German Economic Team Belarus

IPM Research Center

Policy Paper Series [PP/03/2011]

Developing Minsk's Financial Sector towards a Regional Financial Centre

Cyrus de la Rubia, Robert Kirchner, Andrew Skriba

Berlin/Minsk, July 2011

About the IPM Research Center

The IPM Research Center was established in 1999 within the mutual project of the Institute for Privatization and Management (Minsk, Belarus) and CASE - Center for Social and Economic Research Foundation (Warsaw, Poland). It is a member of the CASE research network, William Davidson Institute NGO Alliance, and Economic Policy Institutes Network (project of the UNDP's Regional Bureau for Europe and the CIS). The IPM Research Center actively cooperates with the German Economic Team in Belarus (GET Belarus). Within this cooperation the IPM Research Center provides independent policy advice on economic issues to the different official agencies, namely to the Council of Ministers, National Bank, Ministry of Economy, Ministry of Finance and other organizations involved in the process of formation and implementation of economic policy.

The Mission of the IPM Research Center is to enhance national competitiveness through elaboration of the research-based economic policy recommendation and the promotion of professional dialogue on the urgent issues related to economic performance.

IPM Research Center
50B Zakharova Street, 220088, Minsk, Belarus
Tel: +375 (17) 2 100 105
Fax: +375 (17) 2 100 105
E-Mail: research@research.by
http://www.research.by

About the German Economic Team Belarus (GET Belarus)

The main purpose of GET Belarus is to conduct a dialogue on economic policy issues with the government, civil society, and international organizations. Experts of German Economic Team have experience in policy advice in several transition economies, including Ukraine, Moldova, and Russia. In Belarus the IPM Research Center and the German Economic Team provide information and analytical support to the Council of Ministers, the National Bank, the Ministry of Foreign Affairs, the Ministry of Economy and other institutions involved in the process of formation and implementation of economic policy.

German Economic Team Belarus
c/o Berlin Economics
Schillerstr. 59
D-10627 Berlin
Tel: +49 30 / 20 61 34 64 0
Fax: +49 30 / 20 61 34 64 9
E-Mail: info@get-belarus.de
http://www.get-belarus.de

Developing Minsk's Financial Sector towards a Regional Financial Centre

Executive summary

The Belarusian authorities plan to develop Minsk’s financial sector into a regional financial centre, serving also neighbouring countries with a broad range of financial services. A well-developed and diversified regional financial centre would be able to attract additional foreign savings, thereby supplementing the national savings and allocating them in a more efficient way. This would positively affect domestic investment and support diversified economic growth, for which the authorities have set very ambitious targets in the socio-economic plan for 2011-2015.

There are a number of important advantages connected with a regional financial centre beyond the economic benefits mentioned above, e.g. the creation of highly-qualified jobs in the financial service industry and in supporting sectors, the positive external effects of necessary infrastructure investments (both technical and physical) and agglomeration effects. A basic prerequisite in any major international financial centre is the convertibility of the capital account, i.e. the full freedom to convert domestic into foreign assets at a market exchange rate at any time. In order to reach this objective, a medium-term gradual strategy of capital account liberalisation is required.

We identify six areas, which are of paramount importance for a regional financial centre: The macroeconomic environment, the banking sector, non-bank financial institutions (including institutions other than banks, capital markets and service providers), the legal environment, infrastructure as well as a number of soft factors. Each of these areas has to meet certain ambitious objectives if the aim of successful regional centre is to be achieved.

We focus in our policy recommendations on a limited number of priority areas, where in our view swift action is necessary:

1. Macroeconomic environment: Achieving rapid macroeconomic stabilisation is the main challenge in the short term, as the current macroeconomic imbalances pose a threat to the overall stability of the financial sector. Authorities must further tighten monetary/credit and fiscal policy and need to attract external finance by various sources to support the adjustment process. Making the currently dysfunctional FX market work is a further top priority. Ideally, this should be supported by a shift towards more exchange rate flexibility, where the exchange rate is determined by market forces.
2. Banking sector: The authorities need to conduct extensive structural reforms in order to improve the economic efficiency of the banking sector. This implies less state and more private ownership (incl. FDI) as well as limiting lending under government programmes (“directed lending”). In case –as planned– the new Development Bank takes over existing and new lending programmes in a transparent manner, this can be considered a major step forward.
3. Non-bank financial institutions: The main objective of policymakers must be to create a level playing field and thereby fostering competition among non-bank financial institutions, as this would increase financial deepening and help to improve the allocation of resources in the economy. Developing deep domestic security and bond markets is thus a crucial task in this respect. The Belarusian Universal Commodity Exchange (BUCE), one of the biggest commodity exchanges in Eastern Europe, could be an important basis for the establishment of other capital market segments.

Authors

Cyrus de la Rubia	delarubias@yahoo.de	+49 (176) 54 04 59 24
Robert Kirchner	kirchner@berlin-economics.com	+49 (30) 20 61 34642
Andrew Skriba	askriba@gmail.com	+375 (17) 2 100 10 5

Acknowledgments

The authors would like to thank Prof. Dr. Jörg Franke for providing valuable comments to the paper.

Contents

1. Introduction

There is little dispute about the general positive impact of a well-developed financial sector on the rest of the economy. Even though the global financial crisis of 2007-2009 has raised some doubts about certain activities in financial markets it remains clear that economic growth depends on the access to capital in a sustainable way. Against this background, the recently initiated government project to establish a regional financial centre (RFC) in Minsk is a possible way to develop the financial sector towards modern global standards. A regional financial centre would be able to allocate the national savings in a more efficient way, thereby supporting investment and economic growth, for which the authorities have set very ambitious targets in the socio-economic plan for 2011-2015. At the same time, a regional financial centre in Minsk would be able to offer its financial services amongst other countries, e.g. to Kazakhstan and Russia with whom Belarus has formed a customs union and has agreed on forming a Common Economic Space by 2012.

This paper aims at showing what has to be done to establish a productive and powerful financial sector in Belarus (or to be more specific, in Minsk) which is not only able to support economic growth but which, in addition, provides financial services to neighbouring countries in the long run, thereby building up new revenue sources and diversifying the economic structure of Belarus. The structure of the Paper is as follows: In the second chapter the advantages and disadvantages associated with the establishment of a financial market industry will be analysed. In chapter 3 it will be shown how a broad and well-established financial sector that is able to compete on a regional basis should look like in general. Reference will be made to the required macroeconomic framework and the necessary stability of the banking sector. While Belarus was able to master the global financial crisis in terms of macroeconomic and banking sector stability rather well in comparison to neighbouring countries, the current external and domestic imbalances pose certain challenges in that respect. Additional aspects covered are non-bank financial institutions and capital markets, the legal framework, characteristics of the supervision as well as the financial infrastructure (including the technical infrastructure). In chapter 4, we assess the status quo by analysing the current strengths and weaknesses of the financial sector of Belarus, and provide some policy recommendations. Finally, a roadmap towards a regional financial centre will be presented in chapter 5, summarising the main measures to be taken.

2. The significance of a modern financial sector which serves as RFC

An important prerequisite for building a RFC is that the capital account must be liberalised almost completely. Such a strategy of capital account liberalisation is connected to a couple of advantages and disadvantages which will be discussed first. After that, the advantages and disadvantages connected directly to the building up of a RFC will be analysed.

2.1. Prerequisite: Liberalisation of the capital account

Capital account convertibility is the freedom to convert local financial assets into foreign financial assets at market determined exchange rates. It implies unrestricted mobility of capital.

Generally it is seen as the most important advantage of capital account liberalisation to give companies access to funding from abroad. This could spur economic growth as investment projects could be realised for which the national savings wouldn't be enough. In addition, the positive effects of increased competition should be taken into account given that the free entry of capital flows is also connected to foreign direct investment which is related to know-how transfer while the government may feel some pressure to reform the economy to attract more capital from abroad. However, the recent global financial crisis as well as the Asian crisis of 1997/98 has shown the risks of being exposed to "sudden stops" and foreign capital withdrawals. Two measures seem to be crucial to handle these risks:

- First, a floating exchange rate regime, where the central bank intervenes only on an occasional basis to limit sharp fluctuations, is in our view the best way to avoid the sudden depreciations which in fixed exchange rate systems are not sufficiently taken into account by market participants thereby damaging the economy in such a pronounced way as they did e.g. during the Asian crisis.

- Second, regulators should be given the possibility to regulate and limit hot money inflows as these can cause undesired bubbles.

While the restrictions to hot money inflows means that the capital account convertibility will not be complete this may reduce the attractiveness of the corresponding financial market place only at first sight. At second sight, investors should realise that hot money restrictions are a factor which provides for more stability of the financial sector and reduces the chances of a financial crisis triggered by capital flows.

2.2. Advantages and Disadvantages of a RFC

The establishment of a RFC has a number of advantages, but is also subject to some potential disadvantages. These will be discussed below:

Advantages

- The city which succeeds in building up a RFC benefits directly in the form of well-paid jobs and taxes. The job creation induced by the financial institutions in the broad sense, i.e. including supporting services like law firms, consultants, etc. is usually significantly higher than the direct job creation in financial institutions.
- Many of the needed infrastructure investments as modernisation of airports, roads, public transport, IT and so on are valuable also for other economic sectors.
- By the same argument, it is claimed that a RFC leads to a diversification of the economic structure in general and of export revenues in particular.
- Economies of scale / agglomeration effects: There are positive economies of scale as the set-up of many institutions and infrastructure projects have certain fixed costs elements which are more or less independent on the size of the financial sector. The agglomeration effects refer to the well observed fact that many industries tend to concentrate in certain areas taking advantage e.g. of the pool of qualified people.
- While an ordinary financial sector is important to allocate the savings to their most productive use, a RFC which is up to international standards should be expected to work even better in this respect thus reaping some benefits for the economy.
- An RFC should widen the possibilities to local companies to get access to funding and to get it cheaper than in a more closed financial sector.
- A country with a sizeable financial sector is in a better position to influence the regulatory decisions taken on the global stage.

Disadvantages

- If you invest and build an RFC, will participants come? There is a risk that the financial centre will not attract enough market participants as to render the investments into infrastructure and so on profitable. In addition, it is possible that even after having established an important RFC some events trigger foreign investors to leave the country belaying the saying that the financial industry is a footloose industry.
- Experience shows (London is one example) that the price level in financial market centres is higher than in the rest of the country. This can influence the competitiveness of other sectors negatively.
- Some critics emphasize that the building up a financial centre gives birth to some unproductive activities (e.g. excessive trading desks) absorbing thereby highly qualified people which could

add much more value to the economy in other sectors. In how far this argument counts depends certainly on the regulatory environment amongst other things.

3. How should a modern and regionally competitive financial centre look like?

The requirements with respect to a regionally competitive financial centre can be divided into six subcategories. The first subcategory refers to the macroeconomic environment. It has to be stable in order to provide the conditions for the economy to prosper. Secondly, the banking sector, which can be considered as the core of every financial sector, must show stability and competitiveness over a longer period of time. This relates also to non-bank financial institutions, which usually complement the banking sector. The legal infrastructure is the fourth issue to be considered. Next, the technical infrastructure needs to be in place. Finally, in addition to these "hard" requirements, there are some soft factors which could play an important role.

3.1. Macroeconomic environment

Macroeconomic stability can be narrowly defined as a situation where GDP as well as inflation develop in a fairly stable way, which means that neither output nor consumer prices show excessive variations. One important requirement to achieve that is a central bank which is independent from the government and which is enabled through corresponding monetary instruments to concentrate on achieving price stability, e.g. by following an inflation targeting framework. Such a setup implies that the currency is flexible, instead of being fixed to the USD or the EUR. If the currency was fixed to another currency, the central bank would have to follow the monetary policy of the country of the anchor currency, irrespective of the inflationary development at home.

Given that very often macroeconomic instability is connected to big moves of the national currency, some economic advisers claim that a fixed exchange rate does a better job with respect to the target of macroeconomic stability. However, such a policy framework would imply the necessity to have a very high amount of foreign exchange reserves to withstand any speculative attack against the currency in case of trouble. Apart from that the arguments mentioned above (monetary policy depends on decisions taken abroad), one should also add that by giving up exchange rate flexibility, the country loses an important instrument to react to external shocks. In this context the issue of the convertibility of the capital account as well as the rationale of capital controls should be discussed: Given the plans to establish a regionally competitive financial centre with international transactions taking place, full convertibility of the Rubel must be introduced.[1]

As recent experience in the Euro area, but also more general among developed countries shows, sound public finances are also an important part of a solid macroeconomic framework. A fiscal policy that puts a focus on a sustainable debt ratio, and a healthy public sector balance sheet more generally, is here to mention.

Finally, macroeconomic stability has also to do with the supply-side production structure of the economy. High concentration in certain sectors bears the risk of big output volatility. As a consequence, those economies with a broad and diversified economic structure have the best chances to generate a stable output growth.

Conclusion 1: An important prerequisite for a regional financial centre is a sound macroeconomic framework.

---

[1] However, this does not mean that all kind of capital controls must be abolished. In fact, there is a wide consensus in the academic community as well as among policy makers that certain capital controls can make a lot of sense to put a break on the (potentially destabilizing) inflow of so called hot money.

3.2. Banking sector

There are very different opinions as to how an ideal banking sector should look like. The discussion ranks about the share of state-owned banks, the openness with respect to investors and banks from abroad, the required capital ratio as well as the question if a few big banks are better than a lot of small ones (i.e. concentration). The latter argument is often complemented with the proposal to separate investment banking activities from classical commercial banking (with the latter involving deposit taking activities). In the following these aspects are discussed from the viewpoint of the stability of the banking sector as well as its competitiveness.

One issue discussed vividly is if the banking sector should be dominated by state banks or by private banks. In the past decades, a clear preference for private institutions could be observed, as more and more state-owned institutions were privatised. This followed the generally accepted view that the allocation of credit by private banks is superior in terms of the efficiency of resource allocation. State institutions are often used for politically driven "directed lending" to priority projects and sectors, and it is questionable if sound banking practices are being followed. During the financial crises, however, a significant number of banks had to be fully or partly renationalised, as the state was forced to acquire stakes in systemically important institutions[2]. Currently, this process is in reversal in many countries again.

Having said that, there is little doubt that in the context of following the goal to build a RFC in a transition country, private capital and know-how especially from abroad is needed. The aiming at being internationally competitive implies that foreign investors (including foreign banks) must be given the possibility to enter the banking market. This is the fastest and most efficient way to modernise the local banking sector. It is also mostly accepted that a significant presence of foreign capital is good for the stability of the sector. This could be seen for example during the banking crisis of neighbouring Ukraine during 2008-2010, when the parent companies from abroad did recapitalise their subsidiaries in Ukraine so that these banks - in contrast to many institutions which relied solely on local capital - were enabled to continue their operations[3].

Another aspect regarding banking sector stability is the capital ratio that should be required. While it is clear that the banking sector is the more stable the higher the required capital ratio is there is no clear view about the right level of the capital ratio as well as the method to calculate it. Regarding transition countries, the generally accepted view is that these countries should have higher minimum capital rations than developed (e.g. OECD/EU) ones, as the business risk in these markets is higher, thus a higher capital buffer is required.

Finally, there is an extensive discussion about the right structure of the banking sector. While there are a lot of proponents of breaking up systemically important banking institutions into small ones, which are less able to pull down the entire economy, this proposal does not look attractive from the viewpoint of a country that wants to create an internationally competitive banking sector. The same applies to the idea to separate classical banking from investment banking.

Conclusion 2: There is no conclusive empirical evidence which particular structure of the banking sector serves best to provide financial services and stability. However, a number of important ingredients can be identified: The banking sector should be based primarily on private banks, which are tightly regulated and endowed with sufficient capital. This goal requires the opening up of the banking sector for private investors and banks from abroad, as this will bring additional capital as well as an improvement of the risk management skills.

---

[2] It should be stressed that the main motivation behind these bail-outs was to prevent a systemic collapse with potentially grave implications for the real sector, and not to restore state-directed lending. Also, many of these recapitalisations were in fact mandatory.

[3] The so-called „Vienna initiative", in which major western banking groups promised to keep their exposure to the countries in Central and Eastern Europe in return for assistance by international financial institutions to these countries during the crisis was a very important stabilising factor in this respect.

3.3. Non-bank financial institutions

While it is clear that the banks build the core of almost every financial sector in the world a competitive banking sector is usually complemented by a couple of other institutions and specialised market participants. These are financial institutions other than banks, markets and other service providers related to the financial market.

i.) Financial institutions other than banks[4]

- *Insurance companies (life insurance, health insurance, other)*
- *Pension funds, mutual funds, hedge funds and private equity*

ii.) Markets

- *Stock market*
- *Government bond market*
- *Non-financial corporate bond market*
- *Foreign exchange market*
- *Derivatives market*

iii.) Other service providers related to the financial market

- *Specialised lawyers, notaries, tax advisers, auditors, consultancies, financial media companies*
- *IT service providers*
- *Universities offering finance related study courses*

Ad i.) Financial institutions other than banks

- *Insurance companies (life insurance, health insurance, other)*

The empirical evidence does not show that insurance companies need to be at the same places as banks. In many countries, the banking centre is in another city than the insurance centre is. In Germany, Frankfurt is considered as the main financial centre. However, most insurance companies have their headquarters in Düsseldorf and Munich. While the positive effects of agglomeration play an important role in the insurance industry as well, the proximity to the companies and individuals that need insurance products may play a more dominant role than in the banking industry. It does not seem that the insurance industry and the banking industry are natural partners. There have been some attempts to merge banks and insurance companies ("Bancassurance"). Fortis (Belgium), ING (Netherlands), Sampo (Finland) as well as Dresdner Bank (Germany) were some banks involved in mergers with insurance companies. However, after the failure of the merger of Dresdner Bank with Allianz (Allianz sold the Dresdner Bank stakes to Commerzbank in 2008/2009) the model has become much less attractive. All in all, there is no mandatory necessity of a financial centre to be characterised by banks AND insurance companies, even though insurance companies play also an important role in every sophisticated economy.

---

[4] It should be mentioned that we use the term "non-bank financial institutions" rather loosely. In some jurisdictions, a number of these institutions might be better labeled as "banks with special functions" (i.e. mutual funds in Germany).

Having said that, it is nevertheless recommendable to adjust the legal environment with respect to the insurance industry to global standards, as insurance companies can provide an important demand for financial services on both the asset and liability side of banks.

- *Pension funds, mutual funds, hedge funds and private equity*

Above said is also true with respect to pension and mutual funds as well as hedge funds and private equity. They all need the payment system established by the banking sector, they need to invest cash surpluses and they look for a variety of investment products which are partly offered by the banking sector. Apart from that, these institutions deal with stocks, government bonds, corporate bonds, derivatives and foreign exchange, providing liquidity to these markets.

In this respect, the Polish pension fund system may be a good example for the significance of the institutional framework applied to the pension system for the stock exchange. In Poland, the pension system was reformed in 1999 towards a three-tier system with a "Pay as you go" first pillar, a mandatory funded second pillar and a third pillar of voluntary occupational pensions. Given that the money of the mandatory funded second pillar had a relatively high limit of 40% which could be invested in stocks, the trade volume of stocks increased significantly after the implementation of the reform. Thus, the regulation for the above mentioned financial institutions can have a significant influence on the working of markets and vice-versa.

<u>Ad ii.) Markets</u>

- *Stock market*

Stock markets are typically organised at the stock exchange where usually only wholesale market participant have direct access, while retail investors (individuals) trade via their respective broker. Most stock exchanges are nowadays organised as an electronic trading system which brings together supply and demand at the market clearing price. In larger and geographically dispersed countries it is quite normal to have various stock exchanges, given the IT-based nature of the trading which does not require necessarily a local proximity to its customers. However, there is a limit to the dispersion as a minimum level of liquidity in stocks trading is necessary to make the stock exchange attractive. Thus, the smaller the total stock market capitalisation of a country is, the more useful it is to have a centralised stock exchange.

Stock exchanges have the potential to form the core of a financial market, as it is known from New York or London. In that sense, capital markets that are developing around a stock exchange are an equally fundamental part of a financial sector as the banking sector. However, certain specifics like the high price volatility as well as the cyclical waves of IPO's mean that it could be an overly risky strategy to rely only on the development of a stock exchange as the crucial feature of a RFC. It should be seen as an important and integral part of it, but must be complemented by other segments as well.

- *Government bond market*

Government bond markets are organised somewhat different than stock exchanges. Taking the experience of the Euro area bond market, the biggest chunk of government bonds is traded on an inter-dealer market. They deal through telephone or trading platforms. Wholesale investors usually don't have direct access to these markets but only indirectly through the primary dealers from whom they request quotes. The market access of individuals is often somewhat limited, due to relatively high minimum volumes of certain government bonds. However, e.g. in Germany there is an increasing number of exchanges where government bonds can be traded directly, also by individuals. The market share of the daily traded volume is still tiny, though.

- *Non-financial corporate bond market*

Corporate bonds are normally traded "over the counter" (OTC) and only in a quite limited way through exchanges. The functioning of a corporate bond market relies very much on the existence of a government bond market, which establishes a risk-free yield curve. Government bonds are usually a very important benchmark for corporate bonds and all other sorts of securities as the risk of government bonds is normally considered to be lower securities issued securities. In most countries but the US corporate bond markets are rather underdeveloped as the bulk of corporate finance is provided through bank loans. However, the development of a corporate bond market should be promoted, as the existence of such a market has advantages for most market participants: Companies have a new funding source, investors a new possibility to diversify their portfolios while the economy as a whole benefits due to cheaper funding costs (through increased competition to ordinary bank loans) and thereby making more investment projects profitable.

- *Foreign exchange market*

The foreign exchange market is a very critical one given that foreign exchange movements can have a significant impact on the whole economy. Foreign exchange markets are normally organised as OTC markets through the use of electronic platforms or by telephone through trading desks. An efficient and liquid foreign exchange market is a necessity for a RFC and for each country which is trading goods, capital and financial services internationally. Even if the local currency is fixed to the US-dollar, the need to trade the local currency against the US-dollar, the Euro or other currencies continue to exist. The more liquid the foreign exchange market is, the lower the costs of buying and selling currencies. Foreign exchange markets are often complemented with foreign exchange derivatives (see below).

- *Derivatives market*

    - Interest rate swaps

The market for interest rate derivatives like swaps seems to be a natural complement to the government bond market. The interest rate risk associated with the purchase of government bonds can be hedged with an interest rate swap. This means for example that traders who trade on behalf of a customer and who don't want to take any interest rate risk on their books in the meantime can hedge this risk away. If such a possibility does not exist, the bid ask spread for the government bond taken on the trading book must be much higher to compensate for the risk taken. In addition, the duration of government bond portfolios can be adjusted with the use of swap contracts. Thus, the existence of a swap market makes the trading of government bonds cheaper and more efficient. However, there is a certain fear of the misuse of interest rate swaps which globally is the biggest derivatives market. In particular, there is fear that given the fact that the notional amount of interest rate swaps outstanding is exceeding by far the outstanding amount of all fixed income securities (government bonds, bank bonds as well as corporate bonds) this market could pose a systemic risk to the financial market, if major counterparties fail to fulfil their contracts. This does not been that it should be given up on building up a market for interest rate swaps but to find ways to minimize the systemic risk which can be associated with this market. One way to handle this risk is a clearing institution through which interest rate swaps are traded. If a counterparty fails to deliver, the clearing house, which has to be capitalised by the member banks and which requires certain margins for each deal, has to fulfil the contract.

    - CDS contracts (Credit default swaps)

The CDS market can be seen as a complement to the government and corporate bond markets as these instruments enable investors to hedge their credit risk exposure. However, there is - similar to the case of interest rate swaps - a dispute about the pros and cons of CDS contracts. While hedging is quite easy to perform with CDS contracts (at least on big issuers) and can help to manage the credit risk of banks and other investors more efficiently, there is the fear that investors which sold CDS contracts may go bankrupt, triggering a widespread financial crisis.[5] Given the fact that even in sophisticated markets most credit risks cannot be hedged with CDS-contracts because the underlying companies are too small to provide for a liquid CDS-market we don't think that the establishment of a CDS-market is an important characteristic of a RFC.

---

[5] There is a widely accepted view that the insurance company AIG was rescued by the US government in September 2008 for exactly this reason.

- Foreign exchange derivatives

Foreign exchange forwards, which are traded over the counter in general, represent a valuable complement to the foreign exchange spot market as market participants are enabled to hedge future foreign currency cash flows. Insofar, FX-derivatives could represent valuable instruments to manage currency risk and to smooth revenues. The potential disadvantage of offering FX derivative instruments is that FX-derivatives can be misused for speculative attacks against the local currency using only small amounts of cash. This risk can refer both to downward and upward pressure on the local currency. While there are different policy instruments to handle these risks (foreign exchange reserves, interest rate changes, margin variations as well as capital controls), in a free floating currency regime market participants should be well aware of the risks, thus running fewer open positions as they would usually do in fixed exchange rate systems. This refers to private households as well as private companies without foreign currency revenues, which have a smaller incentive to take out foreign currency loans. This means that the damage done by e.g. a depreciation of 30% would be much less than in an originally fixed exchange rate system where people did not take into account this risk sufficiently. All in all, the implementation of a foreign exchange derivatives market bears risks as do the opening of the capital account and the full convertibility of the currency. However, if a country aims at establishing a RFC these are risks that have to be taken and are in our view are manageable.

- Derivatives exchanges

The individual derivatives products mentioned above (swaps, FX forwards, CDS) are usually traded bilaterally over the counter between market participants. In order to increase standardisation and liquidity in such products, many financial centres have tried to establish derivatives exchanges, which trade mainly standardised futures and options on a wide range of underlying products like bonds, FX and index products, among others.

Ad iii.) Other service providers related to the financial market

- *Specialised lawyers, notaries, tax advisers, auditors, consultancies, financial media companies*

The establishment of the above mentioned institutions and markets usually goes hand in hand with the emergence of service providers related to the financial market. This refers to specialised lawyers, notaries, tax advisers, auditors, consultancies, rating agencies as well as financial media companies.

- *IT service providers*

Given the high IT-intensity of the financial industry IT service providers would be helpful to let the communication systems run smoothly.

- *Universities offering finance related study courses*

While market forces should provide for these services to be offered in the wake of the expansion of the financial sector, it would be very helpful to have a university and other educational institutions where people can specialise on the corresponding subjects, so that the financial market industry has a pool of well qualified people available. This human capital aspect shouldn't be underestimated, as it can provide for the necessary competitive edge over other centres.

Conclusion 3: Apart from a strong banking sector, a well-diversified financial centre has also vibrant capital market institutions and their supporting structures in place.

3.4. Legal environment

The efficiency of a financial sector depends crucially on the legal environment. Banks have the better chances to develop and to offer a wide range of services at competitive prices the better the enforceability of contracts is. This includes an effective insolvency law. Indeed, an effective insolvency and creditor rights system plays an outstanding role in creating and maintaining the confidence of both local and foreign investors. Bad experience with the enforcement of contracts, in turn, can do huge damage to the reputation of a financial market place.

For developing countries, an effective system for secured rights is especially important. The legal framework should provide for the creation, recognition and enforcement of security interests in all types of assets—movable and immovable, tangible and intangible.

Furthermore, an efficient system of state regulation and supervision of the main players of a financial centre (banks, exchanges, other institutions) is very important for gaining and maintaining a high reputation of a financial market place among local and foreign participants.

Conclusion 4: A legal environment that guarantees the enforceability of contracts and thus secures creditors' rights is of paramount importance for a financial centre.

3.5. Technical infrastructure

For a financial sector to be attractive to local and foreign investors, it is important to have a technical infrastructure in place which is up to international standards. This refers above all to the settlement procedures for payments and trades in stock, bond and derivatives markets. This requires modern telecommunication and data highways which in addition are crucial for investors being interconnected with global financial markets.

Another aspect is the transport infrastructure. Easy accessibility for local and international market participants is an important feature to make a financial sector attractive. This includes an airport which is reachable with modern public transportation means as well as the general transport infrastructure within the city in question.

Conclusion 5: A well-established technical infrastructure with respect to information and communication technology, but also to transport is an important prerequisite.

3.6. Soft factors

There are a lot of soft factors which can be more or less decisive with respect to the success or failure of a financial market to compete internationally. This refers to security aspects, attractiveness of the city in terms of cultural facilities and general quality of life. The better a financial market location scores in this respect, the more probable it is that it can attract well-motivated, sophisticated and highly mobile bankers and other financial sector employees. This obviously implies that employment of expatriates in the financial sector is not restricted by state regulations.

Conclusion 6: Soft factor can play a decisive role for the success or failure of a financial centre.

4. Where does Minsk stand? Assessing the status quo

The last chapter summarised the main requirements for establishing a regional financial centre. In this chapter, we will assess the status quo in Belarus with respect to above mentioned six subcategories.

4.1. Macroeconomic environment

Belarus has manoeuvred through the global financial crisis 2008-2009 relatively well insofar as the economy remained relatively stable, despite major external shocks. The country was able to avoid recession in 2009 (real GDP growth of 0.2%, much better than in the region) and resumed strong growth in 2010 of 7.5%. While foreign exchange reserves shrank initially, a sharp currency devaluation could be avoided during this period, since the authorities started to increase gradually exchange rate flexibility. An important reason for this relative good macroeconomic performance was the cooperation with the IMF during this time, which supported the adjustment efforts done by the authorities with a stand-by-loan of USD 3.5 bn. The policy instrument that carried the main burden of adjustment was fiscal policy; the budget deficit was only 0.7% of GDP in 2009.

Having said that, serious macroeconomic vulnerabilities remained, especially regarding the external sector, which is structurally in a weak position. The big concern was and is the current account deficit, which amounted to 13% of GDP in 2009 and 15.5% of GDP in 2010. This is clearly unsustainable, especially when confronted with the low foreign reserve position[6] and the low inflow of foreign direct investment (FDI).

Despite these vulnerabilities, the authorities loosened during the first half of 2010 macroeconomic policies to a significant extent, especially with respect to fiscal, credit and incomes policy, while trying to keep the exchange rate more or less fixed. This policy loosing was a major cause for the significant internal and external imbalances that Belarus currently faces. The results of this are well know: The Rubel was officially depreciated by 36% in May 2011 after the National Bank tried to contain (unsuccessfully) the pressure on the exchange rate by a combination of administrative and market (i.e. interventions) methods. Inflation jumped to almost 44% yoy in June, one of the highest rates worldwide. Currently, there is still a system of multiple exchange rates in place, as most agents are not able to purchase foreign currency at the official rate. This puts the credibility of the stabilisation efforts currently undertaken into question, and is very negative for corporates and the population.

Conclusion 7: Belarus weathered the global crisis 2008-2009 rather well, due to an appropriate policy response and supported by an IMF-loan. However, the country faces currently massive external and internal imbalances, which need to be addressed urgently in a comprehensive manner.

4.2. Banking sector

The Belarusian banking sector, which is the main pillar of financial intermediation in the country, shows a number of specific features. First, it is clearly dominated by the state. While out of the 32 banks 23 were in the hand of foreign investors (with ownership of above 50%) the asset share of the state was 72.5% by the end of 2009. The two biggest institutions, Belarusbank (BBK) and Belagroprombank (BAPB) alone accounted for approx. 65% of the market in terms of assets and 72% in terms of outstanding loans. By the end of 2009, the government sold 93% stake in the Belpromstroibank which had a market share of 7%. The bank was sold to Sberbank of Russia. While further privatisations in the banking sector are under consideration, the NBB said in January 2011 that it was not able to find a strategic investor for Belinvestbank and Paritetbank and that it expected a delay in the privatisation process. Though some gradual progress can be observed in terms of opening up the economy to private investors, the economy as a whole (where the private sector share in GDP is at some 30% which compares unfavourable with the peers of the region) and the banking sector in particular remain relatively closed to the rest of the world.

Apart from ownership issues, a distinctive feature of the banking sector in Belarus is strong influence the government exhibits over lending; a feature which is also called “directed lending”. By the end of 2009, about half of all outstanding sector loans were loans under government programmes, of which some 75% were extended at subsidised rates. Most of the loans are channeled to the housing and the agricultural sector. While both privately owned are eligible for directed lending programs the bulk of such loans (some 90%) is extended by the state owned banks BBK and BAPB.

---

[6] Here it is to mention that part of official reserve assets are borrowed from banks, which poses further risks.

The problems associated with such activities are well known, and thus were an important part of the IMF-program during 2009-2010. Apart from macroeconomic issues, the dominance of this kind of lending is not supportive as to improve the attractiveness of the banking sector for private investors. Recent steps to establish a dedicated Development Bank that would take over some of the existing loans under government programmes from state-owned banks could be an important step in facilitating further privatisation of the sector and thus attracting foreign capital if it helps to increase transparency and clears the system from government-initiated loans.

The global crisis of 2008-2009 affected also the banking sector negatively, but much less so than in other countries. No bank runs occurred during the crisis, as credible deposit guarantees were issued to keep clients from withdrawing their savings from their bank accounts. Again, an important anchor of stability for domestic and foreign stakeholders was the IMF-programme in place. Summing up, the stability of the Belarusian financial sector amidst the global financial turbulences remained remarkable.

As to current developments, the deteriorating macroeconomic picture has translated into a number of rating downgrades of Belarusian banks, increasing the difficulties of banks to get funding from abroad. Thus, the need to act on the macroeconomic level (see above) is immediately connected to the stability of the banking sector, which is currently facing mounting challenges due to the recent devaluation, a dysfunctional FX market and liquidity pressures.

Conclusion 8: The banking system is dominated by the state, both in terms of direct ownership and through directed lending procedures. This implies a low level of foreign direct investment in the sector. Current macroeconomic turbulences pose a major threat to the near-term development of the banking sector.

4.3. Non-bank financial institutions

Which role play financial institutions other than banks and financial market places in Belarus? The non-bank financial institutions are in general small. The sector is characterised by a high degree of concentration, a limited composition of assets, high share of state ownership, and weak competition. Apart from insurance companies, non-bank financial institutions are basically non-existent.

Ad i.) Financial institutions other than banks

- *Insurance companies*

The insurance sector in Belarus is growing steadily but remains under-developed, with total insurance premium equal to below 1 percent of GDP[7]. The regulatory environment of the insurance sector does not look attractive to private investors and inhibits competition. The insurance supervisor is located within the Ministry of Finance (MoF) instead of acting independently from executive structures. In addition, state-owned enterprises can buy insurance only from state-owned insurance companies which are one example of regulation limiting the scope of activity of privately owned insurance companies. There are certain indications that the reinsurance business is in the process of being monopolised by the state-owned reinsurance company, which was established in 2006.

Having in mind that the insurance sector can provide valuable demand for financial services, the regulation of this sector should be modified towards more openness and increased competition as these are the ingredients for a sustainable expansion. Private insurance companies should be allowed to extend their respective fields of activity.

[7] The following sections draw mainly on: IMF/World Bank (2009): „Financial System Stability Assessment".

Ad ii.) Markets

The securities market in Belarus is rather small and illiquid. At the beginning of 2008, the value of all securities (debt and equity, public and private) in circulation was equivalent to around US$8.2 billion[8] (18 percent of GDP). While different types of government securities represent the largest share of this amount, there is no yield curve on these securities, which could potentially be used as a benchmark for pricing non-government securities (like corporate bonds). The equity market is basically non-existent and is not used for raising capital in public offers.

While the domestic equity and fixed income markets do not play an important role yet, it is worth mentioning that Belarus has a thriving commodities exchange. The Belarusian Universal Commodity Exchange (BUCE) is one of the largest commodity exchanges in Eastern Europe and had 8754 participants from 54 countries at the end of June 2011. The volume of exchange transactions in 2010 was EUR 872 m, a number that grew further during the first half of 2011. At the commodity exchange, trade is concentrated in metal products, timber, agricultural products as well as industrial and consumer goods (incl. a wide range of products from food to high-tech goods). In addition to that, the exchange is working actively on the development of a market for certain commodity futures. It seems that Belarus is well positioned to expand in this area, given its economic structure and the success in the underlying spot markets. There may be a good chance to attract business from other countries, which are less advanced in this respect.

Ad iii.) Other service providers related to the financial market

Due to the underdeveloped nature of the financial markets, the number of service providers active in Belarus is also rather low by international standards. In the future, it will be very important to increase the number of specialists which provide supporting services to the sector (lawyers, accountants, consultants). Since the aim to become RFC implies a significant amount of cross-border transactions, such specialists should also come increasingly from abroad, at least until a qualified domestic support base is established.

Conclusion 9: Non-bank financial institutions are currently underdeveloped in Belarus, and are in clear need for a development boost. This implies in all relevant segments (insurance companies, capital markets as well as service providers) an increase in private sector participation.

4.4. Legal environment

While it is impossible to give a detailed overview of the legal environment, some particular points with relevance for the financial sector can be made. This can be exemplified by means of the "legal rights index" that the World Bank uses in its well-known "Doing Business" index in order to assess the degree to which collateral and bankruptcy laws protect the rights of lenders and borrowers[9]. Strong collateral rules facilitate the access to finance for borrowers, while strong creditors rights help to expand lending and decrease interest rates for good borrowers. On a scale of 0 (low rights) until 10 (maximum rights), Belarus ranks 3 in the latest report (2011), up from 2 over the last years. This is on the same level as Russia, but far below Georgia (7) or Moldova (8). Internationally, the international financial centre in Singapore ranks a maximum 10.

A related aspect deals with efficient contract enforcement. In such cases, banks and other intermediaries are more willing to engage with clients if they can trust the judicial system in resolving disputes quickly. Here, Belarus is ranked 12 in the latest "Doing Business" report 2011 worldwide, which is a very good result.

As was already mentioned in above, despite some progress over the years, there still exist certain shortcomings in the regulatory and supervisory framework. This is particularly relevant for non-

[8] ibid.

[9] World Bank: "Doing Business 2011".

bank financial institutions, e.g. insurance companies and capital markets. Here it is important to ensure full independence of the supervisor and to establish a regulatory framework that allows the further development of the sector.

Conclusion 10: While some small progress has been made in terms of strengthening the rights of lenders and borrowers, there is still a long way to go. Contrary to that, efficient contract enforcement is in place in Belarus. Furthermore, some progress in the regulatory and supervisory framework has been achieved, however, further steps, especially regarding the independence of the supervisory agencies need to follow.

4.5. Technical infrastructure

Considered to be the "scientific powerhouse" of the former Soviet Union, Belarus has an important asset in its quickly developing IT-sector, as the availability of a highly skilled workforce is given. Information and telecommunication infrastructure is developing in Belarus, but needs to be sped up for meeting the requirements of a modern regional financial centre.

Belarus and its capital Minsk have also a relatively well-functioning transport infrastructure. In some areas, e.g. regarding the airport, there is still a lot of work ahead. This relates to physical infrastructure development, in order to increase capacity, but also in terms of connections with other financial centres abroad.

Conclusion 11: The technical infrastructure necessary for a financial centre is basically in place, but needs to be enhanced and improved in certain areas.

4.6. Soft factors

As written in chapter 3.6, soft factors are difficult to define, but decide often over the success (or failure) of a financial centre. While Minsk scores well in a number of respective factors, e.g. regarding quality of life, cultural facilities, etc. it seems that these advantages go internationally largely unnoticed. A relevant point here might be also certain bureaucratic and financial hurdles connected to the required visa[10]. An important goal of the authorities must be to abolish these hurdles and to increase the visibility of the advantages to a wider audience.

Conclusion 12: While Minsk has a number of positive soft factors to its advantage, the authorities need to communicate this more strongly to a wider international audience.

5. A roadmap towards the establishment of a RFC

A comparison of the necessary requirements for establishing a RFC (chapter 3) and their current status quo in Belarus (chapter 4) revealed a number of areas where concrete measures should be taken. Our roadmap towards the establishment of a RFC in Minsk summarises our policy recommendations in the following three areas: Macroeconomic environment, banking sector, and non-bank financial institutions. While further requirements mentioned in the previous chapters are also important, and respective reforms should not be delayed, we recommend focusing the attention of the authorities on above mentioned areas in the near term. The largely interdependent character of the reform areas explained below should be also noted.

5.1. Macroeconomic environment

Growing macroeconomic imbalances in Belarus make a swift and comprehensive anti-crisis response indispensible. This would help to make the economic model of the country– which came

[10] Neighbouring Ukraine abolished the required visa for a number of countries in 2005 and recorded a steady inflow of foreigners as a result. Further relief in terms of bureaucratic hurdles (abolishment of immigration cards) were conducted in 2010.

under pressure recently – more sustainable. The focus has to be put on macroeconomic stabilisation, as only a stable macroeconomic environment –coupled with structural reforms and liberalization efforts– can lay the foundations for long-term financial sector and economic development.

In the current situation, where external financing gaps are unsustainably large, a policy mix of adjustment and financing is needed. This implies a tightening of monetary/credit and fiscal policy, and thus a renunciation of the expansionary policies that have to be blamed for causing the crisis. While the authorities were relatively quick in announcing and implementing a number of monetary and fiscal policy measures, there is still the need for a comprehensive and credible anti-crisis strategy, including the attraction of sufficient external loans and other balance-of-payments financing (via FDI-attraction/privatisation) which could help to stabilise the situation.

Regarding the FX market, whose uninterrupted functioning is a basic requirement in any RFC, some further urgent steps are necessary. We suggest unifying the currently dysfunctional cash and interbank market and letting the exchange rate set by market supply and demand. A flexible exchange rate system, in which the National Bank intervenes only to prevent excessive fluctuations, and which is supported by an "inflation targeting" policy framework is in our opinion the only credible alternative to shield the economy against external shocks.

Recommendation 1: Achieving rapid macroeconomic stabilisation is the main challenge in the short term. Authorities must tighten monetary/credit and fiscal policy further and need to attract external finance to make the adjustment process credible. Making the currently dysfunctional FX market work is a further top priority. This includes a gradual shift towards more exchange rate flexibility, and letting the exchange rate to be determined by market supply and demand.

5.2. Banking sector

The macroeconomic environment defines the operating framework for the banking system to a large extent. This implies that these reform areas are intrinsically linked and should not be seen as being independent of each other. As seen during the global crisis throughout the region, achieving macroeconomic stability has also a positive impact on financial and banking sector stability, especially in dollarised economies like Belarus. At the same time, the crisis reminded policymakers on the high risks connected with dollarisation, as borrowers turned out to be very vulnerable towards movements in the local currency.

Two structural features of the banking system in Belarus stand out in terms of urgent need for reforms. These concern the ownership structure and the wide-spread practice of government-directed lending.

Regarding the first issue, ownership, it was mentioned that the system is strongly dominated by the state, while private (and foreign) owners play only secondary roles. In order to create a competitive environment and to improve risk management and corporate governance, we support the authorities to renew their efforts in privatising state-owned banks. Here, it is of paramount importance to attract also foreign direct investment, preferably from a diversified geographical background.

The second feature, directed lending, is a rather unique instrument in international comparison, as the banking system in Belarus is used by the state as a quasi-fiscal instrument to implement public policy goals. This poses a number of microeconomic and macroeconomic threats as a consequence. Here again, it is crucial that state as well as private banks make lending decisions based on commercial considerations, rather than on political decisions. In this respect, the current plans of transferring lending under government programs to a newly created institution ("Development Bank") would be a major step in reducing government interference as well as freeing the National Bank from delivering non-market-conforming support to banks participating in such programs. However, this implies that the new institution should be the only provider of such lending, which should be also accounted for in the fiscal accounts in a transparent manner.

Recommendation 2: Far-reaching structural reforms are necessary to improve the (micro)economic efficiency of the banking sector. This implies less state, and more private ownership (incl. FDI) as well as limiting directed lending. In case the new Development Bank takes over existing and new lending programmes in a transparent manner, this can be considered a major step forward.

5.3. Non-bank financial institutions

While financial intermediation is currently predominantly bank-based in Belarus, the accelerated development of non-bank financial institutions would be beneficial for both suppliers (i.e. households) and users (i.e. corporates and the government) of financial funds.

Regarding the fundamental building blocks of capital markets, a better developed equity securities market in form of a functioning stock exchange can support long-term economic growth by allowing companies to raise the necessary funds for their investment projects directly from shareholders. Here, the issue of interdependence between the different reform areas becomes once more obvious: The much needed progress in privatisation mentioned above could also increase the supply of shares and facilitate the development of stock trading.

Equity markets should be further complemented by deep and liquid bond markets. Here, it is important that the government develops the market by regularly issuing bonds and establishing a reliable benchmark yield curve in this process. The existence of a liquid government bond market can be used in a second stage by corporates willing to issue corporate bonds, as this provides an important pricing benchmark. In this process, both companies and the government can attract funds in the local market and in local currency, making them less dependent on the observable swings in external markets.

Recommendation 3: Creating a level playing field and fostering competition among non-bank financial institutions would increase financial deepening and help to improve the allocation of resources in the economy. Developing deep domestic securities and bond markets is a crucial task in this respect.