Setting it straight

With the once highly sought after markets in Russia, Kazakhstan and Ukraine now seemingly veering off-course, optimism about doing business in the region is in short supply. Philip de Leon gathers three Eurasian analysts to discuss what the future holds.

Gloomy statistics of Eurasian economics are never far from the headlines. The benchmark Russian Trading System (RTS) index lost over 50% between May and September alone and trading has been regularly stopped ever since; Ukraine had to be rescued with a US$16.5bn bail-out package from the International Monetary Fund (IMF); and Kazakhstan faces the harsh reality of GDP growth of below 5% for 2008, and probably 2009, after averaging over 9% since 2000.

There is seemingly little to inspire confidence in the trade, commodity or export financier, with many now reducing or even cutting their credit lines with the Eurasian countries. **GTR** challenges three representatives from Kazakhstan, Russia and Ukraine to dig up some positive trends across the three regions.

Debate participants

- In Russia, **Richard Hainsworth** is general director of RusRating, an independent national rating agency, assigning credit ratings to banks, leasing companies, banks bond ratings and providing analysis of the banking sector. RusRating is part of the GlobalRating Group, which also covers Kazakhstan, Armenia and Azerbaijan.
- In Kazakhstan, **Jason Hurwitz** is director of the financial sector research team at Visor Capital, a leading brokerage firm and a major investment bank across Central Asia that provides professional investment banking services and advice, including corporate finance, sales and trading, and research.
- In Ukraine, **Edilberto Segura** is a partner and chief economist at SigmaBleyzer, one of the largest equity investors in Eastern Europe, as well as advisory board president of The Bleyzer Foundation, which is an international non-government organisation supporting the successful development of transition economies into healthy, democratic market economies.

GTR: What are the most striking effects of the world financial crisis in your country that have been missed or barely touched upon by the western press?

Hainsworth: The assessment of affairs in Russia by the Western media suffers from significant ingrained biases that are difficult to disentangle. For example, where the state is intervening to support private banks, these are universally represented as "failed institutions" for Russia. State support for financial institutions generates negative comment in other countries too, and for deep ideological reasons, but these objections are kept separate in news coverage from the reporting on state support. This distinction is not so clear when the institutions are in Russia. The response from the Russian state to the crisis has been "swift, comprehensive and coordinated" to quote the World Bank's recent Russian Economic Report.

Whereas the western media has been quick to compare the current crisis with Russia's 1998 experience, the reality is that Russia now is in a far stronger position: it has strong reserves, a united political environment, and because of 1998, its


Richard Hainsworth, RusRating

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economic and financial leadership is experienced in dealing with severe crises.

Hurwitz: Kazakhstan was hit hard much earlier than most CIS countries by the financial crisis, as effects on the banking system and the real economy really began before the end of the summer of 2007. This was due to Kazakh banks having grown rapidly, funded by foreign borrowing, which meant the tightening of international credit markets put the banks, and the economy, in a state of withdrawal. Based on regulatory data, the Kazakh banking system had a massive 228% loans-to-deposits ratio as of year-end 2007 – in most countries, this figure does not get much higher than 100%.

When most banks lost their ability to find cheap funding, much of their foreign debts could no longer be rolled over, putting pressure on the entire financial system as the current account balance shifted to negative. At the end of August 2007, speculators began putting pressure on the currency and thus on the National Bank reserve base. Also, depositors started pulling their money out of the banks, with September and October showing the biggest deposit outflows.

What the international press has not noticed, it seems, is that Kazakhstan has been among the swiftest countries to adapt to the crisis.

Before year-end 2007, the government had stabilised the currency and introduced liquidity support programmes for the banking sector. Banks had already curtailed lending and tightened lending practices.

Total national reserves of US$47.4bn (as of October 31, 2008) are larger than the entire foreign debt of the banking system (US$41bn as of September 30, 2008). Even in a negative scenario, we would expect the banks to be able to handle the vast majority of their own debt obligations without state support, making the total national reserves figure quite ample to support the sector.

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Segura: A point usually missed is that the current financial crisis in Ukraine is likely to be temporary. It could last for about one year, but the country should rebound quickly thereafter. The main reason for a relatively quick turnaround is that Ukraine became vulnerable to the world financial crisis principally because of the large amount of private foreign debt that it contracted over the last two years. During this short period, private foreign debt increased by almost US$50bn.

A lot of this debt was short-term. As a result, Ukraine was faced with about US$40bn of debt service over the next 12 months, a load that it found difficult to handle given the current international liquidity constraints. On the other hand, a positive factor is that government external debt has been stable at less than 10% of GDP. The risk of government debt default is therefore very small. This point was also missing by the press and most international observers, and was not properly reflected even in the credit default swap (CDS) spreads. Nevertheless, under normal international financial circumstances, Ukraine may have been able to obtain international financing to roll-over or repay its private short-term debt. But the current international liquidity crisis made this task more difficult. But with IMF and World Bank financing, Ukraine should be able to address the current short-term debt and correct some of the problems faced by local commercial banks. The IMF programme will also ensure that the current account deficit will be reduced. Therefore, within one year, the country should be able to recover as it would have covered its short-term obligations and addressed its current account deficit.

GTR: In the United States and in Europe, we have seen unprecedented government intervention to bail out financial institutions and companies too big to fail. What is happening in your country?

Hurwitz: Beyond the currency stabilisation and initial liquidity support programmes, the Kazakhstan government has continued to bolster the financial sector. New support and reforms are being implemented, including state capital injections into the top four banks totalling approximately US$3.6bn, reductions in minimum reserves requirements by over US$3.5bn, and the new law on financial stability that provides for a distressed assets fund, a US$42k retail deposit guarantee, a mechanism through which the state can take shareholdings in distressed banks, criminal responsibility for bank executives, and other measures. New and existing support measures could combine for US$17.6bn, by our estimates.

Hainsworth: The Russian government, if anything, has acted ahead of the curve. It followed the example of Kazakhstan in stating clearly and firmly that it would support the financial system. It has provided short and long-term money via the ministry of finance, the central bank, the state-owned banks and the regional authorities. The central bank is encouraging large banks to buy up small regional banks that have faltered in the crisis, providing cash and ensuring that the merger process is not affecting any of the clients of the distressed bank.

My own impression from the figures is that although a recession will continue, the heat of the crisis is passing. If we consider a crisis to have two parts – an initial period of panic, and a second period of reasoned reaction to difficulties – then Russia is still in the panic stage, but is beginning to leave it. Although big sums are involved, the Russian government has not yet had to borrow to accomplish its crisis goals. This is important for the future and demonstrates that rapid and firm action can substantially reduce the final bill.

Segura: The Ukrainian government is implementing an IMF-supported stabilisation programme, which includes recapitalisation of commercial banks. The government has already identified about 20 banks that may be eligible to receive capitalisation support. These banks represent over 90% of the assets of the banking sector. This recapitalisation is expected to be done in accordance with best international practices under technical support expected to be provided by the IMF. Although not yet decided, the government may also support the metallurgical and chemical sectors based on agreements with the largest producers.

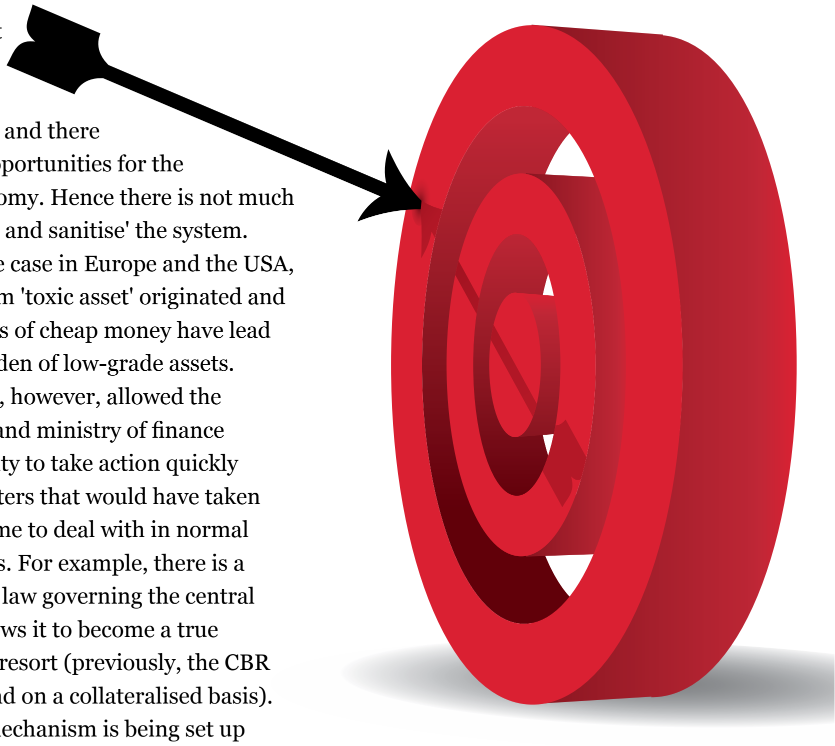
GTR: Russia's state-controlled Vnesheconombank (VEB) has issued US$7.8bn worth of loans to Russian companies to refinance their foreign debts. Has a similar measure been adopted in Kazakhstan or Ukraine?

Segura: This practice is not in place in Ukraine.

Hurwitz: The Kazakh government has already provided significant support for the Kazakh banking sector, including liquidity support programmes with over US$2bn and deposits by state-controlled companies that we believe total over US$7bn. As a result, the loans-to-deposits ratio fell from 228% at year-end 2007 to 186% as of the third quarter of 2008.

GTR: With any major crisis, come measures to clean and sanitise the financial system. Can you mention the three most important measures adopted in your country?

Hainsworth: The crisis was not Russian in origin, nor were there signs of a crisis before August 2008. Asset quality remains good and there are growth opportunities for the Russian economy. Hence there is not much need to 'clean and sanitise' the system. This is not the case in Europe and the USA, where the term 'toxic asset' originated and where decades of cheap money have lead to a large burden of low-grade assets. The crisis has, however, allowed the central bank and ministry of finance the opportunity to take action quickly to rectify matters that would have taken a very long time to deal with in normal circumstances. For example, there is a change to the law governing the central bank that allows it to become a true lender of last resort (previously, the CBR could only lend on a collateralised basis). Secondly, a mechanism is being set up to provide long-term credit resources to the Russian economy via the banking system, namely subordinated debt via the state development bank. Finally, the CBR is encouraging the formation of large nationally significant banks by allowing a chosen few the resources to pick up regional distressed banks.



Hurwitz: In Kazakhstan, state capital injections into the top four banks total approximately US$3.6bn.
The second set of measures is the reduction in minimum reserves requirements by over US$3.5bn and other liquidity support mechanisms.
A new law on financial stability that provides for a Distressed Assets Fund, a US$42k retail deposit guarantee, a mechanism through which the state can take shareholdings in distressed banks, criminal responsibility for bank executives, and other measures.
While we would not suggest that the banking and financial system has escaped from the problems relating to the global credit crisis, we believe that the government's quick reaction and support has already helped mitigate liquidity, capital, and currency devaluation concerns.

Segura: A number of measures have already been taken to sanitise the financial system. First, the National Bank of Ukraine has increased the level of guaranteed deposit insurance by three times from Hrn50,000 to Hrn150,000. This measure may help to prevent bank runs. Second, two weak systemic commercial banks were sold to other owners to avoid their bankruptcies. Further similar actions will be taken in the future. Third, the national bank is requiring banks to carry out audits of their portfolio, to ascertain the level of capitalisation that the banks should hold and define any capitalisation support from the government. Fourth, to decide whether any restructuring of foreign debt service is needed, the national bank passed a resolution requesting commercial banks to report the maturity of their obligations. It also requested banks to clearly classify all existing deposits by their terms as some banks had used hybrid-term-structure for deposits, which combined features of both demand and term deposits.

GTR: What additional measures would you like to see adopted?

Hainsworth: I think the ministry of finance should use the opportunity to pass a law allowing for a non-callable retail deposit. The population has an absolute right to withdraw money from a bank, even if a depositor has agreed to a term contract with a higher rate of interest. This causes liquidity risk for depositors. However, this will not pass the Duma even in a crisis. Second, Russia needs a longer-term capital market. This needs to be done via the flotation of ordinary bonds. However,

Edilberto Segura, SigmaBleyzer

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Hurwitz: Given the severely depressed debt prices of most banks, the government (or some the banks themselves) could consider a bond buyback programme that would generate instant profits and take pressure off the banking sector. Banks that have received support may be in a good position to take advantage of this situation, depending on their liquidity and debt repayment obligations.

Segura: In addition to the recapitalisation of large and systemic commercial banks, it is necessary to support the efforts of commercial banks to deal with their non-performing loans. This requires not only the undertaking of comprehensive portfolio audit of commercial banks, but to devise corporate and household restructuring plans to enable borrowers to serve their debts. In addition, there is a need to take further measures to reform financial regulation (particularly in the areas of transparency, and risk and liquidity management).

GTR: What type of trade-related/ commodity finance/structured trade finance deals and investment projects are you presently seeing and what type of deals do you think will dominate the stage in 2009 for what is predicted to be a challenging year?

Hainsworth: There is no investment in Russia at present. I expect to a see a resurgence of state-sponsored infrastructure investment in 2009 to jump-start the economy. Other sorts of deals will depend on the demand by investors, not on the ability of Russia to oblige.

Hurwitz: This next year (or more) will probably be challenging for such financing. We would expect to see multilaterals provide a limited amount of targeting financing to the SME sector. Structured finance may be quite limited. Banks that talked of such plans in 2008 have apparently postponed them.

Segura: It would take time for Ukraine to regain a sound current account position. In the meantime, import substitution industries are likely to be attractive. Also projects in energy sector, particularly those in the energy efficiency and energy saving technologies, are likely to have good returns. Finally, given the extensive and rich soil of Ukraine, investment projects in agriculture are likely to be economically sound.

GTR: Can you elaborate on the status of privatisations in your country?

Hainsworth: It seems that we are living in a time of nationalisations, but it is not like the US taking over private companies. I don't expect any significant privatisations until the health of the market is restored, and that will take some time.

Hurwitz: The Kazakh government has indicated that it would like to sell shares (IPOs) in a wide range of state-owned companies in order to boost stock market liquidity in Kazakhstan.

Segura: For the near term, privatisation plans are stalled, not only because of political uncertainties, but also because the current international crisis is not conducive to privatisations in any country.

GTR: At a time when countries such as China, India, Brazil and others in the Middle East, South-East Asia and part of Africa are getting a lot of attention, what would be your argument to get foreign companies to engage with or stay engaged in Eurasia?

Hainsworth: Large deposits of natural resources, an educated and increasingly sophisticated population, the need to restructure the nation's infrastructure, a competent state financial management that has been though two crises (1998 and 2004) and looks increasingly to see this one through.

Hurwitz: Eurasia has a rare combination of assets that assures long-term growth in the region. These include: vast oil and mineral wealth that is relatively untapped compared to much of the world; strategic location in the heart of the world's largest land mass; rapidly improving infrastructure; broad ethnic and religious diversification with peaceful coexistence and near 100% literacy rates.

Segura: Although Ukraine may experience one or two difficult years, over the medium term, we are optimistic about Ukraine. It has a large consumer market with a highly qualified and relatively cheap labour force. It has a relatively good infrastructure (ie, electricity grids, transport network). These two factors, plus the fact that Ukraine is at the border of the EU, make it an attractive site for supply to the European Union (EU). These prospects would be improved by the "enhanced" free trade agreement that Ukraine is currently negotiating with the EU. In addition, Ukraine should be able to attract investments in agriculture, given its fertile soils. Output can be increased with only moderate investments by addressing the low level of productivity in agriculture, which is due principally to poor management and technology. **GTR**