

## DEVELOPMENT OF CAPITAL MARKETS IN EMERGING ECONOMIES. THE CASE FOR BUCHAREST STOCK EXCHANGE

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**Abstract.** Capital markets have become one of the drivers of economy growth in emerging economies. Romanian case is no exception: Romania is set to attract billions of Euro once upgraded to an Emerging Market - a status which will allow the economy to benefit from massive capital inflows. The economic function of a stock exchange is to: handle transactions with reasonable cost; find the two sides of a trade, discover the fair price, generate a return for investors and facilitate capital rising in the primary market - a vibrant IPO market is vitally critical for a country's economic growth. Our research is focused on identifying if 1) There is a positive relationship between the market capitalization, trading volume and BET index of Bucharest Stock Exchange; 2) There is a positive relationship between the stock market capitalization and economic performance in the case of Romania. The study indicates that the market capitalization of Bucharest Stock Exchange is directly proportional to the trading volume and BET value. When it comes to the second hypothesis - the relationship between the stock market capitalization and economic performance - our analysis indicates that there is no significant correlation between the two variables.

**Keywords:** Bucharest Stock Exchange; capital market; emergent economy; economic growth; Romania.

## Introduction

Capital markets have become the drivers of economy growth in emerging economies. Romanian case is no exception: Romania is set to attract billions of Euro once upgraded to an Emerging Market - a status which will allow the economy to benefit from massive capital inflows (The Diplomat, 2017). This paper aims to analyze, through a quantitative approach, if: 1) There is a positive relationship between the market capitalization, trading volume and BET index of Bucharest Stock Exchange; 2) There is a positive relationship between the stock market capitalization and economic performance in the case of Romania. The results of our study indicate that the market capitalization of Bucharest Stock Exchange is directly proportional to the trading volume and BET value. The year 2017 reflects the historical value of BET index – comprising 12 companies and a significant increase of 15% compared to other worldwide stock markets; at the same time, in 2017, due to the positive results of Bucharest Stock Exchange and positive macroeconomic trends, Romania was included by FTE Russel in the Watchlist for Emergent markets – status that shows the important progress the Romanian capital market realized in the past 4-5 years.

When it comes to the second hypothesis – the relationship between the stock market capitalization and economic performance- our analysis indicates that there is no significant correlation between the two variables. Despite the empirical evidence, Bucharest Stock Exchange has made important steps for Romania in order to become an emergent capital market and more public and private IPOs in the near future will be essential for further development and attracting important institutional investors. In conclusion, Bucharest Stock Exchange represents the largest bourse in south-eastern Europe and an important pillar for further economic development of Romania on a long term by sustaining innovation and competitiveness of the Romanian brands, based on access to the funding like IPOs or issuing bonds listed on the stock exchange.

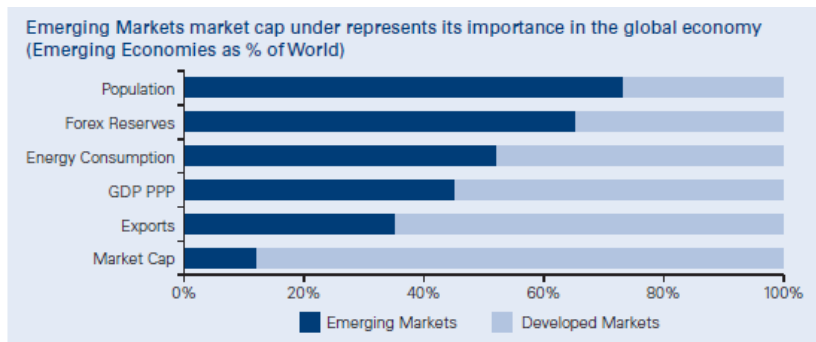
## Capital markets in emerging economies

Despite the fact that we don't have a consensus concerning the definition of emergent economies, we can identify a series of characteristics in comparison with developed economies: 1) In emerging economies, the domestic markets are small in terms of size and purchasing power – this generates monopolies and discourages new entries; 2) Supply chain management –for new entrants there is the risk that their products cannot be distributed through existing channels. Wholesalers have the tendency to control the retail outlets in terms of their product portfolios and financing agreements; 3) In emerging markets, government plays an active economic role. Despite the extent of the privatization process, the share of state-owned economic enterprises is still substantial - especially in steel, gas & oil, railways sectors (Cavusgil et al., 2002, pp.24-25).

Capital markets development is focused on the following pillars: 1) *The breadth and depth of investment opportunities available (issuer side)*: The broader the issuer base (across types of issuers, types of projects, variety of industries, levels of maturity), the broader the range of investment opportunities in the market; 2) *The breadth and depth of the investor base*- Due to the fact that investors have a range of preferences concerning risk, return, cashflow etc. – the broader the investors base, the larger range

of investment opportunities. 3) *The strength of supporting market infrastructure, regulations, and supervision* – the framework guide standards should be focused on disclosure, risk management, issuance criteria, and investment manager duties etc. and should facilitate the development of market infrastructure: stock exchanges and other trading venues, ratings agencies, and data sharing (Strumeyer & Swammy, 2017, p.48).

When it comes to the most important sector weights from emergent markets in Europe, MSCI Emerging Markets Europe Index (2017) indicates that financials (35.8%) and energy (31.6%) are the most attractive sectors for investors; in this regard, the most important emergent markets in the sectors mentioned before are Russia (48,4%) and Poland (19.8%). Goldman Sachs (2016, p.1) stipulates the following factors that on a long term generate important revenues for investors from emergent economies: 1) *Exposure to an improving environment*: the annual rate of growth in emerging market economies is nearly 11% over the past 10 years, compared to only 5% in developed markets; 2) *Exposure to new industries in a still under-researched and inefficient market*: The focus of managers must be on stock picking and fundamental bottom up analysis. 3) *Attractively valued relative to developed markets*: Emerging markets are currently trading at almost a 30% discount to developed markets (see figure 1):



**Figure 1. Emerging Markets Equity Portfolio (Goldman Sachs, 2016)**

In regard to the development of capital markets in emerging economies, World Economic Forum (2016, p.6) has defined a set of recommendations and best practices focused on the following dimensions: 1) *Encourage greater issuer participation*: limit market distortions that bias against corporate bond markets and optimize the issuance process and costs- key outcomes: lower the cost of financing & improve efficiency and time to market; 2) *Improve the investor value proposition*: a) Introduce reforms to encourage domestic long-term savings (investment culture through education, provide incentives for domestic savings); b) Strengthen the regulatory and legal framework to offer credible investor protection; c) Establish a strong corporate governance framework – key outcomes: Grow the size of the local capital pool, Improve market certainty and investor confidence in entering the market & Improve recovery rates. 3) *Enhance market efficiency and transparency*: a) Improve information availability and accuracy - robust accounting and reporting standards & improve collection and assimilation of market data; b) Enhance the competitiveness of market infrastructure and intermediaries - Minimize fragmentation in market infrastructure/ Development of a sophisticated and competitive environment for financial intermediation – key outcomes: market participants can assess the market's costs and benefits; increase

secondary market liquidity; match capital supply with demand more effectively; 4) *Attract global interest*: a) Define a clear strategy for developing capital markets; b) Implement a tax regime aligned with financial development objectives; c) Position country to be included in global indices and portfolios – key outcomes: Increase exposure in the global emerging market portfolio & Be better positioned to serve as a financial center.

PricewaterhouseCoopers (2011, p.4) defines the most important trends that will shape capital markets in emerging economies by 2025: 1) *The economic growth and increasing financial sophistication of emerging markets mean that competition among stock exchanges is intensifying* – Local companies from emerging economies will choose emergent markets for listing. In comparison to local companies, corporations will continue to choose to list in developed markets. In this regard, Shanghai will become one of the most attractive stock exchange for foreign listing; 2) *The focus of IPO activity is shifting East* – The most important countries that will attract foreign capital will be China, India, and Brazil & Russia from BRIC countries; 3) *Increasing competition between developed market exchanges – especially New York Stock Exchange and London Stock Exchange*. 4) *The most important factors that could increase the cleavage between emergent and developed markets are the legal and regulatory environment, followed by political uncertainty and government intervention*; 5) *The developed market exchanges will need to rethink their offer in order to attract companies from emerging economies to list*.

*How will the landscape of capital markets change in the near future due to global macro-trends?* 1) The landscape will be more fragmented into balkanized capital markets, creating opportunities for new players (e.g. users of capital markets). Given continued geopolitical tensions, capital markets participants and users will need to be vigilant regarding sovereign risks. Liquidity pools will continue to aggregate in established global financial hubs – Despite the fact that London and New York will still dominate the landscape of capital markets, the Asian hub will gain importance – especially, Hong Kong, Shanghai, Tokyo, and Singapore. Through 2020, capital markets-based will become the best alternative to bank lending (e.g. greater use of securitization and direct access to markets). In this regard, users of capital markets such as pension funds, hedge funds, private equity firms, as well as other non-bank financial intermediaries will play a critical role. Capital markets players will fully master redefining their business models to generate mid-teen returns on equity. In order to succeed in this regard, PwC (2015, p.30) stipulates that players of the capital market will need to look at issues strategically and holistically and manage their transformation efforts in a coordinated manner: 1) proactively manage risk, regulation, and capital; 2) establish stronger culture and conduct; 3) Redefine the business model; 4) Strategically renew the operating model; 5) Enable innovation and the capabilities to foster it; 6) Obtain an information advantage.

### **Romania financial market development**

Ioana Andrada Moldovan (2015, p.460) indicates that the real economy influences the market capitalization in Romania only on the short run, the financing function being performed almost exclusively by the banking system, while the capital market is small and does not fulfil the function of financing the real economy. When it comes to

financial market development, The Global Competitiveness Report (2017) that comprised 138 countries - indicates that Romania was ranked 86 (with a score of 3.73), much lower than top 3 countries: New Zealand (5.79), Singapore (5.69) and United States (5.64). Top 5 most problematic factors for doing business in Romania are access to financing, inefficient government bureaucracy, tax rates, inadequately educated workforce and corruption. The most important indicators of the Financial market development pillar from the Global Competitiveness Report (2017) that ranked Romania between 125-121 out of 138 countries are the aspects concerning financial services meeting business needs, venture capital availability, financing through local equity market and affordability of financial services (*see the figure below*):

8th pillar: Financial market development	86	3.7	
8.01 Financial services meeting business needs	125	3.4	
8.02 Affordability of financial services	121	2.9	
8.03 Financing through local equity market	123	2.6	
8.04 Ease of access to loans	110	3.1	
8.05 Venture capital availability	125	2.1	
8.06 Soundness of banks	90	4.4	
8.07 Regulation of securities exchanges	114	3.5	
8.08 Legal rights index 0-10 (best)	8	10	

**Figure 2. 8<sup>th</sup> pillar: Romania Financial market development (World Economic Forum, 2017, p.305)**

When it comes to the economic development of Romania, Bucharest Stock Exchange has an important role due to the potential of attracting foreign investments: “Romania is now sixth in terms of the largest return among world capital markets and third in the European Union. Moreover, the Romanian stock market is one of the very few in the entire world sharing consistency as regards the valuations of assets, being in ‘plus’ also in three years’ perspective backwards. The Bucharest Stock Exchange has come a long way from where it was five years ago and its continuing efforts to ensure the upgrade to the Emerging Market status are quintessential” (Sobolewski, 2017).

In the last years, the strategy of Bucharest Stock Exchange (2014, pp.4-11) has been focused on:

- 1) *Enlargement of the local investors’ base*: The “Eight Barriers Removal” program served directly or indirectly the interests of local institutional investors, namely the pension investments funds;
- 2) *Enlargement of the individual investors’ base*: initiatives relating to financial education (Investors Clubs, Fluent in Finance, Individual Investors Forums, Financial Expos, InvestQuests, Experts Call Center, Open Doors Day), to new transactional tools (ArenaXT), to the upgrade or release of new communication means (websites, mobile applications), to the creation of new market segment naturally dedicated to retail investors (AeRO), to the decrease of transactional costs and reliability of the dividends distribution and special schemes promoting day-trading (inactive);
- 3) *Transforming the BVB into a marketplace for the financing of already listed issuers*: segmentation of the market, new indexes, including “total return” indexes”, new obligations attached to the presence in the “premium” segments and for constituents of the BVB main index. Other initiatives that consisted of organizing investors’ meetings with listed companies were arranged by the BVB, including a brand-new project of the “reverse road shows”, engaging international investors coming to Bucharest.

4) *Transforming the BVB into a marketplace for the financing of new companies*: BVB launched many initiatives aimed directly at potential new listings, both from the private sector and SOEs. The requirements for admission to trading of companies were simplified. Road shows and presentations involving candidates for listings and confronting them with potential investors, the creation of AeRO, are among them.

5) *Enhancement of intermediaries' efficiency*: Partnerships with brokers-members of the BVB in several educational and marketing-intense initiatives, new instruments designed for the brokers (market-making revenue schemes, issuers' market making), instruments giving outreach to retail clients (ArenaXT platform on mobile devices), institution of Authorized Advisors – marked the new approach of the BVB which consisted of real support given to brokerage industry. This line of actions will be continued and intensified;

6) *Modernizing the market infrastructure to face challenges and opportunities*: The most relevant envisaged the separation of trading and post-trading systems, the increased flexibility of settlement on a gross basis, the T+2 implementation, and the introduction of two settlements cycles. The trading environment got improved with new market making programs, reduction of suspension from trading, elimination of the Odd-lot market, new tick size, new trading hours and new market stage, implementation of the auction models. The trading tools brought mobile apps and ArenaXT platform enhancements (Bucharest Stock Exchange, 2014, pp.4-11).

Ioana Andrada Moldovan (2015, p.447) indicates that “the development of the capital market is a sine qua non condition for modernizing the Romanian economy, by increasing funding potential and enhancing competition in the financial market (...) The author claims the need for government support and recommends economic policy measures in order to accelerate financial market's expansion in the Romanian economy”.

## **Methodology**

Our quantitative research is focused on identifying the relationship between the stock market capitalization and economic performance of Romania, over the period 2014-2017. Our approach is based on the data provided by the National Institute for Statistics and Economic Studies and the Bucharest Stock Exchange – Annual reports. The selected variables were based upon the analysis employed by Ioana-Alexandra Năstase (2012): MCR-Market capitalization, TVR- Trading volume, BETCR-BET-C index and GDP - Gross domestic product. The first three variables were selected as proxies of the Romanian stock market. Economic growth was represented by the gross domestic product. In order to achieve the objectives of the study, we tested the following hypothesis: 1) There is a positive relationship between the market capitalization, trading volume and BET index of Bucharest Stock Exchange. 2) There is a positive relationship between the stock market capitalization and economic performance in the case of Romania.

## Discussion

The results indicate that the market capitalization of Bucharest Stock Exchange is directly proportional to the trading volume and BET value (*see table 1*). The positive trend (except for 2015) is linked to the concrete efforts that Bucharest Stock Exchange has made for upgrading from frontier to emergent market: important public and private IPOs listing, reforms in order to modernize capital market infrastructure, highest yielding dividends and increasing daily trading volume.

**Table 1. Pearson's Correlation Coefficient Analysis - Hypothesis 1 (authors' calculations)**

Correlations						
		MCR	TVR	BETCR		
MCR	Pearson Correlation		1	.622	.535	
	Sig. (2-tailed)			.573	.641	
	N		3	3	3	
	Bootstrap <sup>a</sup>	Bias		0	.000	.000
		Std. Error		0	.000	.000
		95% Confidence Interval	Lower	1	.622	.535
Upper			1	.622	.535	
TVR	Pearson Correlation		.622	1	.994	
	Sig. (2-tailed)		.573		.068	
	N		3	3	3	
	Bootstrap <sup>a</sup>	Bias		.000	0	.000
		Std. Error		.000	0	.000
		95% Confidence Interval	Lower	.622	1	.994
Upper			.622	1	.994	
BET	Pearson Correlation		.535	.994	1	
	Sig. (2-tailed)		.641	.068		
	N		3	3	3	
	Bootstrap <sup>a</sup>	Bias		.000	.000	0
		Std. Error		.000	.000	0
		95% Confidence Interval	Lower	.535	.994	1
Upper			.535	.994	1	

a. Unless otherwise noted, bootstrap results are based on 1000 stratified bootstrap samples

In 2014, the value of transactions with shares (excluding public offers) increased at Bucharest Stock Exchange by 22% compared to 2013: "It was the second best in the history of Bucharest Stock Exchange after 2007. Due to public offers, the number of active investors increased by almost 30%. BET increased by 9.1%" (Anghel, 2015). The most traded shares on Bucharest Stock Exchange in 2014 come from utilities and financial sector: Fondul Proprietatea, OMV Petrom, SIF Transilvania and Banca Transilvania (Tudor, 2014). At the same time, the year 2014 represents a new stage for Romanian capital market in order to upgrade to emerging market status. In this regard, "The European Bank for Reconstruction and Development (EBRD) acquired a 4.99 per cent stake in the Bucharest Stock Exchange (BVB), demonstrating its support for Romania's comprehensive efforts to strengthen local capital markets. The Bucharest Stock Exchange is at the center of Romania's capital markets and is the largest bourse in south-eastern Europe. In Romania, the Bank has also invested in the IPOs of electricity distributor Electrica and natural gas producer Romgaz" (Rosca, 2014).

The year 2015 represents the decline point of Bucharest Stock Exchange: low liquidity- the trading volume on the main market decreased with 32% compared to 2014: "The share trading volume for the whole year was around EUR 2 billion, down from EUR 3 billion in 2014, as the public offers (initial public offerings, secondary offerings, and other share placements) were almost non-existent. Local fund Fondul Proprietate's sale of a 4% stake in gas producer Romgaz, for EUR 103 million, was the only notable transaction on the Bucharest Stock Exchange last year. The average daily stock trading, excluding public offers, also declined by 16% to EUR 7.3 million" (Chirileasa, 2016). In 2015, the most important transactions were made in the banking sector: Erste - increased volume by 51,16%, Banca Transilvania - increased volume by 45,56% and BRD - increased volume by 38,29%. Detrimental to the positive results from the banks traded at Bucharest Stock Exchange, the companies from energy and petroleum sectors didn't raise to the expectations of their investors - OMV Petrom and Romgaz ended the year with decreases of 28.92% and respectively 23.08%; at the same time, better results for Electrica shares - plus 7.30% and Transgaz- plus 5.36% (capital.ro, 2016). The performance of the Romanian capital market was significantly negatively influenced by the oil price hitting minimum level for the last decade. Heavy weight in BET index of the oil and gas industries was the main reason for the poor 2015 year for the local capital market.

After 2015 decline, the period 2016-2017 marks the historical value of BET index - comprising 12 companies and a significant increase of 15% compared to other worldwide stock markets; at the same time, in 2017 - compared to 2016- the trading volume increased with 42% and the daily volume trading with 61%. Due to this, the total market capitalization of BVB reached 37 billion Euro. A very important aspect concerning transition of Bucharest Stock Exchange from border to emergent market resides in private IPOs such as Medlife (medical sector) and DIGI (telekom industry). The most traded shares at BVB in 2017 belong to companies from the private sector (Transilvania Bank -19%, BRD Societe Generale - 10,16%, OMV Petrom - 8,25%, DIGI Communications - 5,27%), Fondul Proprietatea (14,89%), Romgaz (10,66%), Electrica (6,72%). The positive trend concerning Bucharest Stock Exchange development is also connected to the value of dividends that have reached 7%-8%. In 2017, due to the positive results of Bucharest Stock Exchange and positive macroeconomic trends, Romania was included by FTE Russel in the Watchlist for Emergent markets status.

When it comes to the relationship between the stock market capitalization and economic performance for the case of Romania, our analysis indicates that there is no significant correlation between the two variables (*see the table 2*). Our results are in line with a similar study conducted by Ioana Andrada Moldovan - *Financial Market's Contribution to Economic Growth in Romania (2015)* - that outlines the fact that the financing function of the capital market does not fulfil yet the function of financing the real economy. Despite the empirical evidence, Bucharest Stock Exchange has made important steps for Romania in order to become an emergent market status as capital market and more public and private IPOs in the near future will be essential for further development and attract important institutional investors. At this point, in order to sustain the economic development, innovation and competitiveness of the Romanian brands, Bucharest Stock Exchange has implemented the project "Made in Romania". The selected Romanian companies from the private sector that will benefit of consultancy for further development and projects come from the following economic sectors: IT (2Performant Network, Amber, Lasting System, Smart Bill, Softelligence),



aircraft & automotive industry (Blue Air, vola.ro, Autonom Rent-a-Car), electrical industry (Electrogrup), agriculture (Agricover, IRUM, Prutul), pharma industry (Ivatherm) and HORECA (Cris-Tim, Good People).

**Table 2. Paired Samples Test – Hypothesis 2 (author’s calculation)**

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	MCR - GDPR	-137.667	14.978	8.647	-174.873	-100.460	-15.920	2	.004

## Conclusions

The study indicates that the first hypothesis is validated: the market capitalization of Bucharest Stock Exchange is directly proportional to the trading volume and BET value. Despite the fact that in 2015 the trading volume on the main market decreased with 32% compared to 2014, the period 2016-2017 marks the most important evolution of Bucharest Stock Exchange: the historical value of BET index – comprising 12 companies and a significant increase of 15% compared to other worldwide stock markets; at the same time, in 2017 – compared to 2016- the trading volume increased with 42% and the daily volume trading with 61%. Due to this, the total market capitalization of BVB reached 37 billion Euro – an important aspect for upgrading Bucharest Stock Exchange from frontier to emergent market status.

When it comes to the second hypothesis – the relationship between the stock market capitalization and economic performance- our analysis indicates that there is no significant correlation between the two variables. Despite the empirical evidence, Bucharest Stock Exchange has made important steps for Romania in order to become an emergent market status and more public and private IPOs in the near future will be essential for further development and attracting important institutional investors.

In conclusion, Bucharest Stock Exchange represents the largest bourse in south-eastern Europe and an important pillar for further economic development of Romania on a long term by sustaining innovation and competitiveness of the Romanian brands based on access to the funding like IPOs or issuing bonds listed on the stock exchange.

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