CAREC

Central Asia Regional Economic Cooperation Program

**CAREC Economic and Financial Stability Cluster**

2022 CAREC Economic and Financial Stability Cluster High Level Policy Dialogue
**Dealing with Risks and Vulnerabilities: Tightening Global Financial Conditions Amid Post Pandemic Recovery and Geopolitical Conflict**
4 October 2022, 7-9 PM (GMT+8) • Virtual

The Central Asia Regional Economic Cooperation (CAREC) Economic and Financial Stability Cluster High-Level Policy Dialogue was designed to connect senior officials from central banks, financial regulatory authorities, senior official from finance ministers of CAREC countries, representatives from Asian Development Bank (ADB), International Monetary Fund, the World Bank and the CAREC institute discuss the rising risks and financial system vulnerabilities of CAREC countries amid tightening global financial conditions, post pandemic recovery and geopolitical conflict.

**Key Takeaways**

- The financial sector of CAREC region is facing formidable challenges emanating from high global inflation, faster than expected monetary tightening in advanced economies, weaker global economic prospects, heightened regional uncertainty associated with geopolitical developments, and elevated climate risks.

- Full and partial implementation of Basel III which capitalizes on the lessons learned from the previous financial crisis, especially the 2008 global financial crisis, have proven to be effective in maintaining financial stability in most CAREC countries.

- Support from international financial institutions is imperative to enhance the capacity of the central banks and financial supervision institutions to address potential bank resolution and financial crisis. This entails deposit insurances, resolution framework, legal framework, and insolvency mechanism.

- International experience advocates that dollarization can only be tackled through market friendly measures, forced measure are often counterproductive and result in disintermediation of financial sector. Prudential measures such high reserve requirement for foreign currency deposits and digitizing payment system were effective in decreasing dollarization in Georgia.

- Elevated climate risks require focused attention from the relevant stakeholders at international and domestic level as  it impacts the broader financial sector’s resilience through amplifying credit, liquidity, and counterparty related risks.

- Regional financial cooperation is critical to enhance  the prospects of financial stability and to mitigate financial risk and vulnerabilities. CAREC member countries agreed on the need and desirability of initiatives such as a mechanism for regional financial surveillance, enhanced technical and economic cooperation to strengthen domestic and regional financial systems and regulatory capacities.

**Next steps**

- Eroded policy buffers have made the policy tradeoff more difficult. To strengthen macroeconomic stability and resilience to shocks, CAREC member countries need to rebuild the buffers that served them well during pandemic. This needs to be done in a manner that does not derail the economic recovery.

- Diversification of the financial systems of the CAREC countries is important as it allows the financial institutions to expand beyond their traditional business boundaries while reducing risk.

- CAREC member countries must embark on structural reforms to mitigate short-term and medium-term challenges.

**Opening, Welcome, and Keynote Speeches**
*Moderator: Ms. Lyaziza Sabyrova, ADB*

**Georgia:** Mr. Koba Gvenetadze, Governor, National Bank of Georgia, opened the forum by providing a comprehensive background on the continuing effects of the pandemic and recent geopolitical tension that hobbled countries around the globe. He emphasized that inflation is the biggest global challenge and central banks are expected to ensure price stability while not derailing economic recovery. Governor highlighted that the financial risks against the backdrop of the global pandemic has increased due to Russian- Ukraine war, and financial systems of emerging economies with structural challenges, such as current account deficits, significant dependence on international financial flow, dollarization and high level of debt are at greater risk. He added that faster than expected monetary policy tightening in advanced economies may weaken the balance of payments accounts of most emerging economies in the medium term which will lead to currency depreciation and threatening the asset quality and financial stability in these countries. He acknowledged the timeliness of this event and saw this event as an excellent opportunity to learn from the experiences of CAREC member countries.

**ADB:** Mr. Eugenue Zhukov, Director General of Central and West Asia Department, delivered welcome remarks. He highlighted that world economy is again in crisis, in just over a little more than two years after the serial shocks of the COVID-19 outbreak triggered global recession. Global inflationary pressures have intensified, and in response the central banks have tightened their monetary policy. These global developments threaten to undermine financial sector stability in CAREC countries. Those with strong economic and trade ties with Russia are particularly vulnerable, as are CAREC members that face the highest rates of inflation and private and public sector foreign currency debt. All this adds to the strains created by the pandemic and comes amid a yet unfinished recovery. He concluded his remarks with a caveat that remediating the risks to the region's financial stability will be a complex task. He stressed that government institutions, financial sector regulators, and the private sector must work closely together to fully understand the dynamics underlying these risks so that the CAREC members can carefully design and calibrate an effective monetary, fiscal, and financial policy response.

**IMF:** Mr. Subir Lall, Deputy Director, Middle East and Central Asian Department made the keynote presentation. He presented the outlook for the CAREC region, which is shaped by two major factors, namely, heightened regional uncertainty associated to geopolitical developments and by synchronized monetary tightening across the globe to deal with challenge of high inflation. CAREC regions exhibited strong post pandemic recovery on the back of strong domestic demand and buoyant remittances. The strong covid responses, however, eroded macroeconomic buffers that many countries had built before the pandemic. Fiscal deficits widened and public debts reached historic peaks.

CAREC countries have strong economic ties with Russia and to a lesser extent with Ukraine. They are exposed to multiple spillover channels, including trade, remittance flow, tourism, supply chain disruption, higher food and energy prices, weaker global demand, and aid diversion. CAREC oil exporters benefited from high energy prices but are still facing significant risk if, for example, sanctions are extended to transport sector infrastructure and pipelines connecting with the rest the world going through Russia. However, the adverse impact of the geopolitical conflict on the region thus far has been contained. Exports increased considerably and most currencies recovered after the initial sharp depreciation in tandem with ruble. Russian resilience to sanctions, relocation of Russian firms to CAREC countries, high energy prices and robust payment systems muted the negative spillover of the geopolitical tension. As a result, CAREC region grew stronger than anticipated even before war in the first half of 2022. Accordingly, IMF is revising their forecasts upward for the region in their flagship publication, World Economic Outlook.

Inflation continued to rise to double digits, partly due to persistent increases in food and energy prices, and demand pressures have also increased as wages grew in real term. In response, central banks in the CAREC region have embarked on a tightening cycle by raising their policy rates aggressively in some cases. Global food inflation is projected to increase by 14% in 2022, adversely affecting the food security in low-income countries.

The downside risks to the outlook are the global slowdown, spillovers from geopolitical tension, high inflation and tightening global monetary and financial conditions. Further, high uncertainty and the slowdown on the economy of the People Republic of China will weigh down on trade and investment. The rapid tightening of global monetary conditions reflects increased risk aversion, leading to lower equity prices, widening sovereign bond spreads and increased portfolio outflows from emerging markets. The adverse effects of sanctions on the Russian economy are expected to be vivid in the coming quarters, with the Russian economy expected to contract, which will in turn reduce the flow of remittance to CAREC countries. This could hurt the poor who often rely on remittances for subsistence. As a result, poverty and food security could rise.

He added that eroded policy buffers have made the policy tradeoff even more difficult. To strengthen macro stability and resilience to shocks, CAREC countries need to rebuild the buffers that served them well during pandemic. This needs to be done in a manner that does not derail economic recovery. Policy responses must be tailored to country specific situations, and monetary policy in most countries should seek bring the domestic demand down without jeopardizing the financial stability. Fiscal consolidation should be a priority for countries with elevated level of sovereign debt which may entail cuts in low priority expenditures and subsidies.

He stressed that IMF remains fully committed to support the CAREC countries through financing, policy advisory services and capacity development in addition to their standard toolkit which has been enhance and adapted to the new realities during the pandemic. IMF has established Resilience and Sustainability Trust (RST), which helps low income and vulnerable middle-income economies build resilience to external shocks and ensure sustainable growth. Countries can channel their unused Special Drawing Right (SDR) to low-income countries.

**Panel Discussion:**

*Moderator: Mr. Junkyu Lee, Chief of Finance Sector Group, Climate Change Department, ADB*

*What are the specific challenges to financial stability facing your country amid post pandemic recovery, deteriorating global and regional financial condition and geopolitical tension and allude on your policy responses?*

**Azerbaijan:** Mr. Rustam Tahirov, Director of Financial Stability Department, Central Bank of Azerbaijan, stated that despite emerging challenges the country's economy showed robust recovery after pandemic. Currently the economy is growing over 6%, however, heightened geopolitical tensions and high inflation are key risks to financial stability. Price accelerated to 13% in August 2022, driven by high food prices. On the positive side Azerbaijan's nominal effective exchange rate (NEER) has appreciated over 6% this year which helped contain inflation given the high pass-through effect of exchange rate into inflation. Further, high energy prices and growth opportunities for gas exports had a positive impact on balance of payments. He highlighted that despite the close economic ties with Russia and Ukraine, the impact of geopolitical tension had limited effects on financial stability in Azerbaijan, mainly because Azerbaijan's banks had limited exposure to sanctioned Russian banks.

**Georgia:** Mr. Koba Gvenetadze, Governor, National Bank of Georgia, alluded that financial stability risks in Georgia stems from external sector. He emphasized that implementation of Basel III which capitalizes on the lessons learned from the global financial crisis in 2008 helped Georgia massively in maintain financial stability. Georgia also benefitted from the IMF support program; Georgia was the first country to receive IMF's support during pandemics. The National Bank of Georgia already introduced system buffers, liquidity, and net stable funding ratios, and introduced regulation that aimed at reducing the indebtedness of borrower prior to global pandemic. These measures proved to be extremely helpful in maintaining financial stability during pandemic and in the current challenging times. Financial soundness indicators are improving, non-performing loan (NPLs) are low. This year the economic is expected to grow by 9%. However, inflation remains the biggest concern of the Bank, , peak inflation was at 15.5% now it is around 11%. Briefly the approach adopted by central bank of Georgia was *"to fix the room while the sun was shining."*

**Mongolia:** Mr. Enkhtaivan Ganbold, Deputy Governor, Central Bank of Mongolia, shed light on post pandemic recovery and current economic and financial challenges in Mongolia. Being a landlocked country with two large neighbors, the inflation pressures are magnified and reflected in the price of imported commodities, especially oil and food. He highlighted that high import bill has widened Mongolia's balance of payment deficit, which widened substantially to 1.3 billion USD in the first seven month of current year. Inflation was around 14.4% in August 2022, with imported inflation being the biggest contributor. In response to high inflation, central bank of Mongolia increased the policy rate by 600 basis point since beginning of this year to 12%. The inflationary pressures remain high in the short run, however in the medium-term inflation is expected to decrease to targeted level (6%) due to slower economic growth and tight monetary policy. He emphasized that due to mounting instability, calls for adjustment in macroeconomic policies, tighter monetary and fiscal policy with greater exchange rate flexibility is essential to ensure external and domestic stability.

**Pakistan:** Mr. Muhammad Javaid Ismail, Director, Financial Stability Department, State Bank of Pakistan, underscored three leading developments underpinning macroeconomic and financial vulnerabilities (i) surge in global inflation (ii) heightened uncertainty (iii) rapid monetary policy tightening. He stressed that geopolitical tensions are the primary root cause of the global economic and financial stress. Pakistan economy performed relatively well during global pandemic, but it is now facing growing macroeconomic challenges emanating from high inflation and widening current account deficit (2.6% of GDP) and exchange rate depreciation. These, combined with policy uncertainties resulted in volatilities in equity and foreign exchange market. He stressed that the catastrophic flooding has compounded the economic challenges, incurring as estimated damage of 30 billion USD to the economy. Risk to domestic financial stability has increased amid tighter global financial conditions, limited access to international market and capital outflows. Consequently, imports are becoming increasingly expensive, Pakistan rupee has weakened as well as the debt servicing capacity.

Banking sector in Pakistan has adequate capital cushions and resilience to withstand the impact the macroeconomic condition. The Central Bank of Pakistan is working closely with commercial banks to enhance banking sector resilience and crisis management framework. In addition, the Bank has increased the policy rate to 15% and cash reserve requirement by 100 basis point to 6%.

**Turkmenistan:** Ms. Jamilya Yusupova, Head, World Economy Division, Macroeconomic Analysis and Monetary Policy Department, Central Bank of the Republic of Turkmenistan, stated that the Turkmenistan's banking system in 2022 is relatively stable, due to some factors, including limited restriction measures  during the global pandemic and the strong pre-crisis positions of the key financial indicators, which provided great opportunities for adaptive measures during the pandemic period.

Given the current global and regional instability, the Central Bank of Turkmenistan continues to implement measures to support sector, and incentivize the agricultural industry, the private sector, as well as mortgage lending to citizens. She stresses that the country ensures full and timely payment of various social benefits to the population and business entities. To increase the volume of cashless settlements and payments, various online banking products were offered.

When implementing the mandated goals of maintaining price stability, the Central Bank is guided by the principles of expanding the domestic potential of the economy by increasing the output of export-oriented and import-substituting products and services. In turn, these measures help to reduce pro-inflationary influences in terms of the food and non-food consumer basket.

Response measures launched in 2020 are still being maintained at this stage. They relate to the rights of enterprises and organizations of the country of various forms of ownership to a credit moratorium and the functioning of a temporary foreign exchange reserve fund to fulfill current obligations of residents in the country's foreign economic activity. These measures have had a positive impact on the development of the entire national economy. Financial stability of the country's banking sector is still acceptable in the context of global post-pandemic development.

Uzbekistan: Mr. Shukhrat Sharipov, Deputy-Director, Macro-Fiscal Analysis Department, Ministry of Finance, remarked that Uzbekistan enjoyed robust recovery after the global pandemic, where the economy grew by 7.2 % in 2021 and 5.4% in the first half of 2022 with inward remittance flow being equal to the same period of 2021. In April this year Uzbekistan observed an increase in remittance like other countries in the CAREC region. High global inflation and rapid increase in the interest rates in advanced economies has increased the risks to financial sector. The Central Bank of Uzbekistan is taking necessary measures to contain inflation and enhances the financial stability in the country, meanwhile Government of Uzbekistan is allocating sufficient resources to support the vulnerable and needy people.

*What specific challenges do you see in the region and what effective policy responses can CAREC countries consider?*

**World Bank:** Mr. Jean-Denis Pesme, Global Director, Finance, in Finance, Competitiveness, and Innovation (FCI) Global Practice, emphasized that the region and the world is going through very challenging times, and the lessons learned from the previous financial crisis have been incredibly helpful to absorb during pandemic. He stressed the importance of diversification in the financial sector and managing challenges through structural reforms. He has three main messages for the policy makers:

First, policy makers need to be proactive to monitor evolving risks and vulnerabilities and ensure there is transparency, not opacity. He highlighted the importance of having reliable and detailed balance sheets of the banks as it helps in understanding critical dynamics such as stress testing, and asset quality review institution by institution. This enables the policy makers to take actions when something is not going well. Currently the NPL levels are low, but private sector business pulse surveys indicate a potential problem coming at the firm and household level.

Second, policy makers must ensure that the tools to address potential bank resolution and financial crisis are in place. Some CAREC member countries need to enhance deposit insurance, resolution framework, and insolvency mechanism to treat the real economy side and make sure the tools can address corporate debt. He also underscored the importance of legal tools.

Third, policy makers should pay attention to supporting the economy, all the work around access to finance, financial inclusion should support private sector development and growth. It is equally important to make sure that the banking sector is not engaged in sovereign lending.

*How does the CAREC Institute view these rising risks and vulnerabilities to financial stability in the region and what implication should policy maker carefully consider?*

**CAREC Institute:** Mr. Syed Shakeel Shah, Director, CAREC Institute, stated that CAREC region achieved quick turn around after COVID induced shocks. In 2021-22, growth momentum was regained . All CAREC economies achieved growth since Q2 2021, except Mongolia. All CAREC economies achieved or surpassed pre-pandemic GDP level by Q2 2022, except for the Kyrgyz Republic . Growth in PRC also decelerated to 0.4 % in Q2 2022.

He highlighted those risks and vulnerabilities to financial stability stem from the geopolitical tension, disruption in global supply chain, high inflation, heightened uncertainties and worsening global economic prospects. Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Mongolia, Pakistan, and Uzbekistan all saw double-digit inflation rates since March 2022. Of particular concern is food inflation, especially for net food importing countries.

He mentioned that several CAREC economies has higher debt levels. In most CAREC economies, external debt exceeds two years of export earnings. In Pakistan, Mongolia, and Tajikistan, it is more than four years of export earnings. Prevailing high interest rates has constrained external financing.

Central Asian CAREC countries have proved to be resilient. Higher remittances, the strong ruble, and relocation of Russian firms to Central Asian countries had some stabilizing effect on the economies and financial sector of Central Asian countries. However, with the 8$^{th}$ Sanction Package of EU and G7 coming into force in December against Russia, there can be more adverse impact on Russian economy and its ripple impacts on Central Asian countries.

*What are the specific support and roles Azerbaijan expects from international financial institutions (IFIs) like World Bank and ADB in dealing with the rising risk and vulnerabilities?*

**Azerbaijan:** Mr. Rustam Tahirov, Director of Financial Stability Department, Central Bank of Azerbaijan, stated that capitalizing on the experiences of global financial crisis and regional crisis in 2015-16 allowed us to fix the vulnerabilities of financial system to a large extent and to make Azerbaijan's financial sector more resilient. He alluded that one the main pillars of the Central Bank of Azerbaijan's strategy for 2022-2026 is development and stability of the financial sector. The Bank is working closely with international financial institutions in finalization of financial safety net and implementation of Basel III. He emphasized that the NPL resolution frame is critical as it is one the leading indicator of financial stability, currently the NPL level is just over 4%. He highlighted that support from IFIs, especially Asian Development Bank, is imperative to establish a local credit rating mechanism, improve digital payment ecosystem, implementation of financial inclusion strategy, and green finance.

*For Georgia, how has relatively high dollarization of bank deposits and loans affected the financial system, and how does the central bank respond to this specific risk?*

**Georgia:** Mr. Koba Gvenetadze, Governor, National Bank of Georgia, stated that dollarization in Georgia started after the breakup of Soviet Union, and was primarily driven by hyperinflation and the US dollar was the only currency that fulfilled all the function of money. Experiences of Chile, Peru, Poland, and Israel confirm that dollarization can only be tackled through market friendly measures. Forced measures are counterproductive and often result in disintermediation of financial sector and the real sector. The Central Bank of Georgia increased reserve requirements for foreign currency denominated deposits and made advances in digitizing payment system, and these measures proved to be very effective in de-dollarizing the financial sector. As a result, credit dollarization decreased to 45% from 65% and overall dollarization went down to 35% from 60%. He stressed that de-dollarization is time consuming process, patience is needed and will rely on market driven measure to further de-dollarize our economy.

*For Mongolia, what do you think is the role of regional cooperation for Mongolia in dealing with current challenges and further development of the Mongolian economy?*

**Mongolia:** Mr. Enkhtaivan Ganbold, Deputy Governor, Central Bank of Mongolia stated that the government of Mongolia is implementing key structural reforms that aims at accelerating economic growth. Mongolia is building two new railway lines to China that will significantly increase our export volume and reduce transportation costs. The construction of the railway lines will be completed next year. In addition, Oyu Tolgoi (OT) underground copper will start sustained production in the first half of 2023, at peak production, copper exports could increase three folds. He underscored the role and support of IFIs in development, preparation, financing of large projects. He named diversification of exports, development of industry and value chain as key strategic areas for economic development in Mongolia and stressed that knowledge sharing from CAREC members would be valuable.

*How do climate and disaster risk impact financial stability in the region and how should our countries and IFIS respond effectively to these challenges?*

**Pakistan:** Mr. Jameel Ahmad, Governor, State Bank of Pakistan, highlighted the impact of recent flooding in Pakistan which has affected 33 million people in over one third of the country, with total casualties reaching1600. Dwelling, livelihood, livestock, and infrastructure have been washed away in affected areas, and the damage is estimated to be around 30 billion U.S. dollars. He believed that climate change risks require focused attention from the relevant stakeholders at international and domestic levels as it impacts the broader financial sector’s resilience through amplifying credit, liquidity, and counterparty related risks. A sustainable approach is needed to help countries and financial systems to deal with climate change risks. Banks are the main source of credit and are uniquely positioned to reallocate credit and mobilize capital away from environmentally harmful activities towards green projects and activities. International Financial Institutions (IFIs) can play an important role by developing principles, guidelines, compiling and sharing country experiences and developing banking supervisory capacity of CAREC member countries. He emphasized on three areas of potential cooperation between multilateral institutions and developing economies. First, multilateral institutions should prioritize multilateral lending for social and climate-based project. Second, developing, and emerging economies should allocate financial resources for investment in green transition, and ecosystem and ecological conservation. Third, generating electricity through renewable resources is important as well as reducing reliance on fossil fuels.

*What would be examples of innovative approaches to deal with climate related challenges and risk?*

**World Bank:** Mr. Jean-Denis Pesme, Global Director, Finance, in Finance, Competitiveness, and Innovation (FCI) Global Practice, averred that climate finance is a top priority for the World Bank, with 32 billion U.S. dollars dedicated to climate finance in bank lending over the last fiscal year. The World Bank has extensive engagement with countries on climate related issues and is not limited to mitigation of the negative impact of climate change, but also adaptation and resilience. He underscored that the World Bank has developed new diagnostic tools, such as the Climate and Development Report (CCDRs) in addition to embedding climate finance and climate issues in existing tools. A good example of this is the Financial Sector Assessment Program (FSAP) which incorporates climate risks when relevant. Furthermore, he highlighted three moves. The first is on disclosure, for example, disclosure requirements related to Environmental, Social and Governance (ESG) coordinated with the Financial Stability Board (FSB) in collaboration with International Financial Reporting Standards (IFRS) and International Sustainability Board (ISB). The plan is to adopt these new standards by early 2023. The second one is on disaster risk and disaster risk prevention, both at the sovereign firm level and household level. There is also an insurance angle, it is important to focus on readiness and mobilizing private capital through the insurance market and opportunities for innovative products. The third move on project financing, there is a need to scale and go beyond project by project to make sure there is allocation of capital for climate related factors.

*What do you think is the role of regional cooperation in dealing with the challenges and risk raised by CAREC DMCs? And how can CAREC as a platform for regional cooperation coordinate and work with other IFIs and other development partners like the CAREC Institute to support our countries on this?*

**CAREC Institute:** Mr. Syed Shakeel Shah, Director, CAREC Institute, alluded that regional cooperation can play a significant role in helping CAREC DMCs in dealing with multiple and complex challenges. Regional approaches have proved successful elsewhere in forging long term processes of reform and development. Commitment to regional actions can help CAREC DMCs in committing effort and resources in these processes. He added that initiative like regional single window of trade regulation can be a next priority for regional action. For example, a regional trading arrangement can also help improve trade diversions and investment in the region. The CAREC 2030 health strategy aims to enhance regional health security and prevention of future outbreaks like pandemic. Food security and inflation is also important since the region has net food importing and exporting countries, and a regional framework to allow trade of food group items, especially in times of crises , can help mitigate adverse impacts of the situation. Climate risks are already manifesting themselves in terms of climate-induced mega disasters. Moreover, severity and frequency of such events is also increasing. Regional cooperation for climate action can be a useful framework securing policy makers' attention, advocacy, and mobilization of resources.

**Summary and Closing Remarks:**

**ADB**: Lyaziza Sabyrova, Director, Central West Asia Regional Cooperation and Operations Coordination Division, summarized and closed the forum. She appreciated the participation and discussion on the rising risks and vulnerabilities to the financial stability in the CAREC region due to high inflation, rising interest rate and heightened uncertainties. She noted that importance of interconnectedness, role of government, and green financing and the effects of climate change on financial stability. She emphasized that changing nature of the risks and fluctuations in the financial markets and broader economy require timely monitoring of the key financial indicators and CAREC countries must actively engage in financial stability research to understand the underlying dynamics of issues related to financial stability and engage with IFIs and other members on important policy discussion.