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Capital Markets Development in Southeast Europe and Eurasia – An Uncertain Future

The Impact of the Global Financial Crisis and the Need for Engagement

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Introduction

Why Do We Devote Donor Resources to Capital Markets Development?

1. What exactly are we trying to achieve?
2. It depends on when one asks the question.
 - 1995 -2002
 - 2002 – 2008
 - 2008 - present



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Introduction

Why Do We Devote Donor Resources to Capital Markets Development?

How do the capital markets contribute to economic growth, creation of jobs and raising the material standards of living?

- Access to finance for companies
- Building the country's investment base
- Access to finance for savers
- Connection to other social and economic facets



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Origins: Support to Mass Privatization

- Capital markets development within E&E began as a supporting function to mass privatization.
- End goal = protecting the millions of new shareholders by providing an open, fair and secure environment to buy and sell the newly created shares in the privatized companies.
- The creation of capital market systems required entirely new legal and business concepts, institutions and infrastructure.



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Stage #1: The End Goal? Support to Mass Privatization

- The supply of securities was guaranteed. The development focus was on building secondary trading capacity, not on facilitating new offerings.
- The inattention to new offerings and behaviors of the privatized companies have had a long-lasting legacy on further capital markets development.



Post Privatization Gains

Most Mass Privatization programs were finished by 2002, and things were looking up. **Trading volumes** were rising.

TRADING VOLUMES (selected CEE and SEE Capital Markets)								
	Bulgaria	Romania	Croatia	Serbia	Bosnia (Fed)	Mace.	Bosnia (Srpska)	Mont.
2002 Volume (million US\$)	155	206	145	112	21	29	2	10
2007 Volume (million US\$)	6,394	5,560	4,088	2,530	887	655	411	375
Data Source: Federation of Euro-Asian Stock Exchanges (FEAS)								



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Stage #2: The End Goal? Trading Levels (?)

- There are no collective records on levels of securities offerings.
- The anecdotal evidence is that demand for new offerings is weak.
- PFS is conducting a survey of SEE and Eurasia markets to collect this data for 2005 through 2010.



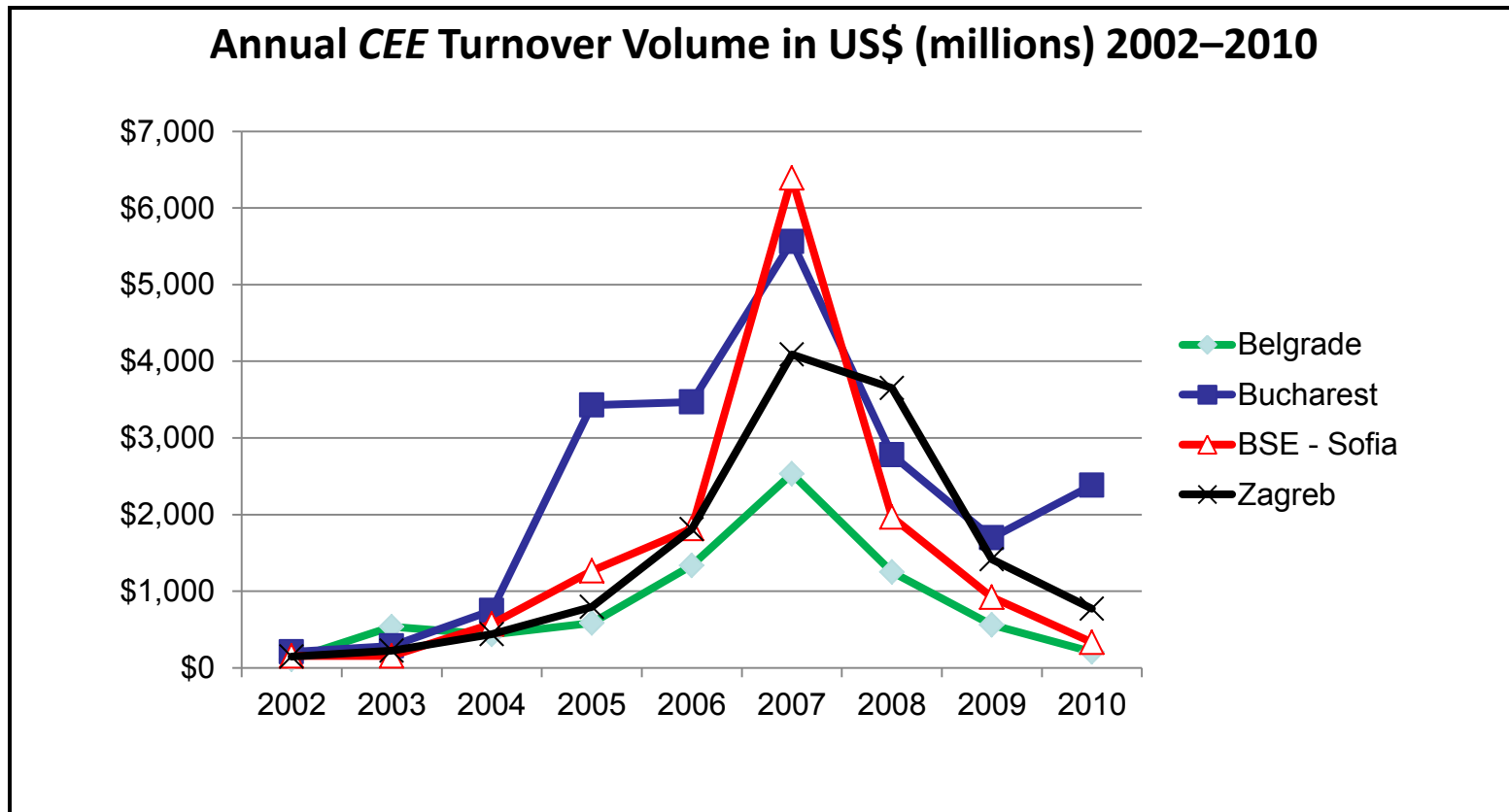
Impact of the Global Financial Crisis

The Global Financial Crisis Halted These Gains.

- ❑ Foreign portfolio investors: (1) rushed to liquidity, and (2) retrenched their risk profiles.
- ❑ Capital moved out of thinly traded markets (wherever located) and there was capital flight to highly rated countries and positions.
- ❑ Both types of flows badly damaged the emerging markets, including those in CEE, SEE and Eurasia.

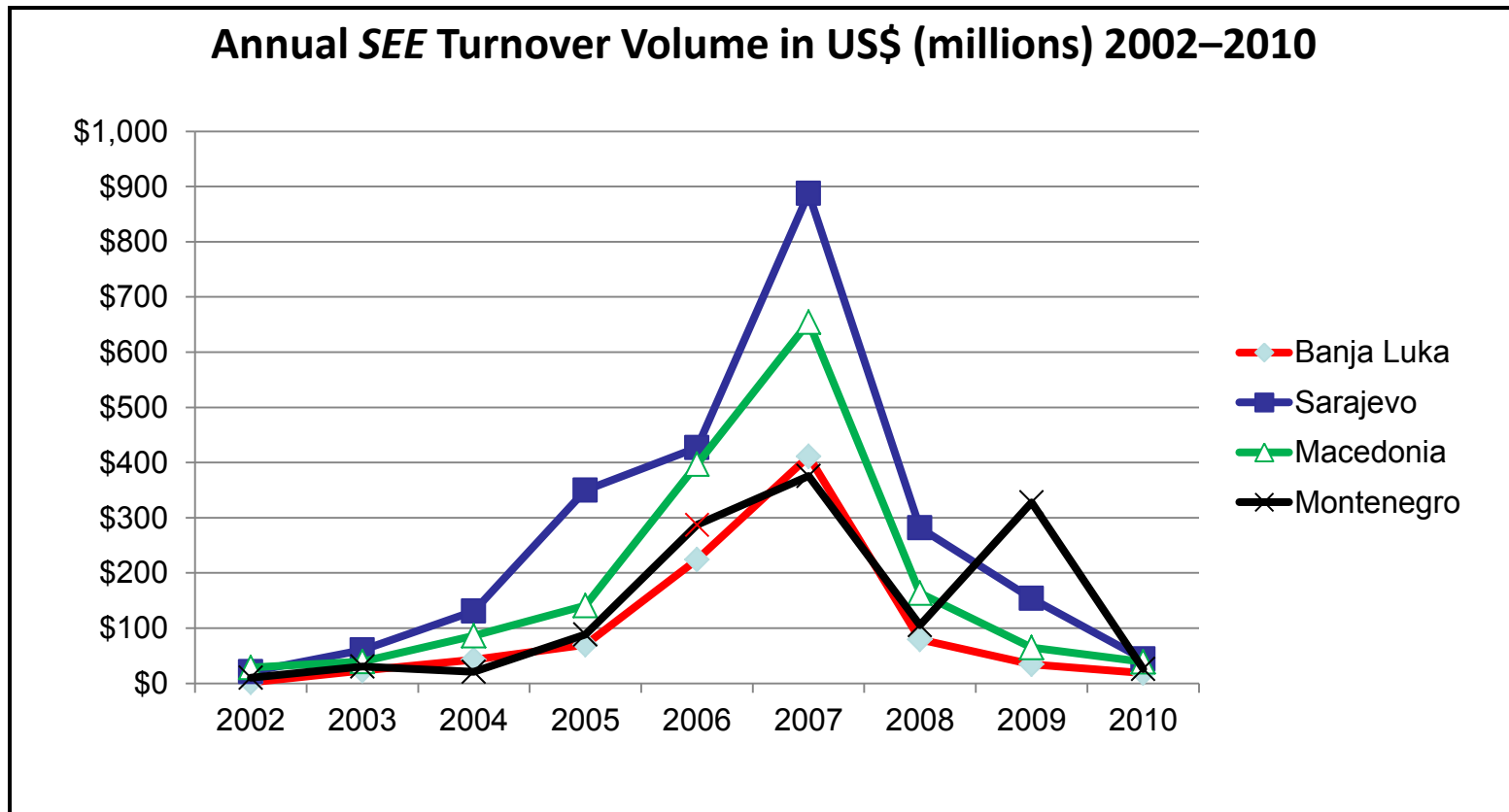


Impact of the Global Financial Crisis



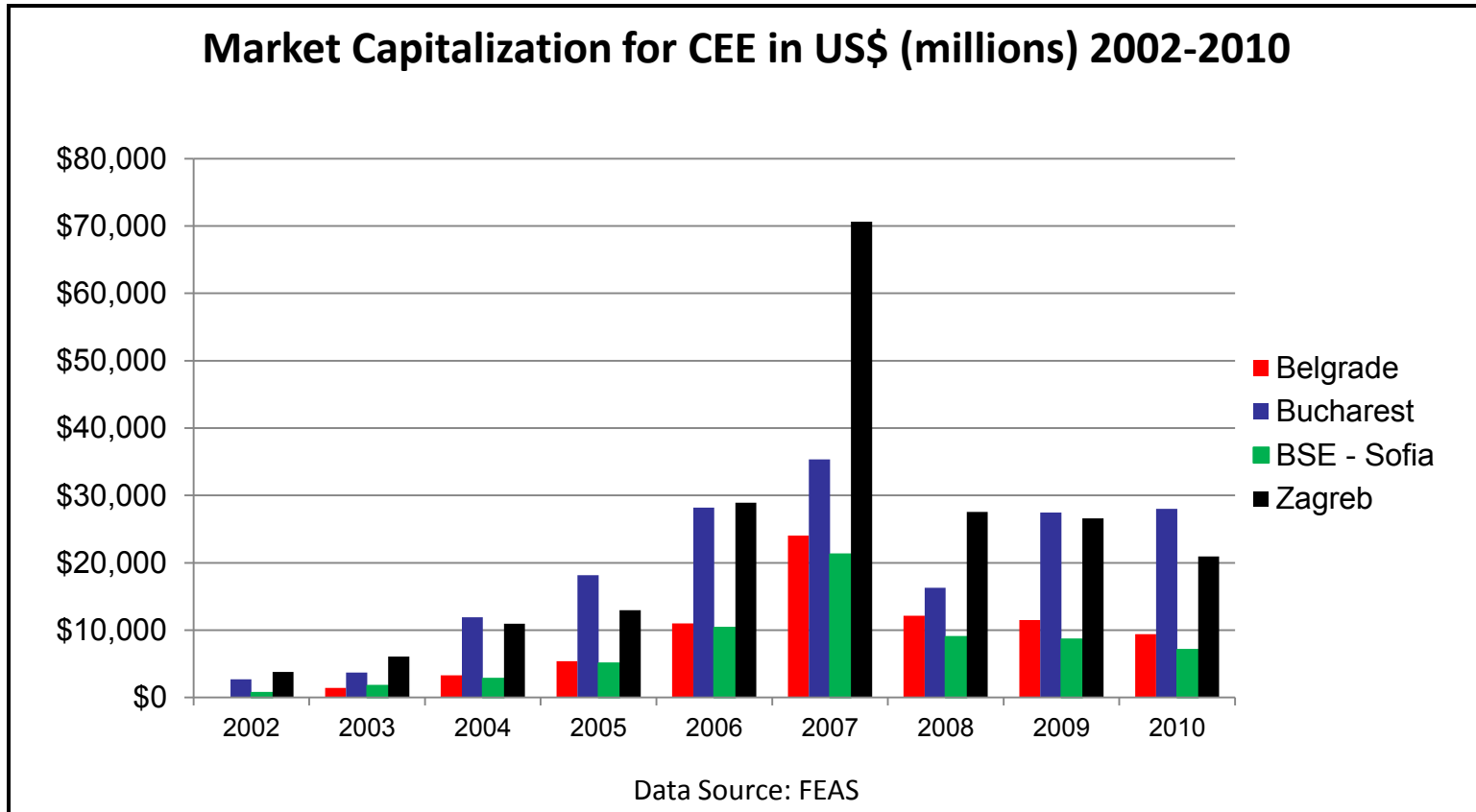


Impact of the Global Financial Crisis



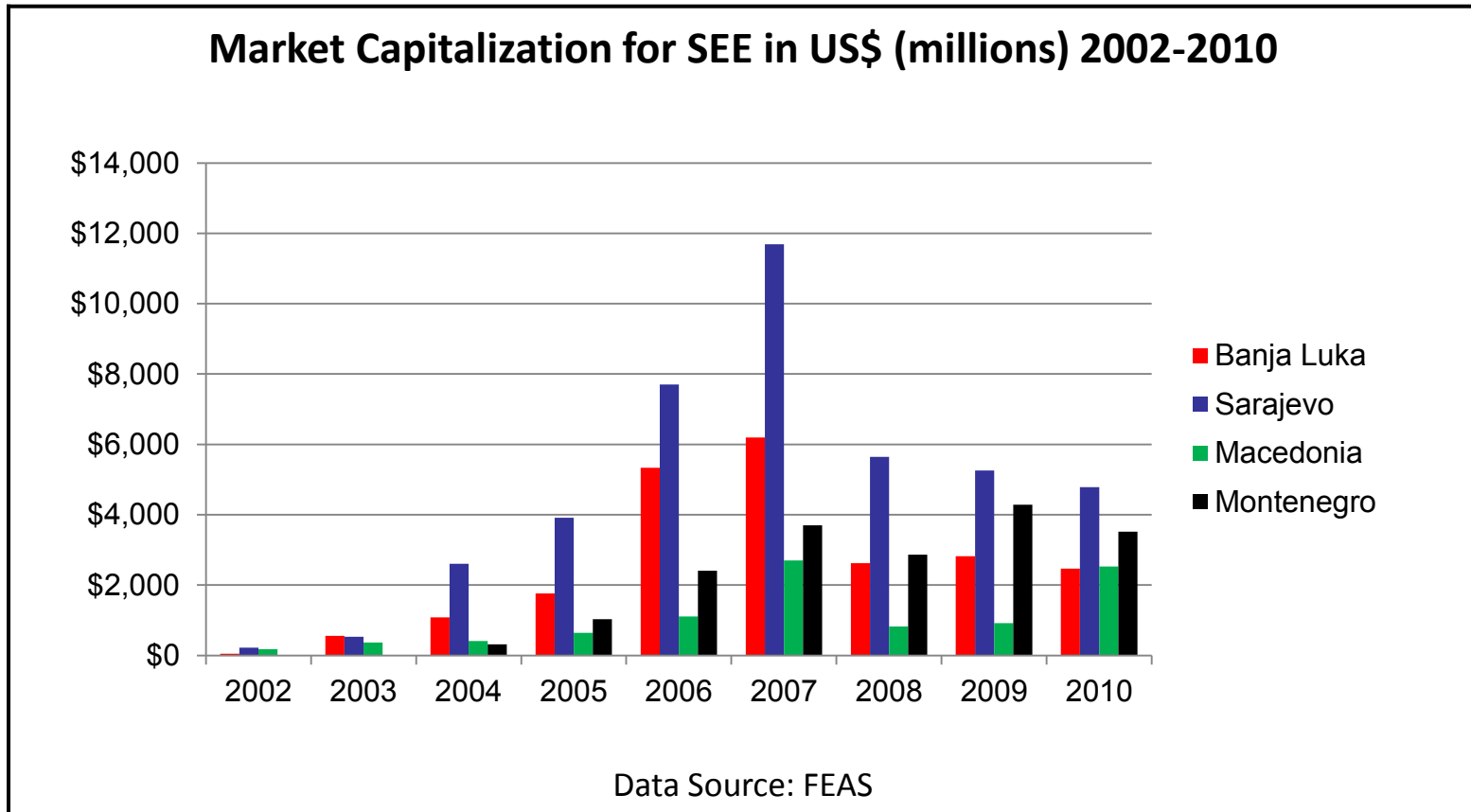


Impact of the Global Financial Crisis





Impact of the Global Financial Crisis





Measures of Regulatory Capacity

Country	Signatory	MMOU Applicant	MMOU Non-Applicant
SEE			
Albania	X		
Bosnia (Federation)		X	
Kosovo			Not Applicable
Macedonia	X		
Montenegro	X		
Serbia	X		
Bosnia (Republic of Srpska)	X		
Eurasia			
Belarus			Non-Member
Moldova			Non-Member
Ukraine			X
Armenia		X	
Azerbaijan			Non-Member
Georgia			Non-Member
Data Source: IOSCO			



Measures of Regulatory Capacity

Qualitative Aspects

1. Securities Regulators are all “new” government institutions.
2. Building a strong knowledge base and proactive regulatory culture takes time.
3. In general, they suffer from poor financial resources.
4. In general, they are subject to political influences.

These institutions must be strengthened, provided the necessary resources and given political independence.



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Vulnerabilities and Challenges

The Good News

- ✓ Suitable **enabling environments** are in place.
- ✓ **Information flows** are improving.
- ✓ **Regulatory attitudes are changing.**
- ✓ The Beneficiary country markets possess “**centrality**”.

The development gains achieved in a short timeframe remain strong foundational elements.



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Vulnerabilities and Challenges

Old Structural Constraints Are Again Highlighted

A main constraint is the “**scale**” of the SEE and some Eurasia countries.

The capital markets in SEE and Eurasia exist within relatively small countries. This begs the question of whether each country needs its own capital market infrastructure.



Vulnerabilities and Challenges

A Question of Scale

Relative Rankings within the FSU (2009)			
<u>GDP (US\$ bill.)</u>		<u>GNI Capita Income (PPP)</u>	
Russian Fed.	1,231.89	Estonia	\$19,120
Kazakhstan	115.31	Russian Fed.	\$18,330
Ukraine	113.54	Lithuania	\$17,310
Belarus	49.03	Latvia	\$14,500
Azerbaijan	43.02	Belarus	\$12,740
Lithuania	37.21	Kazakhstan	\$10,320
Uzbekistan	32.10	Azerbaijan	\$9,020
Latvia	26.20	Turkmenistan	\$6,980
Turkmenistan	19.95	Ukraine	\$6,180
Estonia	19.08	Armenia	\$5,410
Georgia	10.74	Georgia	\$4,700
Armenia	8.71	Moldova	\$3,010
Moldova	5.41	Uzbekistan	\$2,910
Tajikistan	4.98	Kyrgyzstan	\$2,200
Kyrgyzstan	4.58	Tajikistan	\$1,950

World Development Indicators database, World Bank, 14 April 2011



Vulnerabilities and Challenges

A Question of Scale

Relative Rankings within CEE and SEE (2009)	
<u>GDP (US\$ bill.)</u>	<u>GNI Per Capita Income (PPP)</u>
Poland 430.07	Slovenia \$26,470
Czech Rep. 190.27	Czech Rep. \$23,940
Romania 161.11	Slovakia \$22,110
Hungary 128.96	Croatia \$19,200
Slovakia 87.64	Hungary \$19,090
Croatia 63.03	Poland \$18,290
Bulgaria 48.72	Romania \$14,540
Slovenia 48.48	Bulgaria \$13,260
Serbia 42.98	Montenegro \$13,110
Bosnia & Herz. 17.04	Serbia \$11,700
Albania 12.01	Macedonia \$10,880
Macedonia 9.22	Bosnia & Herz. \$8,770
Kosovo 5.39	Albania \$8,640
Montenegro 4.14	Kosovo n/a

World Development Indicators database, World Bank, 14 April 2011



Vulnerabilities and Challenges

Is a pan-regional operation -- a (“MTF”) – the answer?

- In an MTF, several countries use one trading mechanism open to all qualifying intermediaries, together with a regional clearance and settlement system, linked to the share registries in the individual countries.
- The contra argument is that MTF operations ignore a country’s development needs and that the “single-country architecture” is better equipped to enable “emerging companies” to grow by attending to their financing needs.



Vulnerabilities and Challenges

These Market Operators Have Their Own Acquisition and Expansion Strategies

CEE Stock Exchange Group	Acquiring Markets (4)
NASDAQ/OMX	Acquiring Markets (9)
Warsaw Stock Exchange	Acquiring Company Listings
London Stock Exchange	Acquiring Company Listings



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Vulnerabilities and Challenges

Who Wins and Loses in the Consolidation?

Acquiring Exchange = win

“Acquired” market or company = win

Former host country market = loss

Host country Emerging Companies = loss.



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Lingering Impact of the Financial Crisis

The Consolidation is Adding to Weaknesses

1. As transaction-based revenues have plunged over the last three years, market players have been experiencing steep operating losses.
2. This applies equally to securities exchanges, clearance and settlement entities, depositories, share registries and brokerage firms.
3. These institutions must find ways to consolidate and reduce costs, or face near-term insolvency.
4. There are three categories of risk.



Lingering Impact of the Financial Crisis

1. Possible Loss of Investor Funds due to Insolvencies
 - Financial responsibility regimes – including the segregation requirement – are not uniform
2. Possible Insolvency of an Infrastructure Institution
 - The loss of one component will lead to a shutdown of that market
3. Possible “Surprise Failures”
 - Over-brokered? Perhaps Yes. But managed closures are the goal.



Stage #3: The End Goal -- Capital Formation

Refocusing on Capital Formation

- Within the vacuum created by these forces the “Emerging Companies” may find themselves with limited alternatives.
- Their ability to attract cost-effective, long-term, nonbank financing is decreasing as the host-country markets become weaker.
- Yet, they may be viewed as the main engine for potential economic growth.



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Stage #3: The End Goal -- Capital Formation

Refocusing on Capital Formation

Two Frequent Concerns to Coming to Market

- Loss of Control.
- Preference for Privacy.

There are ready answers to these concerns.

**Cautious Optimism: PFS' "Investor Relations Online:
Survey of the Websites of the Largest Listed
Companies in CEE"
(launched in 2001 and continuing)**



Lessons Learned:

#1: The Need to Intervene to Promote Access to Finance Remains

- ❖ Current consolidation of capital markets can act to exclude emerging companies and savers from access to investment finance within their own countries.
- ❖ This threatens sustainable economic growth.
- ❖ Access to finance and the linkages between the financial sector and the private sector will not improve without intervention.



Lessons Learned:

#2: There Should Be a Renewed Focus on Capital Formation

- ❖ Improving management attitudes towards corporate governance, transparency and willingness to come to market should be supported.
- ❖ There must be adequate investable instruments to support development of the insurance sector and implementation of Pillar II and III pension reform systems.



Lessons Learned:

#3: The Single-Market Model for Capital Markets Infrastructure Must be Reconciled with Industry Trends

- ❖ The donor community should explore ways to leverage these positive developments in a manner that acknowledges the business needs of the participants but at the same time protects the interests and needs of the emerging companies.
- ❖ Absent a proactive, inclusive approach some of the small SEE and Eurasia countries may be left without effectively functioning markets.



Lessons Learned:

#4: Capital Requirements and Financial Responsibility Regimes Must be Strengthened

- ❖ Thinly capitalized firms are also failing in the aftermath of the crisis, a result of over-brokered markets.
- ❖ In the current economic climate there needs to be a renewed focus on protecting investor assets and ensuring systemic integrity. Countries should raise required capital levels in an orderly manner to eliminate thinly capitalized firms and prevent “surprise failures”.



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Conclusions

There is a need for the donors to be actively and substantially engaged in directing the future of the capital markets within the SEE and Eurasia countries.

Without effective intervention, the overarching goal of the last decade of development -- access to finance, economic growth, job creation and increases in the material standard of living – may be jeopardized by the lingering impacts of the global financial crisis.

Now is the time to validate the commitment to these goals.