereign obligations typically provide a natural benchmark for other paper over a wide range of maturities. Notwithstanding limited funding needs, many governments in the transition region have made considerable efforts to develop such a bond market. Through this strategy governments have sought to overcome the traditional dilemma between the currency risk associated with external borrowing, and the inability to borrow at long maturities in domestic markets (see Section 6).

Despite ongoing issuance, including at long maturities, the depth of sovereign bond markets in the transition region remains extremely limited (Table 5). An obvious constraint is the limited public sector debt stock. Many countries have run very prudent fiscal policies for many years (as for instance in the Baltics), or have even accumulated substantial foreign assets following the recent boom in commodity prices (Russia, Kazakhstan and Azerbaijan). More fundamentally, both domestic and foreign investors will continue to doubt the sustainability of monetary and fiscal policies, and with it the credibility of the authorities' commitment not to debase the real value of claims through inflation. Nevertheless, the abolition of restrictions or taxes on capital account transactions, and the establishment of capital account convertibility may prove supportive of greater foreign participation in domestic sovereign debt markets.[18] The depth of sovereign bond markets and the extent of foreign participation in them is a reflection of these factors.

[17] J. Roldos (2004): "Pension Reform, Investment Restrictions, and Capital Markets", IMF Policy Discussion Paper no. 04/4, available at: http://www.imf.org/external/pubs/ft/pdp/2004/pdp04.pdf.
[18] Recent reforms in Russia are encouraging in this context, though greater financial openness will also expose the domestic financial system to greater volatility.

Table 3: Key indicators of banking systems in transition countries

	2006 Transition Score						
	Banking reform & interest rate liberalisation	Securities markets & non-bank fi..ncial institutions	Share of state owned banks in total assets (2004)	Share of foreign-owned banks in total assets (2004)	Domestic Credit to GDP (2005)	Domestic credit to private sector to GDP (2005)	Real growth in credit to the private sector (2005)
CEB							
CZECH REPUBLIC	4.0	3.7	3	97	39.2	32.8	7.6
ESTONIA	4.0	3.7	0	20	71.3	60.0	59.2
HUNGARY	4.0	4.0	7	85	68.7	50.3	14.7
LATVIA	3.7	3.0	4	98	72.1	67.5	52.9
LITHUANIA	3.7	3.0	0	63	46.6	34.9	50.1
POLAND	3.7	3.7	22	49	40.5	31.0	11.8
SLOVAK REPUBLIC	3.7	3.0	1	91	53.7	35.0	21.4
SLOVENIA	3.3	2.7	13	71	64.0	..	..
SEE							
ALBANIA	2.7	1.7	..	..	44.8	12.4	49.6
BOSNIA AND HERZEGOVI..	2.7	1.7	4	81	48.8	..	..
BULGARIA	3.7	2.7	2	82	43.6	44.5	24.2
CROATIA	4.0	3.0	3	91	73.1	61.1	10.4
FYR MACEDONIA	2.7	2.3	2	47	25.3	25.4	21.1
MONTENEGRO	2.7	1.7	..	..	27.8	..	..
ROMANIA	3.0	2.0	8	..	19.0	21.1	33.8
SERBIA	2.7	2.0	..	59	20.2	23.8	35.8
CIS							
ARMENIA	2.7	2.0	0	34	8.7	8.2	33.7
AZERBAIJAN	2.3	1.7	56	..	11.4	9.5	42.8
BELARUS	1.7	2.0	70	8	20.9	..	..
GEORGIA	2.7	1.7	0	58	21.6	14.8	67.5
KAZAKHSTAN	3.0	3.0	4	..	25.2	..	..
KYRGYZ REPUBLIC	2.3	2.0	4	12	9.5	8.0	14.9
MOLDOVA	2.7	2.0	18	4	33.6	27.2	23.3
MONGOLIA	2.3	2.0	..	57	39.9	37.5	27.1
RUSSIAN FEDERATION	2.7	3.0	50	6	20.6	25.5	27.0
TAJIKISTAN	2.3	1.0	12	6	12.4	17.1	4.8
TURKMENISTAN	1.0	1.0	..	58	18.9	1.4	0.8
UKRAINE	3.0	2.3	8	6	35.8	35.2	48.9
UZBEKISTAN	1.7	2.0	68	70	21.0	20.4	-13.9

Source: OCE Banking Sector Survey.

Table 4: Volume and structure of assets held in pension funds of the mandatory pillar

	Year of introduction of second pillar	Total assets under management as of Dec 2005, million USD	Total assets as percentage of nominal GDP 2005	Percentage of assets in foreign currency	Asset allocation by category in per cent of total assets				
					Bank deposits	Bonds	Stocks	Investment funds	Other
CEB									
Estonia	2002	375	2.8	90.0	4.0	48.0	37.0	9.0	2.0
Hungary	1998	5,717	5.2	5.3	1.0	81.5	7.7	na	9.8
Latvia	2001	138	0.9	28.4	30.4	50.3	6.6	12.8	0.0
Lithuania	2004	147	0.6	80.6	1.0	62.0	9.0	28.0	0.0
Poland	1999	26,394	8.7	0.9	3.8	63.7	32.1	0.0	0.4
Slovak Republic	2005	283	0.6	4.3	80.8	10.9	7.8	0.0	0.6
SEE									
Bulgaria	2000	266	1.0	1.5	17.0	75.3	7.0	na	1.7
Croatia	2002	1,924	0.8	11.0	4.1	79.0	3.9	9.8	3.2
CIS									
Russia	2002	6,128	0.8	0.0	16.8	82.6	0.6	0.0	0.0
Kazakhstan	1998	4,849	8.6	7.5	19.5	70.5	9.8	0.1	0.2
Total/Average		46,222	3.0	22.9	17.8	62.4	12.1	7.5	1.8

Source: National authorities.

Table 5: Domestic debt of the general government

	GG domestic debt	
	in per cent of GDP	in USD billion
Armenia	3.7	0.2
Azerbaijan	6.6	1.1
Bulgaria	6.2	1.9
Croatia	27.5	11.4
Estonia	2.8	0.4
Hungary	43.2	51.2
Kazakhstan	4.1	2.4
Latvia	6.3	1.1
Lithuania	7.7	2.2
Macedonia	16.2	1.0
Moldova	15.3	0.5
Poland	37.6	120.9
Romania	4.4	5.1
Russia	5.1	43.4
Serbia	20.8	6.0
Slovakia	25.3	13.0
Slovenia	19.7	7.1
Ukraine	4.8	4.6

Source: Fitch Ratings, and OCE estimates.

C. Regulatory Prerequisites

A basic prerequisite for the Bank to engage will be the authorities' willingness to adapt the regulatory framework in a way that will support the Bank's local currency operations. This would most clearly be signalled through shared policy objectives for the development of local bond markets, for instance expressed in the authorities' financial sector strategy or sovereign debt management strategy. In the first instance, the Bank's engagement will require a willingness to grant EBRD bonds a status equivalent to that awarded to government obligations, importantly by encouraging their purchase by pension funds and insurance companies, allowing repurchase operations with the central bank, and classifying EBRD bonds as 'immediate liquidity' under the prudential standards imposed on the local banking sector. Such rights may be more difficult to negotiate in countries where the government draws on the banking system for a large part of its funding requirements.

Transactions with local banks and public sector bodies are likely to be fraught, as in many markets laws and regulations are unclear, or conflicting, and subject to frequent changes. Imposition of new taxes, currency restrictions and other controls may require the Bank to seek recognition of its immunities and privileges. In several markets, documentation and ongoing due diligence requirements may prove excessively onerous.

The Bank's long term objective to stimulate development of a local private bond market will need to be supported by a broader effort in regulatory reform and institution building. This is typically a step that only countries at a fairly advanced stage of financial development can take. Creditor rights, corporate governance standards, and bankruptcy procedures need to be well established to support bond markets and their requirements for transparency and information sharing. Generally, this is only the case where the local banking system is well regulated and has developed a certain degree of maturity.[19]

5. Considerations on Widening the Type of Clients

In designing the Bank's future operations, it will be important to take into account sector-specific developments across a range of countries that are likely to stimulate demand for local currency products.

In the financial sectors supervisors in particular in the CEB and SEE countries have recently adopted a wide range of stricter prudential measures and more effective supervisory tools to stem the rapid growth in foreign currency denominated lending, and thereby control the direct and indirect currency risks to banks. These include:

- Tightening of limits on net open currency positions;
- Differentiated capital requirements based on the currency composition of the loan book;
- Greater provisioning requirements for foreign exchange loans;
- Tightening the eligibility requirements for foreign exchange loans to only include borrowers with corresponding foreign exchange revenues;

[19] See IMF (2005): "Development of Corporate Bond Markets in Emerging Markets", in: Global Financial Stability Report, Chapter IV, available at: http://www.imf.org/External/Pubs/FT/GFSR/2005/02/pdf/chp4.pdf.

- More intensive surveillance and inspection regimes for banks with large foreign currency denominated loan books.[20]

In addition there are moves within the industry to tighten credit screening procedures for foreign currency loans, and sensitise borrowers to currency risks.[21] It is too early to judge the effectiveness of the wide range of prudential measures that have been adopted. Few affect the sources of funding, in particular from parents of banking subsidiaries in the CEB and SEE countries. Still, Croatia is a case where tight restrictions imposed on foreign currency borrowing by banks (a 72 per cent unremunerated reserve requirement) appear to shift the lending behaviour. Elevated perceptions of currency risk among borrowers in the region may begin to reduce demand for foreign currency lending.

Unlike in the public and financial sectors, maturity and currency mismatches in the corporate sector are not well measured, let alone regulated. The growth in cross-border claims on corporate sectors, and the number of new credit ratings issued would suggest that currency mismatches have grown rapidly on the back of high profitability and rapidly widening access to international capital markets. Nevertheless, two factors point towards strong demand for local currency products in future. Firstly, industrial sectors in transition countries show a disproportionate growth of mid-size firms which are less likely to have secure foreign currency revenues, and will seek funding primarily on domestic financial and capital markets. Secondly, the use of hedging instrument that could mitigate foreign exchange risk in the absence of local funding is likely to remain limited. Hedging instruments, such as forward currency contracts and currency swaps, are well established in the large CEB markets, and, based on MosPrime and following a number of regulatory changes, are beginning to take hold in Russia. Nevertheless, hedging markets can only develop on the back of a liquid money market that provides a floating reference rate for contracts, and legal and regulatory reforms are needed to allow the netting out of risk positions.

In the public sectors in transition countries there has been a trend towards devolving financial management to local authorities while tightly circumscribing the granting of sovereign guarantees. Public sector enterprises such as utilities tend to be managed more as financially independent entities, even where the prospect of privatisation remains remote. Given the absence of foreign currency revenues demand for local currency funding is likely to grow.

Households also begin to discern greater risks, as interest rates on both domestic and foreign currency loans rise and currency volatility increases. However, household indebtedness is still comparatively low relative to income, and a large part of retail lending is secured in mortgages.[22] A protracted deflation in housing prices could add to pressure on the net worth of households, though as yet there are few signs of this. In Hungary, for instance, where about 85 per cent of lending to households in 2005 was in foreign currency (often the Swiss Franc or the Yen), foreign exchange debt owed by households was just under 4 per cent of GDP. Nevertheless, households are likely to be worst informed about currency risks, and efforts by regulators and some banks to raise 'financial literacy' are still relatively recent.

[20] See P. Hilbers et al. (2005): "Assessing and Managing Rapid Credit Growth and the Role of Supervisory and Prudential Policies", IMF Working Paper no. 05/151, available at http://www.imf.org/external/pubs/ft/wp/2005/wp05151.pdf
[21] See Fitch Ratings (2005): "CEE Housing Finance: Rapid Growth, but at what Risk?", November 2005.
[22] IMF (2006): "Household Credit Growth in Emerging Markets", in: Global Financial Stability Report, Chapter II, available at http://www.imf.org/external/Pubs/FT/GFSR/2006/02/pdf/chap2.pdf.

6. Coherence with National Monetary Policies and Debt Management Strategies

The preceding two sections underline that policy support for local currency funding is essential if the Bank's efforts are to lead to a broader development of capital markets. The transition to more fully developed local currency funding in the banking sector and capital markets will require macroeconomic stability, a clearly defined policy on exchange rate management and addressing currency mismatches, a strategy for financial sector development and the wide range of regulatory reform that is associated with it.

Several transition countries have spelled out such a strategy through dedicated financial sector strategies, or emphasize the role of private bond markets in their public debt management strategies. The latter set out the authorities' objectives for the balance between domestic and external debt and the planned issuance programme and targeted maturities in the domestic market. These documents hence define the choice between relatively cheap funding in international capital markets on the one hand, and seeking to stimulate bond market liquidity through issuance in more expensive domestic bond markets on the other. In Russia, for instance, domestic sovereign issuance is clearly directed at the latter objective, as demonstrated by the recent issuance of a 30 year sovereign bond on the domestic market, following the retirement of large shares of external debt to official creditors.

7. Coherence with the Work of Other IFIs

Over the course of its future local currency financing activities the Bank will need to closely coordinate with other IFIs that are active in the capital markets of the transition region. Such activities by other institutions could complement the Bank's efforts, for instance in supporting regulatory change. However, where competing local currency bonds issued by another IFI are either mispriced, or have limitations on their eligibility for repurchase operations or purchase by institutional investors the Bank's aims for developing markets may be compromised. Furthermore, where liquidity in the banking system and among domestic institutional investors is limited, issuance by other institutions could crowd out the Bank's own capital market activities. The EBRD will therefore deepen its dialogue with the World Bank, the IFC, the EIB and the ADB, all of which are active in the transition region.

In selecting countries for future local currency operations the Bank will be able to draw on the technical and advisory work of other institutions. Both IMF and World Bank are conducting regular in depth assessments of the financial and capital market environments in transition countries, through both annual surveillance and more infrequent Financial Sector Assessment Programs (FSAPs). Statistical coverage of domestic capital markets has significantly improved through the work of the Bank for International Settlements (BIS).

Notwithstanding the mitigation of currency mismatches, the Bank's local financing activities may nevertheless give rise to a number of macroeconomic concerns. Making available highly rated domestic currency instruments may attract volatile external capital to the country. This could further aggravate overheating tendencies in the economy, or lead to sudden withdrawals of capital.

In early transition countries the Bank's activities will need to be consistent with the key parameters of macroeconomic policy, which are in many cases governed by IMF programmes.

Private investment is typically negligible and local currency funding can only be accessed from the public sector. A swap with the central bank, for instance, would have the nature of an unsterilised foreign exchange intervention. If not off-set through the open market operations of the central bank or otherwise compensated for this would have a corresponding impact on domestic liquidity and price pressures, and could put at risk the country's monetary policy objectives. The central government could be an alternative investor in EBRD issued bonds. However, such investments would likely require changes in fiscal laws, and be provided for in the budget.

8. Conclusions and Operational Considerations for the Bank

The transition region has witnessed an unprecedented period of exchange rate stability, coupled with a very benign environment of abundant liquidity directed to emerging markets. In consequence, unhedged currency exposures have increased substantially. Large shares of bank lending to households and enterprises remain denominated in foreign currency, and the corporate sector has also gained greater access to external funding. The net exposures of banks are typically limited through prudential regulations, though credit risks from borrower exposures are hard to gauge. As liquidity for emerging markets recedes, those countries of operation with weak macroeconomic fundamentals may confront substantial exchange rate risk. Addressing currency exposures through the development of local currency bond markets is a key element of strengthening macroeconomic and financial sector resilience.

In the CEB and SEE countries this effort will need to confront a widespread perception in the financial sector that the euro be adopted as the official currency in the near future. While this is certainly the official policy objective in most countries, slow progress in convergence and strict application of EMU accession criteria by EU institutions may leave these countries in a monetary half-way house for longer than is currently anticipated. By contrast, most CIS countries are likely to retain monetary independence, though illiquid financial systems, in part due to persistent dollarisation, may hamper efforts to develop local currency bond markets.

The Bank's role as an active borrower and lender in local currencies is both in keeping with the Bank's objective under Article 2 to develop capital markets, and serves to improve the appropriateness of the loan terms offered by the Bank to borrowers with little or no hard currency income. There are, however, significant drawbacks both to the Bank and to the clients themselves. For the latter, although a local currency loan removes or minimises foreign exchange risk, it may subject the borrower to a plethora of other risks – regarding the application of often conflicting or inchoate laws and regulations, and the wide bid-offer spreads and poor pricing transparency resulting from a lack of liquidity in the domestic currency market. Experience in recent bank projects has demonstrated that end borrowers often see the benefits from reducing currency risk outweighed by higher and potentially more variable funding costs in local currency, in particular in markets with an appreciating domestic currency, and remain concerned about the liquidity, and legal uncertainties prevalent in the domestic market.

The Bank should therefore not encourage clients to take local currency loans without seeking to address these risks through reform of the market infrastructure. This would guide the Bank towards raising domestic currency for on-lending through measures that develop the market environment, rather than through, for example, an unhedged foreign exchange position. Where the Bank is able to access even short-term local currency financing in ways that promote market development, the Bank should use its overall liquidity position and triple-A credit standing to assume maturity transformation risk by extending necessary long term loans.

The costs and risks associated with local currency funding are not inconsiderable, and for this reason the Bank's local currency activity to date has been deliberately circumscribed and targeted.. The attendant risks to both the Bank and its clients are mitigated by the openness and commitment of local regulators to work with the Bank to build an effective market infrastructure (including the legal and regulatory framework, and payment and settlement systems). The Bank should therefore continue to prioritise its local currency activity towards markets where a more holistic approach to stimulating and encouraging development of capital markets is achievable.

Isabelle Laurent and Alexander Lehmann
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