The Transition Journey and The Road Ahead

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The Caucasus and Central Asia: From Transition to Emerging Markets

First I would like to thank IMF, EBRD, Kyrgyz and Swiss Authorities for organizing this conference.

Thank you Mr. Kähkönen for your excellent presentation. As we have seen growth in CCA region was strong since 1996's, but there was important base effect as in many countries GDP has declined after the transition process has started. On the example of Georgia, per capita GDP on the PPP terms are about the same what we had in 1989. Even if adjust data, based on our estimation that GDP data was somehow overestimated in 1989, we still get 30 higher GDP compared to 1989, while world GDP grew by 120% on average during the same period.

Transition period clearly was painful in terms of economic growth, in a first five years we lost 60% of our GDP.

We did lots of so called first generation or first stage reforms. As assessed by World Economic Forum, some of CCA countries are recognized as „efficiency driven" economies, but some are still at the first stage so called "factor driven" economies.

Looking back we see some success and some lost opportunities, but as this conference is not only on previous experience but also road ahead I would like to comment on challenges we currently face.

We see an unconventional monetary policy measures, have increased FX capital inflows to EM's; including transition countries. Previously it was predominantly FDI, but recently portfolio and other short term flows have also emerged.

We have ample liquidity in the world and same time, In Georgia as in other emerging countries we have higher interest rates than in developed countries, liberalized capital account and low domestic savings. Thus, there is a potentially Large FX inflows coming to the country.

Question is how to protect from volatile capital flows and same time keep high investment and therefore high Growth rates?

Exchange rate appreciation will limit the growth, reserves accumulation can be costly especially if you already have sufficient amount, fiscal tightening, prudential and capital controls can have impact but up to a limit.

One of the possibility transition countries have is a development of LC markets that will increase domestic savings and/or FX flows will be converted into LC funds, thus country will have less currency mismatch risk. So inflows if channeled to long term papers will have less adverse impact and will help investments to grow as well.

So now is a very good time for development of LC markets.

Development is a risky business, it's costly and it's a long term. Thus there is a role of IFI's to help and guide countries in this process. In case of Georgia EBRD has taken a leadership in LC capital market development which is very welcome and timely decision.

Capital market development needs sequenced approach. First money and FX markets should be developed, then Government T-bills, then Government Bonds, then Corporate Bond market and then equity and derivatives.

In Georgia money, FX and government papers have somehow liquid markets, now we are working with IFI's so they will issue corporate bonds on domestic markets and then banks or large corporates can issue a LC bonds as well.

Our experience verifies well known fact that monetary policy is more efficient, when Central Bank steers short term interest rates by supplying liquidity and not by withdrawal. In case of transition countries were privatization revenues are large, most likely you can have structural liquidity surplus. One can have liquidity supply operations and structural excess liquidity. In Georgia we withdraw 3 and 6 month liquidity and lend short term. I should mention that at the beginning we tried to develop short term money markets by withdrawing liquidity but it does not worked.

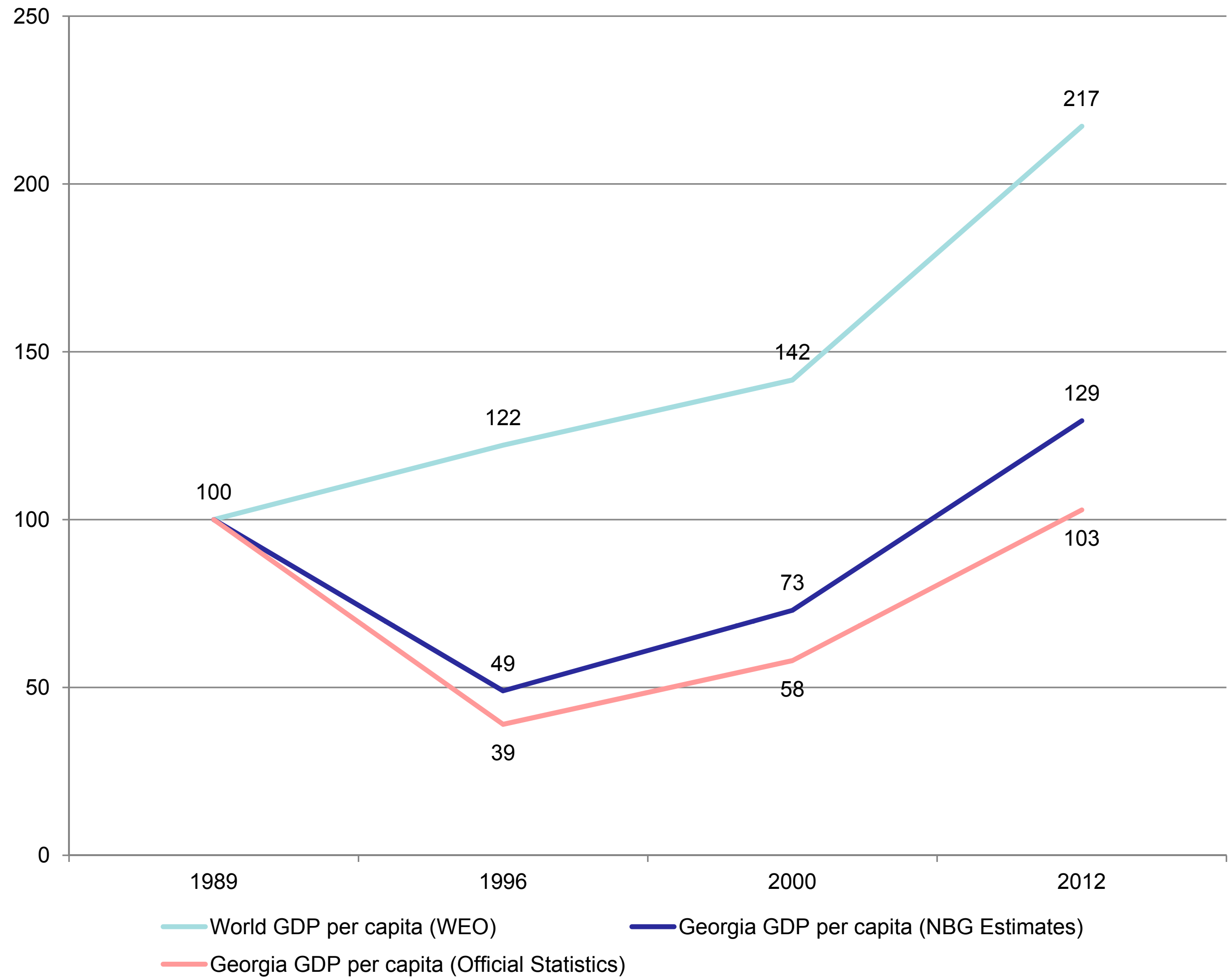
We used to limit short term fluctuations of the FX rate that was not the right policy, but exiting from heavy managed exchange rate regime is always hard and risky. After the financial crises, after we lost half of our reserves there was a lower downside risk so we switched from price based interventions to volume based interventions, with the policy of having as small number of intervention as possible. Initially there were some high volatility but later, as speculative pressures have been removed FX became stable without frequent interventions.

Removing short term expectation for FX appreciate or depreciate has enabled Government to issue longer term T-bill and Government Bonds with lower interest rates. Currently Government of Georgia has 10 year papers, with the interest rates slightly above 10 percent.

Other reforms include improving legal environment, IT infrastructure that made transaction risk virtually zero, etc.

Now we are working to develop liquid corporate bond markets which will be major step toward LC development goals.

GDP Per Capita Dynamics (1989=100)



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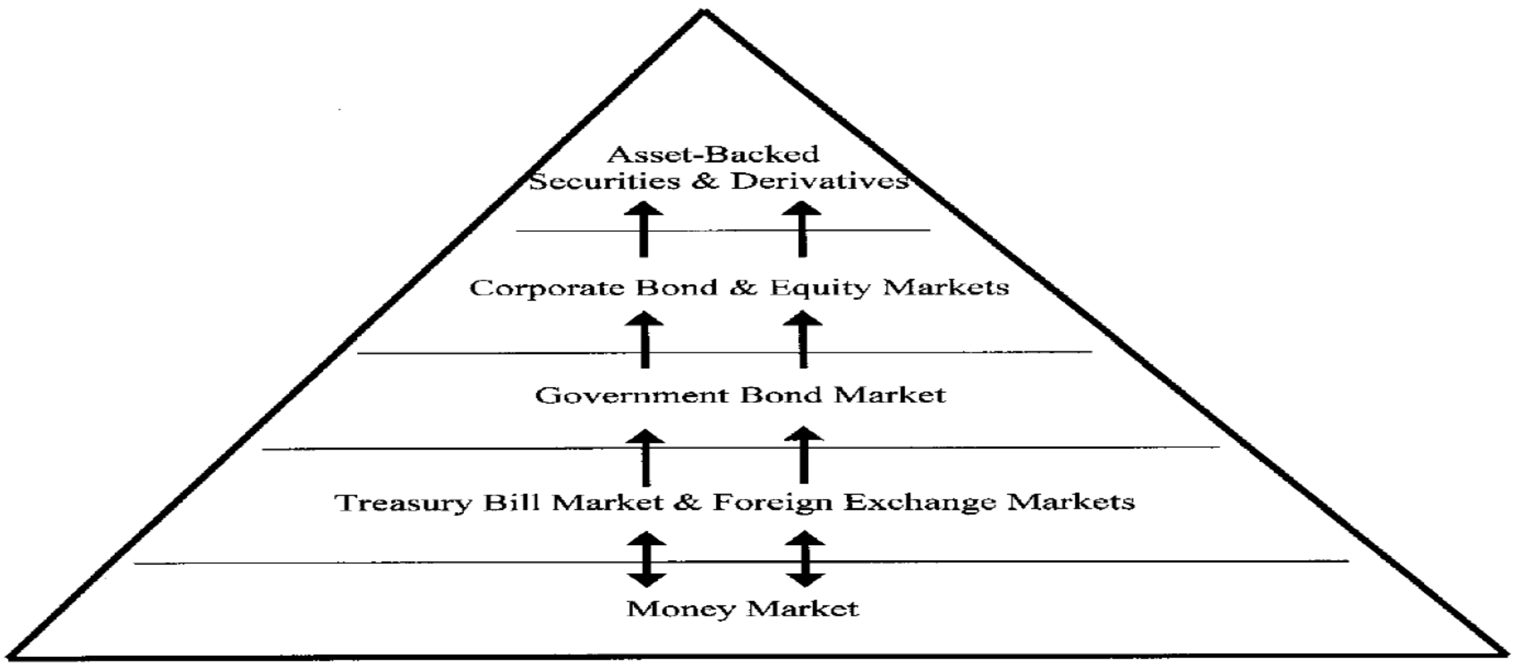
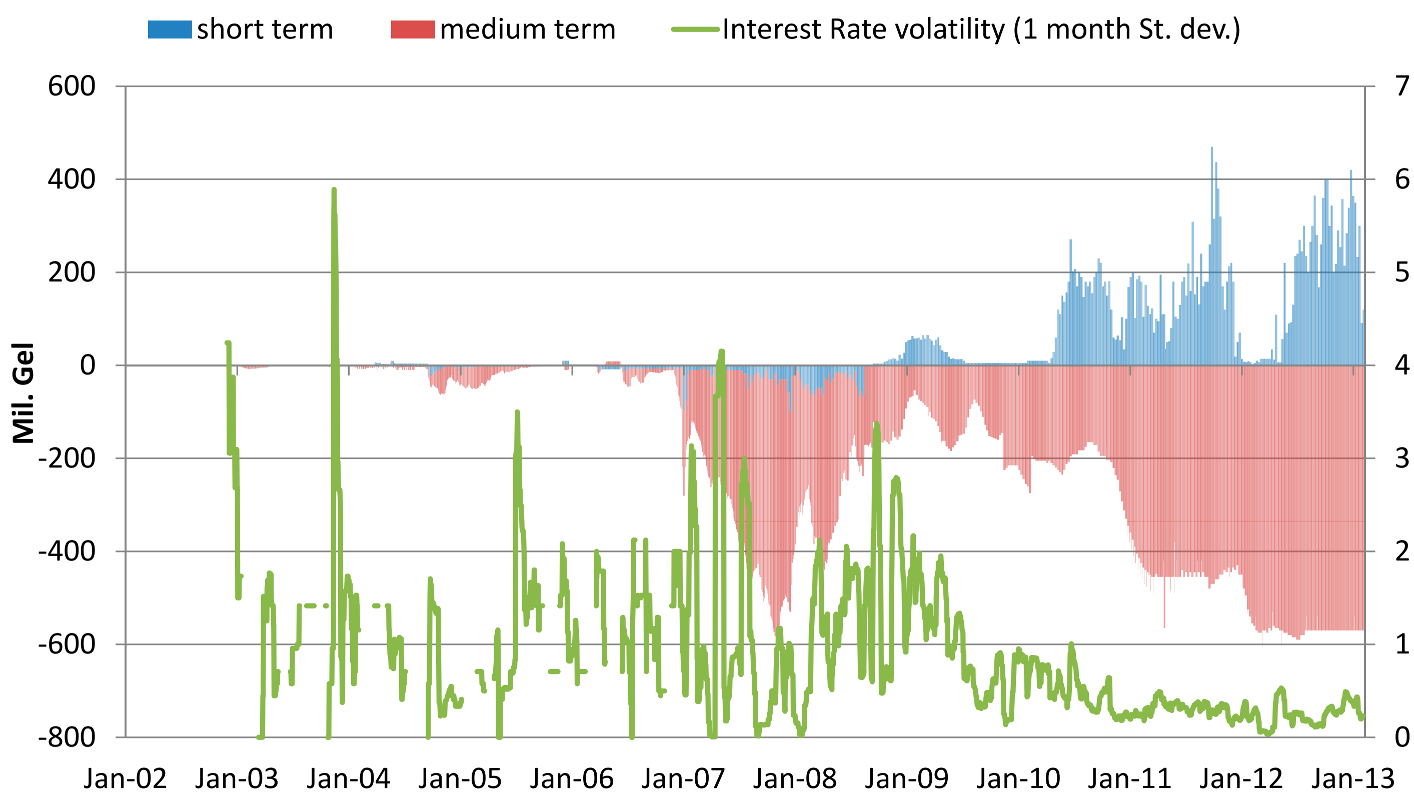
Development of LC capital markets



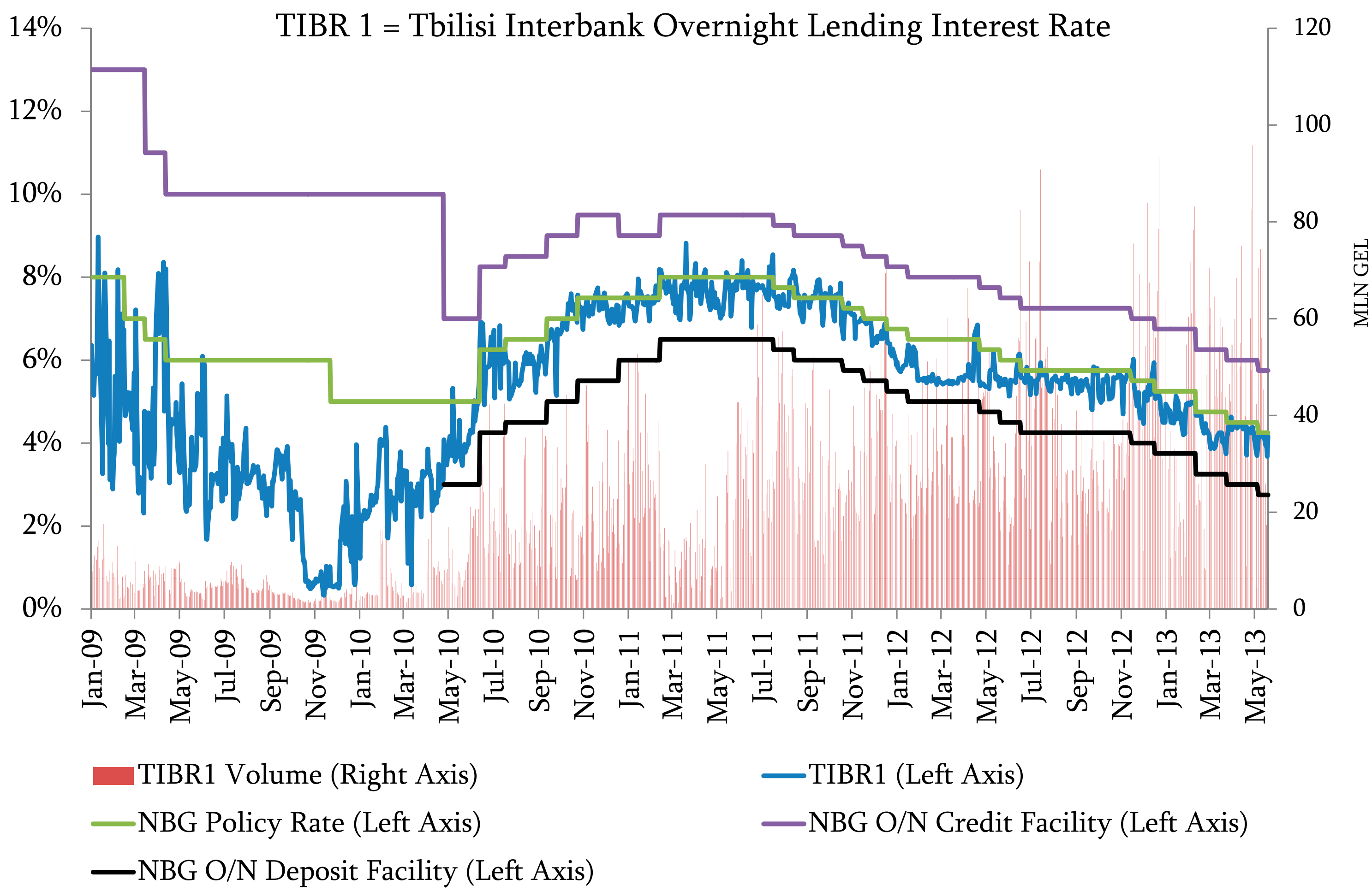
Source: Karacadag, Cem ; Sundararajan, V. ; Elliott, Jennifer A. Managing Risks in Financial Market Development: The Role of Sequencing Working Paper No. 03/116.

Money Markets



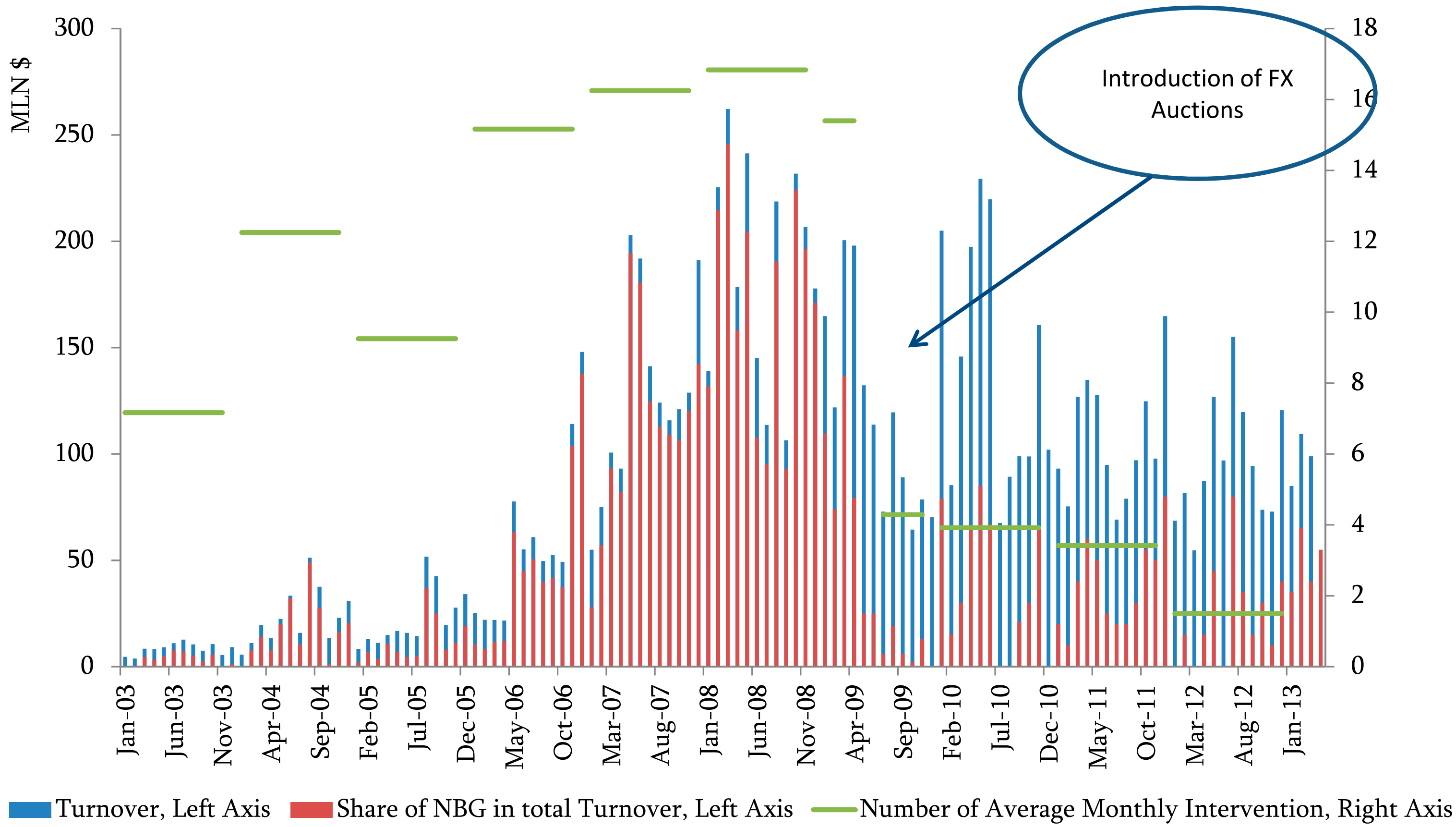
Source: National Bank of Georgia

Interbank O/N Money Market



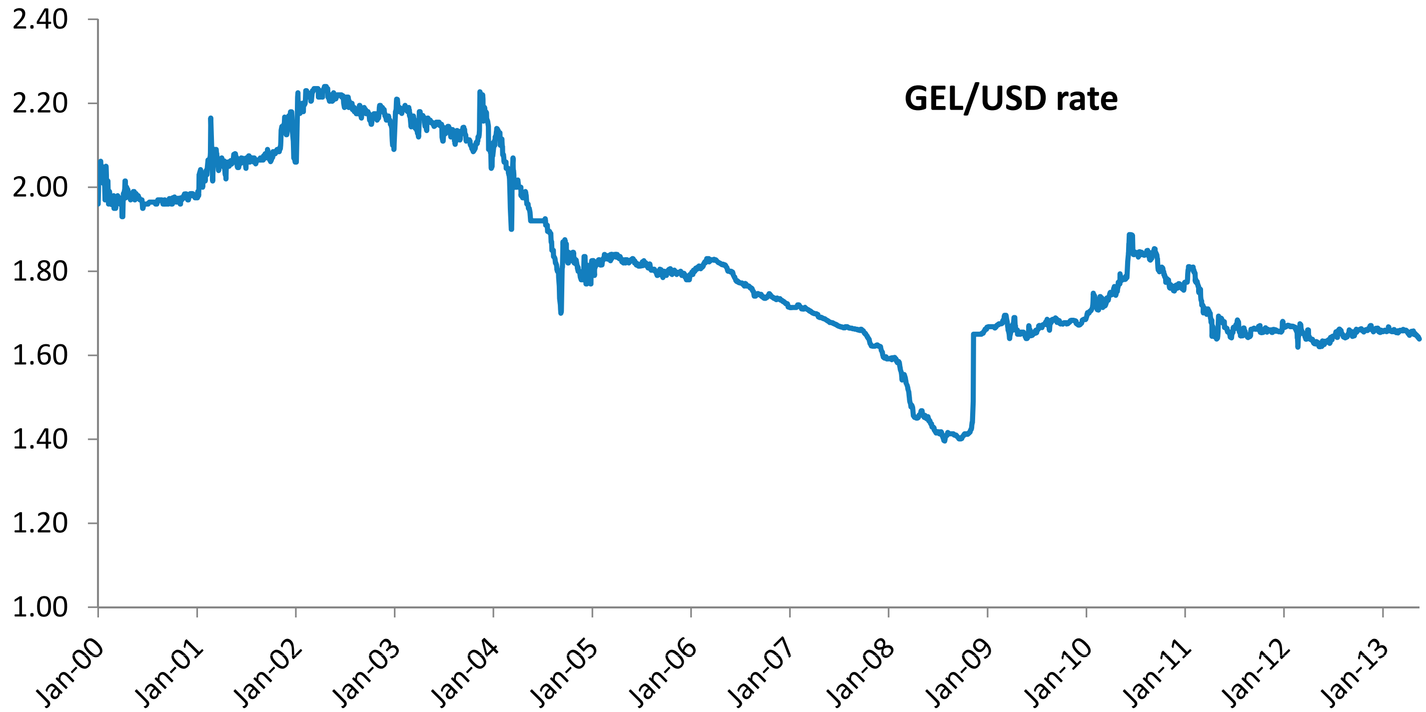
Source: National Bank of Georgia

FX interbank market Turnover



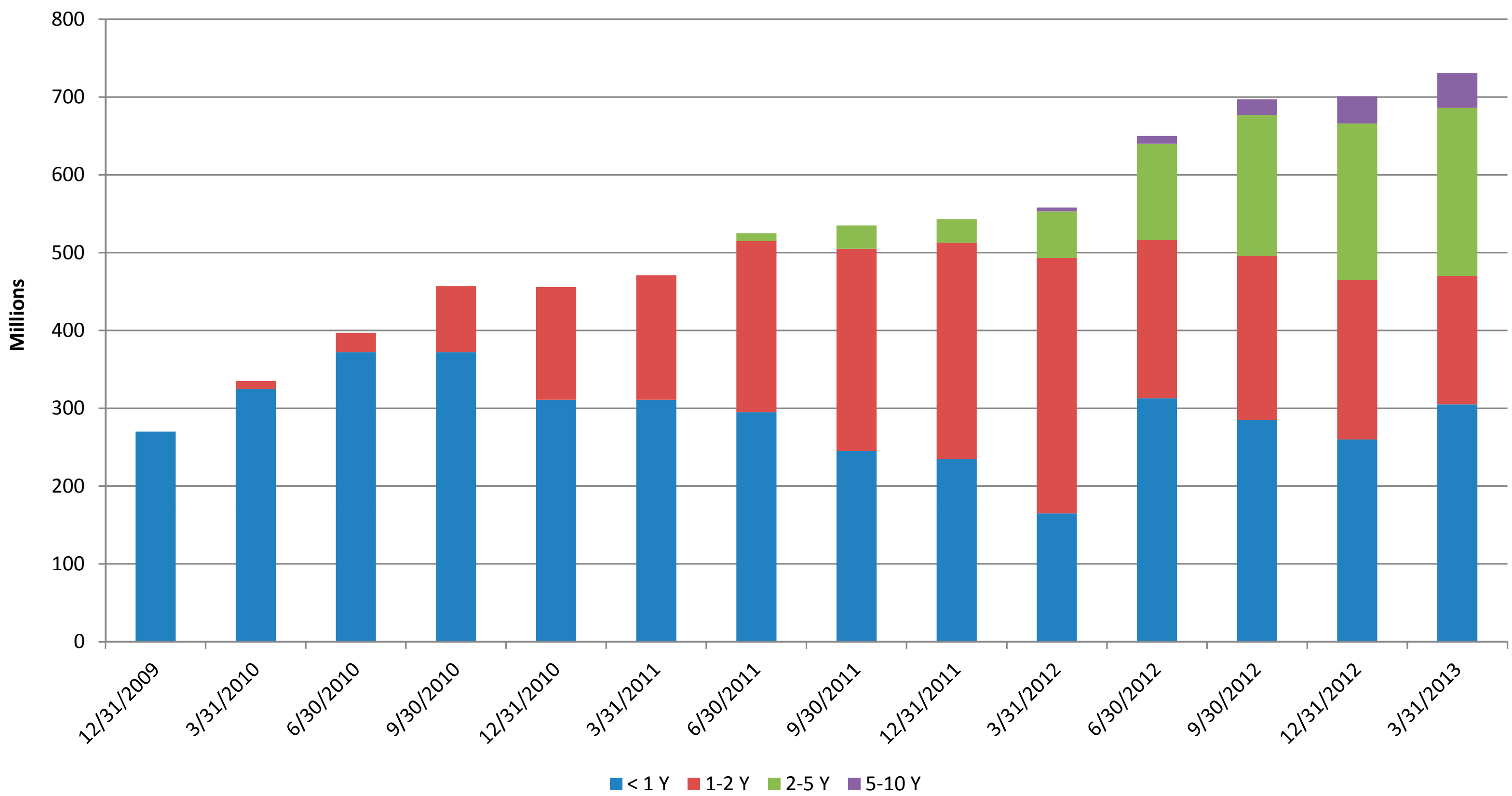
Source: National Bank of Georgia

FX market

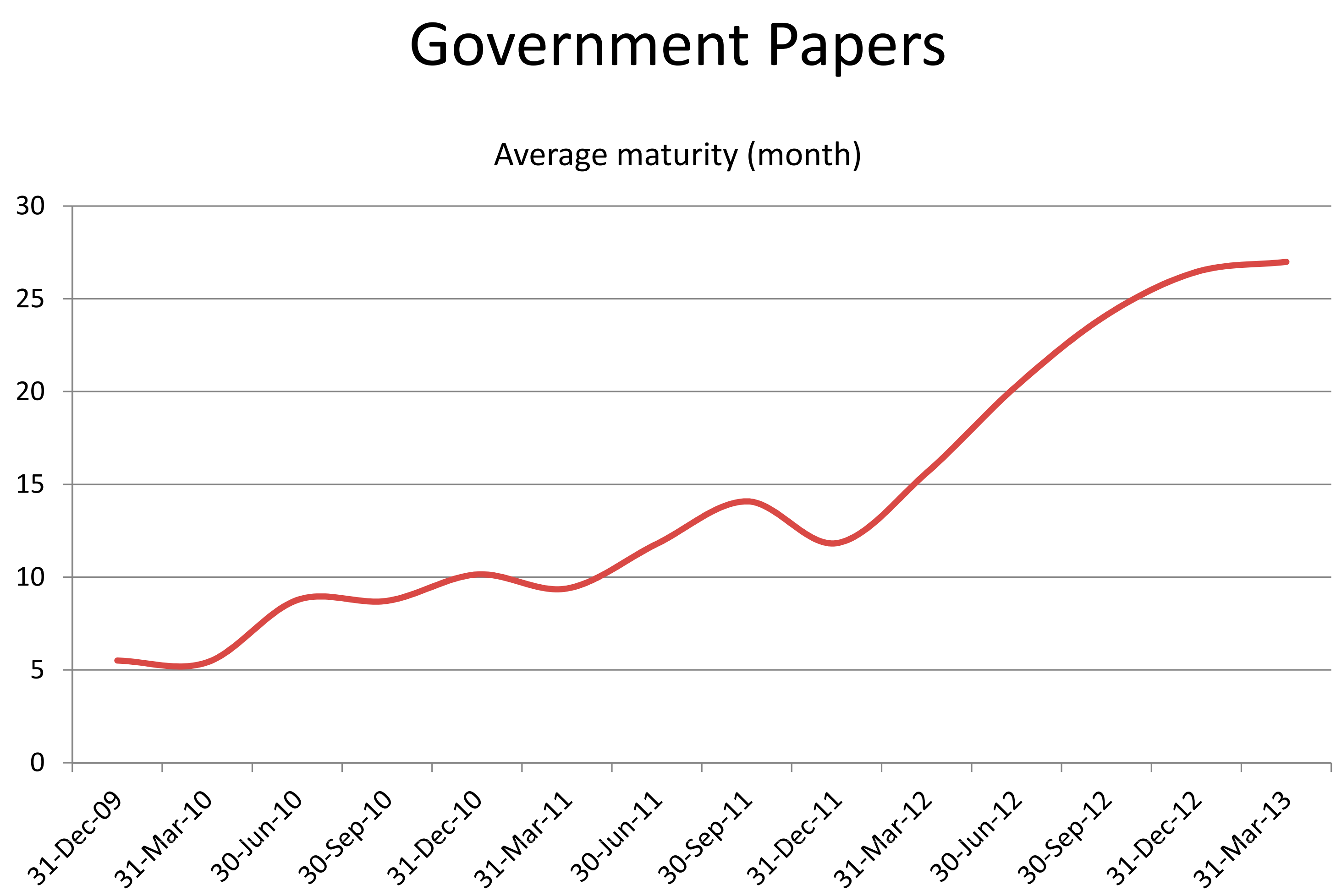


Source: National Bank of Georgia

Government Papers in circulation by remaining maturities

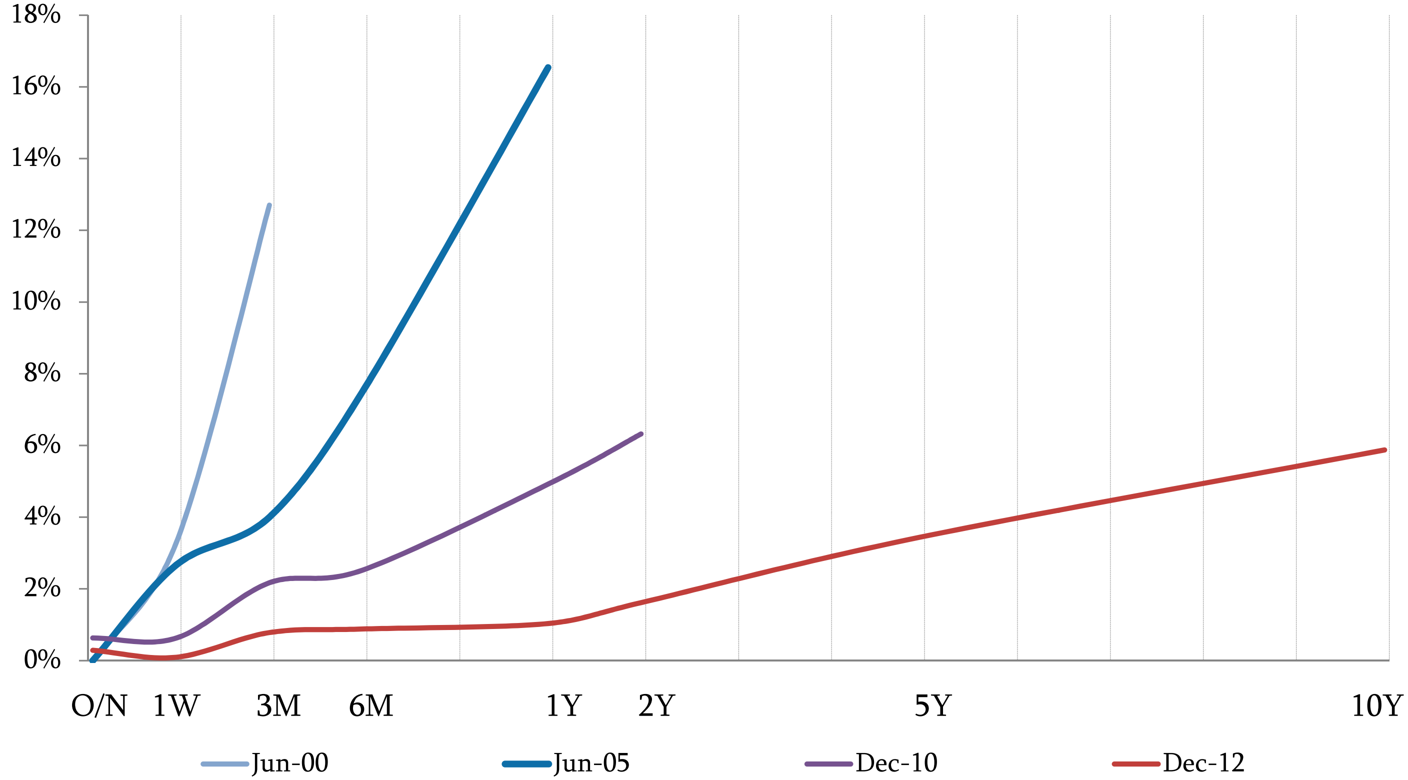


Source: National Bank of Georgia



Source: National Bank of Georgia

Primary market yield spread to policy rate



Source: National Bank of Georgia

Development of LC capital markets

- Next step – Development of a Corporate Bond markets
- Plan is: IFI’s will issue LC Bonds, then banks and then large corporates;

- Then development of equity markets . . .

Thank you