

Capital Market Development in CESEE and the Need for Further Reform

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Domestic capital markets in Central, Eastern and Southeastern Europe (CESEE) are still less developed than capital markets in more advanced economies. Unhedged foreign currency borrowing and dependence on external funding have been among the key vulnerabilities in CESEE during the global economic crisis. Therefore, there is a need for better developed local capital markets in the region, additional sources of domestic funding, and a reduction in foreign exchange exposure in domestic financial markets. International initiatives, such as the Vienna Initiative or the EBRD Local Currency and Capital Markets Development Initiative, support local capital market development in the region. Well-developed capital markets are not only a crucial component for generating economic output, but also foster more stable growth through the ability of diversified financial sources to offset a slowdown of economic activity caused by a credit crunch.

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Before the crisis, cross-border funding in foreign currencies strongly accelerated. Foreign currency lending to households and to other unhedged borrowers was prevalent, implying significant currency risks for the borrowers as well as credit and funding risks for the lenders. When the crisis erupted in 2008, large vulnerabilities in the form of excessive leverage and foreign currency loans were exposed. On the one hand, cross-border net lending turned negative and new loan syndications dropped sharply. On the other hand, weakening currencies inflated loan instalments and caused financial difficulties for unhedged borrowers. These problems have stressed the necessity for measures to strengthen local currency funding and lending by developing domestic capital markets as well as by encouraging long-term savings and investments.

This paper is structured as follows: Section 1 summarizes the benefits of developed capital markets. In section 2 the main characteristics of capital markets in CESEE are presented, while

section 3 identifies necessary conditions for a developed capital market and subsequently explores to what extent CESEE countries fulfill these conditions. Some international initiatives supporting local capital market development in CESEE are dealt with in section 4 and, finally, section 5 concludes.

1 Benefits of Developed Capital Markets

Developed capital markets complement the financial intermediation role of banks and support the efficient allocation of financial resources. In the presence of well-functioning stock and corporate bond markets the corporate sector is less dependent on bank financing. Thus, firms can raise capital at a lower cost, expand their size and achieve economies of scale. The intensified financial flows in a developed capital market result in an increase in capacity and flexibility to react to unexpected market shocks, further leading to a reduction of credit crunch risk. Consequently, the development of capital markets accelerates economic growth and the

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further enhancement of the financial sector by increasing the quantity and the quality of investment as well as by fostering competition (see Rojas-Suarez, 2014; Yartey, 2008; and Mminele, 2013).

The development of local currency and local capital markets can help to reduce unhedged foreign currency borrowing, rendering a country less dependent on capital inflows and less vulnerable to their potential reversal, both having emerged as key vulnerabilities in CESEE during the global economic crisis. However, developing local currency finance and capital markets is a long-term and complex process.

2 The Main Characteristics of Capital Markets in CESEE²

One of the main indicators of capital market development is market capitalization. The capitalization ratio is defined as the share price of listed companies times the number of shares outstanding relative to GDP. To measure the activity of the market, two World Bank indicators are used. The first is the total value traded as a share of

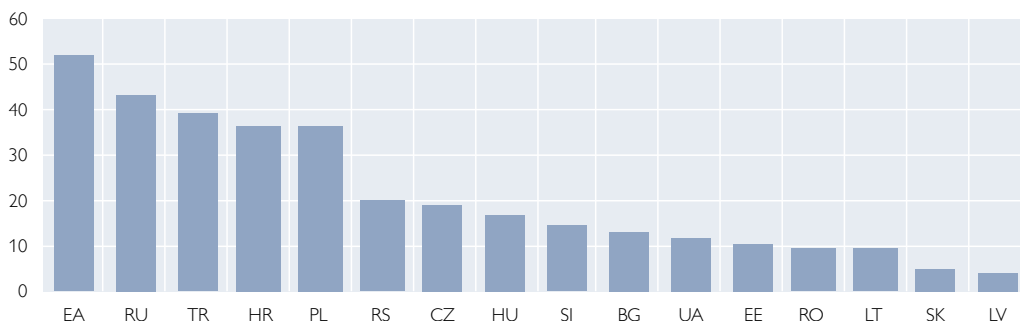
GDP; the second is the turnover ratio, which represents the total value of shares traded during a given period divided by the average market capitalization for that period. A high turnover ratio implies lower transaction costs and consequently higher market efficiency.

These indicators show that, with the exception of some countries, the stock markets in the CESEE region are still underdeveloped, both in terms of size and liquidity. The region can be divided into three groups. The first group includes Russia, Turkey, Croatia and Poland, where stock exchanges show a relatively advanced development by regional standards. On the other side of the scale is the second group, which consists of Slovakia, Romania and the Baltic states. In these countries stock markets are relatively small. The remaining countries, i.e. the third group, exhibit medium-sized stock markets (between 10% and 20% of GDP; see chart 1). Overall, the liquidity of the stock markets in the CESEE region is rather limited, except in Russia and Turkey (see charts 2 and 3).

Chart 1

Market Capitalization

% of GDP, 2012



Source: World Bank, ECB.

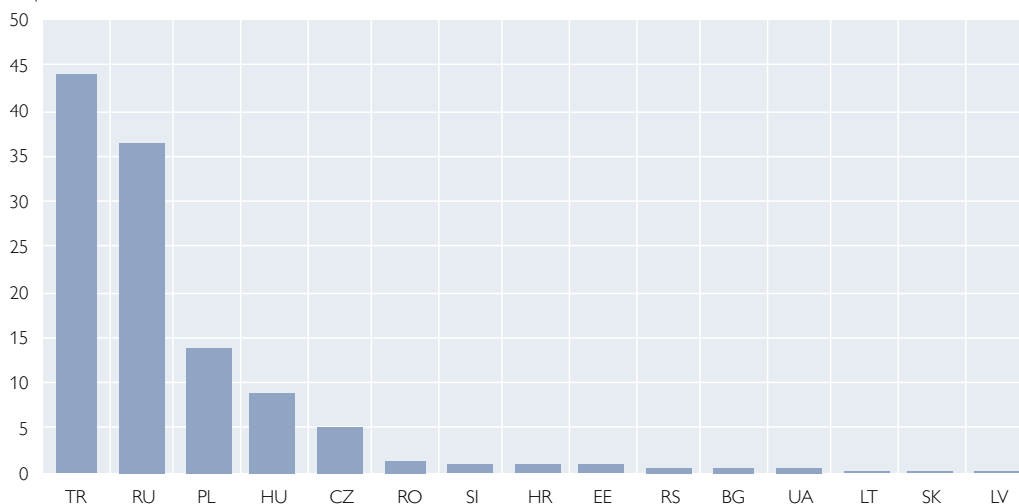
Note: EA = euro area.

² As the indicators used do not change significantly over short time, the latest available World Bank data on stock markets and Eurostat data on government bond markets from 2012 can be considered as representative.

Chart 2

Total Value Traded

% of GDP, 2012

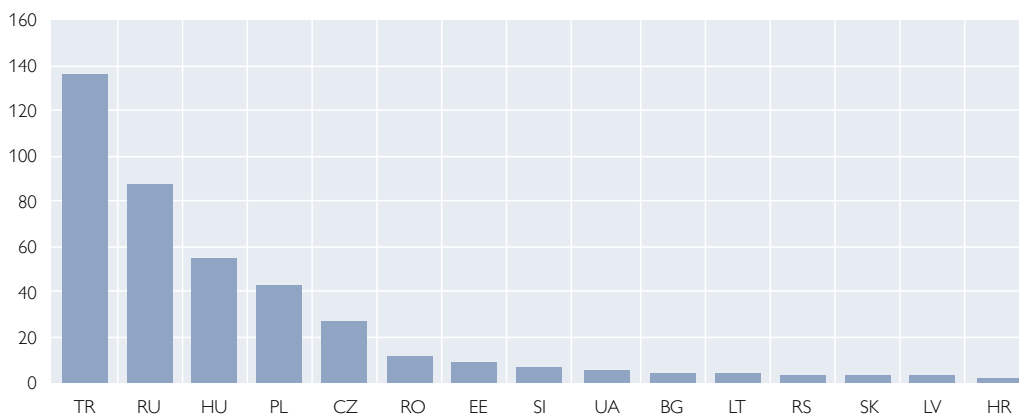


Source: World Bank.

Chart 3

Turnover Ratio

%, 2012



Source: World Bank.

2.1 Government Bond Markets

In the CESEE region the share of government bonds in total government debt is over 80% (chart 4). There are only a few exceptions but two of them are significant: In the case of Latvia this ratio is around 43% and in Estonia it is even lower with 14%. Looking at the development of this ratio over time, Latvian government bonds' share in

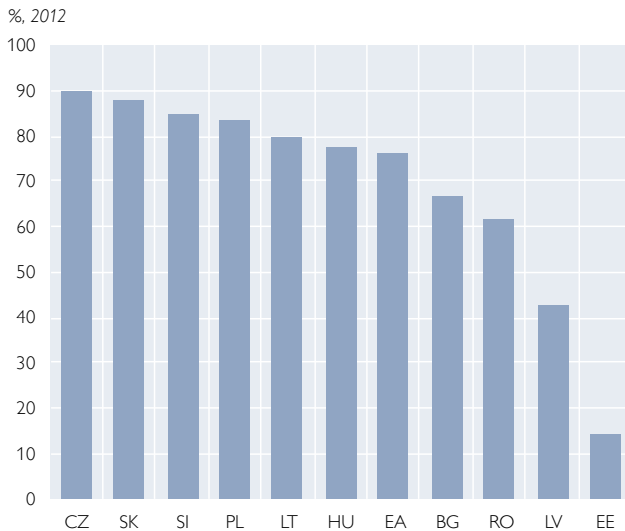
total debt has decreased significantly since the crisis due to the emergency bailout loan received from the IMF and the EU. In Estonia it has never gone above 40% in the last years.

Apart from these exceptions, it can be stated that differences in the size of government bond markets across CESEE countries can be explained by the size rather than the structure of

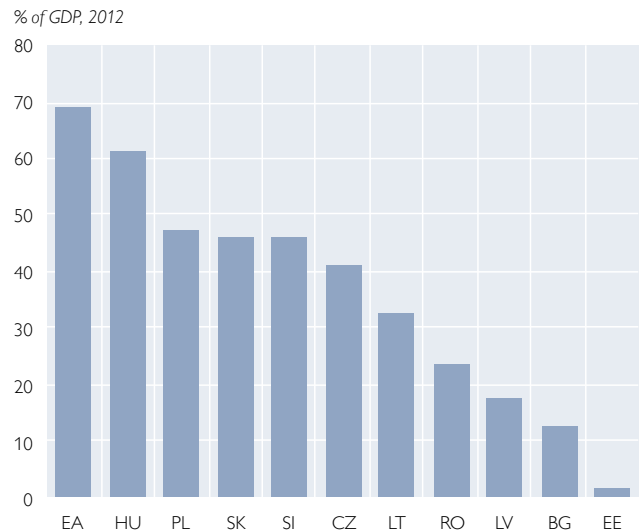
Chart 4

Government Bonds in CESEE

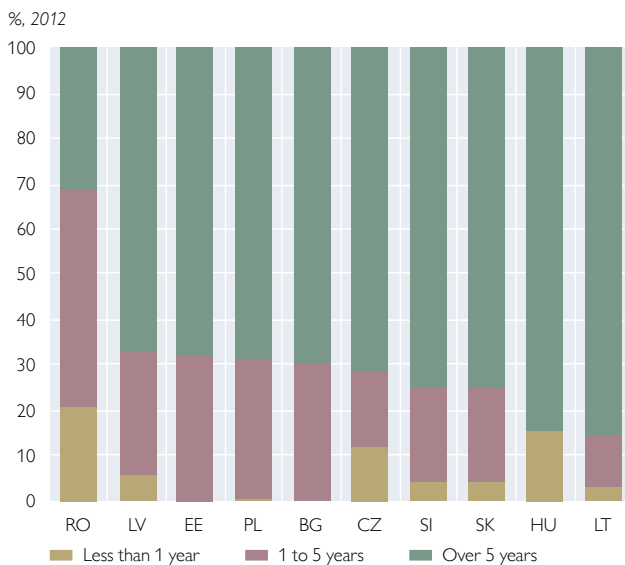
Government Bonds' Share in Government Debt



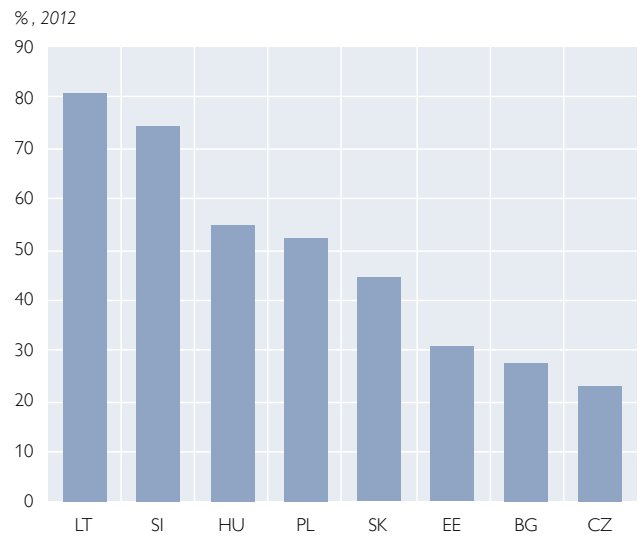
Government Bonds as a Percentage of GDP



Government Bonds by Maturity



Government Bonds Held by Nonresidents



Source: Eurostat.

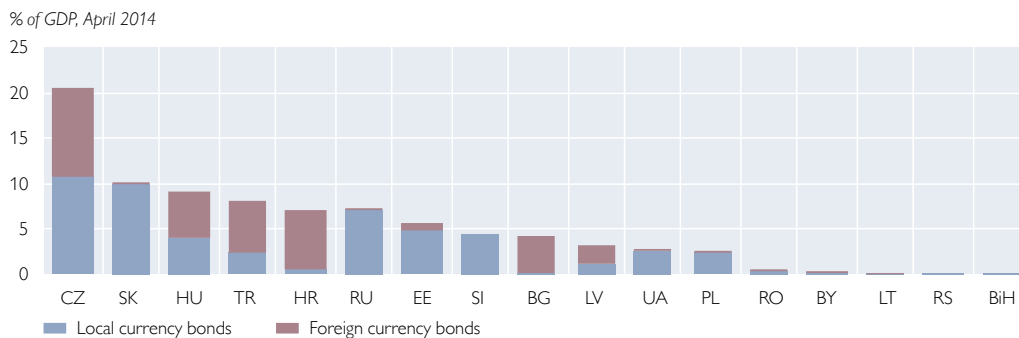
Note: In the case of Hungary the color green indicates a maturity of over 1 year. EA = euro area.

government debt. Hungarian government bonds make up over 60% of GDP. Hungary is followed by Poland, Slovakia and Slovenia with around 45%. The lowest levels both in terms of general government debt and bond size can be found in Estonia, with significantly lower numbers than in other CESEE countries. The maturity struc-

ture of government bonds does not differ across countries; the share of long term bonds varies around 75%. However, in Romania only 32% of government bonds have an original maturity of over 5 years and around half of the bonds mature after 1 to 5 years. Looking at the breakdown by holding sectors, Czech government

Chart 5

Corporate Bonds as a Percentage of GDP



Source: Bloomberg (April 2014), IMF (2013).

bonds are held mainly by domestic financial corporations, and less than one-fourth belongs to nonresidents. By contrast, Lithuanian or Slovenian government bonds are mainly held by foreign investors (chart 4).

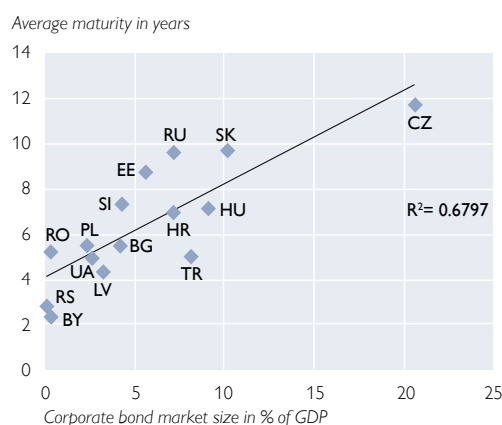
2.2 Corporate Bond Markets

In most CESEE countries corporate bond markets remain small, or even nonexistent, like in Romania, Belarus, Lithuania, Serbia, and Bosnia and Herzegovina (chart 5). One exception is the Czech Republic, where the late banking system reform combined with a significant fall in local interest rates might have supported the growth of the corporate bond market. As a consequence, the country has the deepest corporate bond market, accounting for over 20% of GDP (which is still a relatively low share compared to the euro area value of around 90%). Corporate bond market development and average maturity show a strong correlation; the bigger the corporate bond market, the longer the bond maturity observed (chart 6). While in the most developed corporate bond market in CESEE (i.e. in the Czech Republic) the average maturity is close to 12 years, in the least developed markets, the few bonds available mature within 2 to 3 years. Looking at

the currency structure, large variations across countries can be observed. In some countries corporate bonds are primarily issued in foreign currencies, e.g. in Bulgaria, Croatia and Turkey, whereas other countries show more or less equal shares of local and foreign currency bonds, e.g. the Czech Republic, Hungary and Latvia. In the remaining countries corporate bonds are issued merely in local currencies. From the issuer's point of view it shows that, in the relatively higher-developed markets, bonds are predominantly issued by financial issuers, and conversely, in

Chart 6

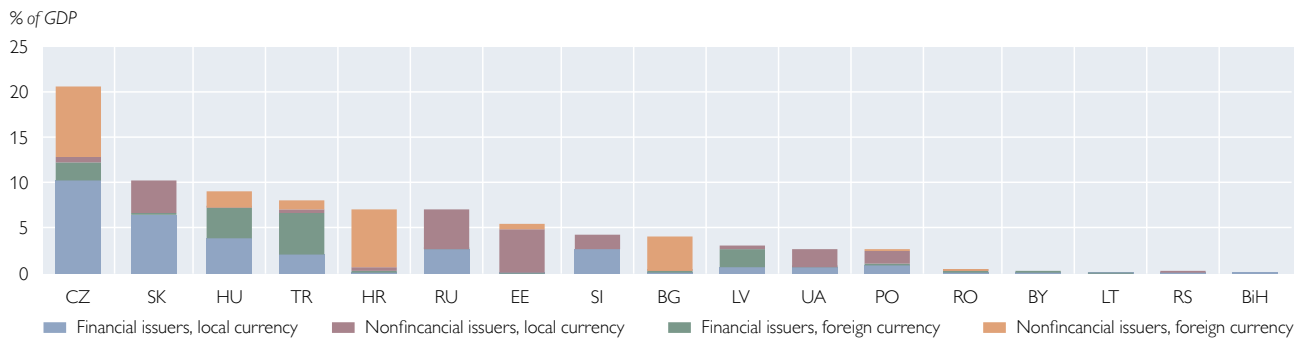
Average Maturity of Corporate Bonds versus Market Size



Source: Bloomberg (April 2014), IMF (2013).

Chart 7

Corporate Bonds by Issuer and Currency



countries with a less developed corporate bond market, nonfinancial issuers dominate. Furthermore, Czech corporate bonds issued by the financial sector are mainly in local currency, but industrial bonds tend to be issued in foreign currency. The latter is valid also for Hungary, but here also financial institutions issue substantial amounts of foreign currency bonds. In Croatia and Bulgaria a small part of bonds is issued in local currency and/or by the financial sector, whereas the industrial bonds dominating the market are in foreign currency (chart 7).

3 Local Capital Market Development Needs Substantial Further Strengthening

It is evident from the data that local capital markets in CESEE need substantial further strengthening. Against this background, necessary conditions for a developed capital market usually can be grouped into several pillars, namely (1) macroeconomic stability, (2) a deep banking sector, (3) high institutional quality, (4) an adequate regulatory and supervisory framework, as well as (5) large domestic savings and investments along with private capital flows. All of these are interrelated and complementary at the same time

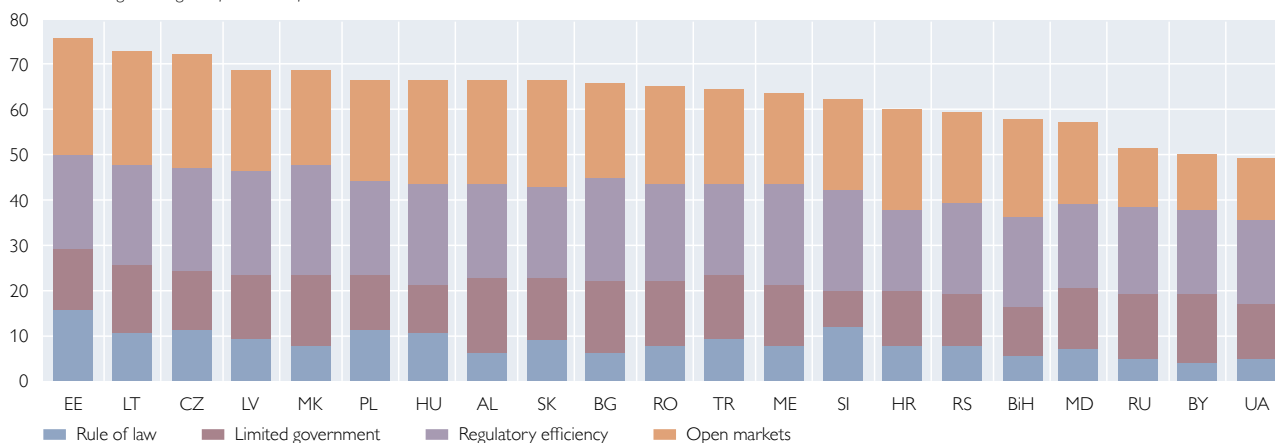
(see Rojas-Suarez, 2014; and Yartey, 2008).

To what extent do countries in the CESEE region fulfill these conditions? To approximate this question we may look at the 2014 Index of Economic Freedom published by the Heritage Foundation. It can provide an idea about corruption, price stability and controls, private property protection by rights and law enforcement, as well as investment and financial freedom in CESEE. The countries that scored highest according to the Index are Estonia, Lithuania and the Czech Republic, whereas Russia, Belarus and Ukraine got the lowest points (chart 8). In the latter countries, many of the necessary characteristics of an appropriate environment for fostering a developed capital market are absent. The highest level of heterogeneity across countries is evident in the “rule of law” category, which is an average of the measure of corruption and property rights. By contrast, the development level in terms of regulatory efficiency and open markets does not show significant differences among the countries, except the relatively low score for Russia, Belarus and Ukraine in the latter category.

Governments and central banks can also influence local capital market

Index of Economic Freedom

Index: 100 = highest degree of economic freedom



Source: The Heritage Foundation, 2014.

Note: The Index is based on ten factors, grouped into four broad categories. Each of the ten economic freedoms within these categories is graded on a scale of 0 to 100. A country's overall score is derived by averaging these ten economic freedoms, with equal weight being assigned to each.

development with administrative tools and measures. Governments, as main participants in the bond market, also indirectly influence corporate bond market development as they create the risk-free benchmark by issuing government securities in local currency across various maturities. This benchmark supports the pricing and therefore also the issuance of corporate debt. Capital market development can also be shaped by high-level policy measures (e.g. policies that encourage the private sector to increase investment or broaden its investor base) or more technical and/or operational reforms (e.g. increase in price transparency), as well as regulatory or legal frameworks (e.g. new forms of taxation and controls). Furthermore, measures related to infrastructure environment (e.g. clearing and settlement) affect capital market development, too (see IMF et al., 2013).

For instance, as of August 1, 2014, Magyar Nemzeti Bank (MNB), Hungary's central bank, will replace its two-week MNB bill with a two-week

deposit facility which will be available only to counterparties and not to foreign or nonbank depositors. One of the objectives is to raise demand for government securities denominated in local currency. However, the long-term impact strongly depends on excluded investors' reallocation of assets into government securities, where the shortest maturity is for three months as compared to the central bank facility's two-week maturity period (see Magyar Nemzeti Bank, 2014). Another example is the ongoing covered bond reform in Poland, which makes it easier for specialized mortgage banks to issue covered bonds. Further examples would be the Bulgarian, Macedonian and Zagreb stock exchanges, which have just started a project promoting the integration of securities markets in order to improve the visibility and efficiency of these markets. The list of government activities designed to further develop local capital markets is long. However, further efforts are needed to achieve deeper and broader capital markets.

4 International Initiatives Supporting Local Capital Market Development in CESEE

Further local capital market development in the CESEE region has recently become an increasingly important issue addressed by international initiatives and institutions, such as the Vienna Initiative or the EBRD's Local Currency and Capital Markets (LC2) Development Initiative.

In the context of the European Bank Coordination ("Vienna") Initiative (EBCI), a Public-Private Sector Working Group on Local Currency and Capital Market Development was established at the Athens Meeting of the EBCI Full Forum in March 2010. At its first meeting in May 2010, the Working Group set up a number of subgroups: one to look at general principles to support local currency lending and capital market development and three country-specific subgroups covering Hungary, Romania and Serbia. One year later the Working Group published a report summarizing results and recommendations. As the reasons underlying undeveloped or less developed local currency and local capital markets can vary significantly across countries, the report suggests that a country-by-country approach is needed to address this issue, which will also require coordination between the home and host authorities of cross-border groups. It is further noted that such coordination should complement ongoing efforts in home and host countries as well as the LC2 Initiative launched by the EBRD (for more details see below). The EBCI would be an appropriate platform for promoting this process but it has not effectively taken advantage of this fact yet. However, there are positive signs for the future, as the Vienna Initiative set priorities for 2014, among others the development of faster local funding

sources in CESEE countries (see Vienna Initiative, 2011; and IMF, 2014).

The EBRD has started an attempt to move forward under the Local Currency and Capital Markets (LC2) Development Initiative. The LC2 Initiative was launched in May 2010 and became one of the EBRD's key strategic initiatives. The initiative aims to support and complement the actions of governments in the CESEE region with the purpose of building up local sources of domestic funding and reducing the use of foreign currency in the domestic financial system. The EBRD contributes to this effort (1) through policy dialogue in coordination with other International Financial Institutions, (2) through knowledge transfer and technical cooperation aiming at development of domestic market infrastructure and (3) through local currency funding, lending, as well as debt and equity investments. The aim is to strengthen the local investor base, especially by supporting pension funds and the insurance sector (see EBRD, 2013).

5 Conclusions

It is evident that domestic capital markets in CESEE are still less developed than in more advanced economies. As a consequence, banks are still by far the dominating financial intermediaries throughout the region. Developing domestic capital markets as an alternative next to a bank-based financial system is a long-term process. Macroeconomic stability plays an important role in this. The greater macroeconomic stability is, the more participants are present in the capital market, enhancing market liquidity. More liquid markets and larger amounts of savings present in the market improve capital allocation and therefore also contribute to capital market development. Overall, there is a need for better economic

policies and for legal and regulatory reforms. Moreover, it is necessary to develop capital market products and the investor base domestically. The markets need more local (institutional) investors with demand for domestic long-term instruments in local currency.

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