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CENTRAL AND EASTERN EUROPEAN CAPITAL MARKET'S DEVELOPMENT POSSIBILITIES

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ABSTRACT. Aim of the article is to present a development scenario for the Central and Eastern European (CEE) capital markets, to identify their competitors, factors which influence that development and its constraints. While observing regions key market indices author compares them to the most developed markets. Author considers market consolidation as a possible way of achieving satisfiable level of its development which will support real economy optimally. The indice measuring the level of regions capital market's development is its capitalization, average rate of return on key indexes. Author shows merges and acquisitions which already take place and the ones that are possible to undertake, that lead to formulated consolidation.

JEL Classification: F21, G15,
E44, F36, G14

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Introduction

Since the fall of Lehman Brothers investment bank (15th september 2008), the global financial markets suffered lack of trust and risk aversion, as a resoult of which investors were nervously backing out of Central and Eastern Europe's capital markets, which are considered risky investments. Generally during panic among the investors, risky emerging makrets loose popularity angainst 'safe' assets like gold and american treasury securities. That is why stock indexes in Central and Eastern Europe noted bigger losses then in markest considered developed. Some indices (RTS, PFTS) even stopped quotes several times because of panical selling out stocks quoted there which made to them unpossible to price at that time.

Over one year after these events the global economy shows first signs of stabilisation¹ and the investors seem to gain apetite for risk and therefore buy equities. Those who seek higher rates of return in exchange for higher risk, buy equities on emerging and frontier markets's stock exchanges. That plot of events creates better developmnet chances for CEE capital markets that will be described in further parts of the article.

¹Vide International Monetary Found (IMF) raport on global economy "Global Ecoomic Outlook September 2009"

Main body

Many factors positively influence the capital market's development in our part of Europe:

- Low interest rates.
- Unsatisfied demand for corporate credit.
- Growth potential of region's economies.
- Market's hi competetiveness.
- State owned companies privatisation plans.

In the third quarter of year 2009 theworld's most liquid currencies (Euro, U.S. Dollar, Japanese Yen) interest rates stay on the historical minimum levels.

Table 1. Worlds most liquid currencies itervention interest rates

	U	J	E
SD	PY	UR	
0	0	1	
,25%	,10%	%	

Source: Reuters, own elaboration.

Although the governeemnts are expected to rise the interest rates in the future because of the inflation risk, their current low level supports the growth of equities quoted on echanges in short term. In short term low interest rates, which mean low rates of return on safe government securities determine investors to seek higer returns on capital markets and buy smore risky assets - stocks. In long term when that mechanism continues to work, the low cost of capital causes the stock exchanges to draw money from the real economy.

In long term, the healthy growth of stock indices must reflect growth in the real economy. That way the healthy growth of stocks supports the economies growth because it fulfills its primary role of capital redistribution. Investors seeking hi rates of return buy stocks which are offered by the companies seeking capital for futrue development.

2. Although the cost of capital of the money market is low, the banks are not willing to finanse companies development and to take risk of crediting them, as much as the economy demands. That is why in the future, the unsatisfied demand for corporate credit would be the main constraint for the global economies development². The alternative source of capital for the companies are the stock exchanges where they can offer their shares (stocks) for a certain price and finance their future development from the capital gathered that way.

3. How many companies will seek capital, and how good development possibilities they present partly depends on regions development potential. Local companies operationg on growing economies will have better chances to develop and therefore their shares would find more buyers willing to offer better prices in order to benefit from that growth.

4. The most competitive stock exchanges offer better investment possibilities for the investors and better financing possibilities for the capital seekers than their competitors. In the global economy market players may invest and seek capital on exchanges from all over the world. This means that in order to succefully compete the region's exchanges have to present better offer. According to Global Finantial Center Index which measures exchanges competetiveness, the main factors that influence that quality are:

- People,
- Business environment,
- Market access,

² *Ibidem.*

- Infrastructure,
- General competitiveness (other).

This index ranks the world's financial centers in terms of competitiveness and is created on the basis of surveys taken by key capital market players

Table 2. Main areas of competitiveness of financial centers according to GFCI

Main Areas of Competitiveness	Area of Competitiveness	Number of mentions by respondents	Main concerns raised
	Business Environment	70	Regulation, taxation and rule of law
	People	34	Quality and availability of staff
	Infrastructure	18	Transport links and business infrastructure
	General Competitiveness	16	General economic factors
	Market Access	8	Cluster of professional advisors and access to international markets

Source: Global Financial Centers Index, September 2009, Z/Yen Group, City of London Corporation.

The most often raised factor is 'business environment', mainly regulation, taxation and rule of law. This means that taxes corporate income taxes, and capital income taxes should be possibly the lowest and transparent. The local judiciary should work efficiently. These factors are our regions biggest constraints. According to 'Paying taxes 2009 Global picture' ³report CEE countries tax systems are among the most difficult and complicated (For 181 analysed countries Poland was on the 142th and Ukraine on 180th places) Considering the rank of regions countries in this report and how important this factor is for the key market players and the economy at all, state of tax systems should be the main concern for the economy decision makers⁴

Another important issue for the market competitiveness according to the respondents is the 'transport links and business infrastructure'. The infrastructure in regions countries is also a constraint of economies development and a big challenge for local authorities.⁵ Authorities are already working on regions infrastructure because of Ukraine and Poland are to organise European football championship in year 2012 and overall are trying to boost economy that way.

Another factor raised by the respondents is the market access, cluster of professional advisors, access to international markets. 'The GFCI has previously highlighted the need for competitive financial centres to be connected and co-operative. Respondents to the GFCI questionnaire believe that the need for connectivity and co-operation is greater than ever if the industry is to deal with, and recover from, the current crisis'⁶ Although regions exchanges are cooperating with each other (double quoting of companies operating in Ukraine and Poland, the advisors are searching for capital and companies in the region, the exchanges Ukrainian and Polish exchanges are cooperating with each other and with Vienna Exchange and Moscow Exchange, the tendency in the capital market is consolidation. A good example is NYSE Euronext which is a pan-European stock exchange based in Paris and with subsidiaries in Belgium, France, Netherlands, Portugal and UK. It is merged with NYSE Group. Another

³Joint publication of: World Bank, Pricewaterhousecoopers, International Finance Corporation.

⁴Vide vice-ministers's response for the parliamentarians interpellation nr. 6970.

⁵For the indices measuring the infrastructure level of region's cities compared to world see 'Worldwide Quality of Living 2009' report.

⁶One of GFCI conclusions.

European group of exchanges that quote its companies on a single index is the CEE Stock Exchange Group: Vienna Stock Exchange (leading subject), Budapest Stock Exchange, Bucharest Stock Exchange, Zagreb Stock Exchange and Ljubljana Stock Exchange. Companies quoted on these exchanges are listed on single index: 'CEESEG', which is a Composite Index. CEESEG is a capitalization-weighted price index which is composed of the constituents of the leading share indices of the members of the CEE Stock Exchange Group. Thus the index comprises the stocks included in the ATX, BUX, PX and SBITOP. The index is calculated and disseminated on a real-time basis in EUR and USD. The CEESEG Composite index should serve as a transparent benchmark for investors and represent the development of the capital markets of the whole group.⁷

Table 3. GFCI ranking

Financial Centre	GFCI 6 Rating	GFCI 6 Rank	Change In Rating since GFCI 5	Change In Rank since GFCI 5	Financial Centre	GFCI 6 Rating	GFCI 6 Rank	Change In Rating since GFCI 5	Change In Rank since GFCI 5
London	790	1	9	► 0	Monaco	563	39	30	▼ -2
New York	774	2	6	► 0	Madrid	560	40	54	▲ +7
Hong Kong	729	3	45	▲ +1	Sao Paulo	560	41	120	▲ +13
Singapore	719	4	32	▼ -1	Copenhagen	560	42	28	▼ -4
Shenzhen	695	5	-	-	Qatar	558	43	51	▲ +3
Zurich	676	6	17	▼ -1	Bahrain	558	44	45	▼ -1
Tokyo	674	7	63	▲ +8	Kuala Lumpur	557	45	47	► 0
Chicago	661	8	23	▼ -1	Vienna	555	46	42	▼ -4
Geneva	660	9	22	▼ -3	Milan	554	47	33	▼ -7
Shanghai	655	10	117	▲ +25	Bahamas	551	48	14	▼ -12
Sydney	651	11	41	▲ +5	Glasgow	550	49	-4	▼ -18
Frankfurt	649	12	16	▼ -4	Johannesburg	550	50	47	▼ -2
Toronto	647	13	32	▼ -2	Gibraltar	543	51	-6	▼ -18
Jersey	640	14	27	▼ -1	Malta	543	52	-	-
Guernsey	638	15	23	▼ -3	Mumbai	542	53	57	▼ -4
Luxembourg	637	16	25	▼ -2	Wellington	541	54	109	▲ +2
San Francisco	634	17	25	► 0	Mexico City	541	55	-	-
Boston	634	18	16	▼ -9	Oslo	538	56	15	▼ -17
Paris	630	19	30	► 0	Rome	537	57	98	▼ -2
Washington D.C.	630	20	34	▲ +1	Mauritius	536	58	-	-
Dubai	617	21	37	▲ +2	Helsinki	533	59	21	▼ -15
Beijing	613	22	135	▲ +29	Bangkok	532	60	52	▼ -10
Dublin	613	23	-5	▼ -13	Rio de Janeiro	532	61	-	-
Taipei	609	24	91	▲ +17	Jakarta	511	62	-	-
Isle of Man	609	25	8	▼ -7	Buenos Aires	507	63	-	-
Cayman Islands	608	26	17	▼ -4	Manila	494	64	-	-
Edinburgh	605	27	5	▼ -7	Prague	492	65	96	▼ -7
Hamilton	597	28	33	▼ -1	Lisbon	477	66	68	▼ -9
Vancouver	589	29	20	▼ -4	Moscow	462	67	99	▼ -7
Munich	588	30	30	▼ -1	Riyadh	457	68	-	▲ -
Amsterdam	586	31	11	▼ -7	Warsaw	456	69	75	▼ -10
Montreal	586	32	18	▼ -6	St. Petersburg	453	70	-	-
British Virgin Islands	584	33	35	▲ +1	Tallinn	445	71	-	-
Melbourne	584	34	22	▼ -6	Istanbul	442	72	-	-
Seoul	576	35	114	▲ +18	Athens	433	73	98	▼ -12
Stockholm	569	36	13	▼ -6	Budapest	425	74	119	▼ -12
Brussels	568	37	16	▼ -5	Reykjavik	415	75	-	-
Osaka	565	38	96	▲ +14					

Source: Global Financial Centers Index, September 2009, Z/Yen Group, City of London Corporation.

⁷Vienna Stock Exchange.

The GFCI ranks very hi cities where quoting of these groups take place. Which could be a signal that strategy of merging and integration of financial markets leads to success in terms of competetiveness.

In 1st of June 2006 the Euronext exchange was bought by NYSE. The Deutsche Boerse made also a bid for Euronext acquisition, but it didn't succeed eventually. The Deutsche Boerse did not desert strategy of creating a large European group of stock exchanges. Another chance of implementing this strategy appeared when the polish Ministry of Treasury which controls 98,8% shares of Warsaw Stock Exchange made an offer selling it to strategical investor. WSE privatization plans which assume selling 51-73,82% to strategical investor and up to 22,82% to other financial institutions. The only strategical investor that made a final bid for WSE was the Deutsche Borse and it is expected that the transaction will be finalized by year 2010. Although the WSE is developing rapidly⁸, its current owners understand that it is derived from the countries and regions GDP level and development ratio, which is not enough to successfully compete with other region's exchanges and world leaders which are all private owned. In order to ensure its development, it needs an investor ⁹with know-how, position on the market and who is willing to support it. Deutsche Boerse AG seems to shares WSE's development strategy: it has its representative office in Moscow and is cooperating with Moscow's MICEX while WSE's representatives work in Ukraine and Belarus and cooperate with PFTS stock exchange in Kiev. There is also a matter of possible acquisition of PFTS stock exchange by MICEX. The owner of PFTS Stock Exchange is the PFTS (Piersza Fondowa Torgowielnia Sistiema) assosiation which consists of 315 members, if the acquisition was to take place it requires 75% of association's members agreement.

These facts show that creating a large capital group of stock exchanges like NYSE Euronext or CEESEG is theoretically possible. This capital group would be likely to successfully compete with NYSE and CEESEG because it would consist of stock exchanges from economies which represent a large part of Europe's GDP as well. Creating a common indice of companies from this theoretical group could possibly increase liquidity of exchanges, which could be measured as trade volume to capitalization ratio. It could happen so, because foreign investors would more trust companies quoted from a large group of exchanges with a Deutsche Boerse in it. If the investment risk would seem to be lower, the global capital would flow to local companies helping them to develop. If the local markets would be more liquid and considered safer than now because of developed strategical investor they could be 'promoted' from frontier and emerging to developed markets in the longer period. Having such a 'promotion' of market category means that foreign financial institutions that invest on capital markets would have higher limits on engaging in local markets.

Table below shows current average weekly rates of return and risks of mentioned indexes.

Table 4. Average weekly rates of return and risks of European chosen stock indices

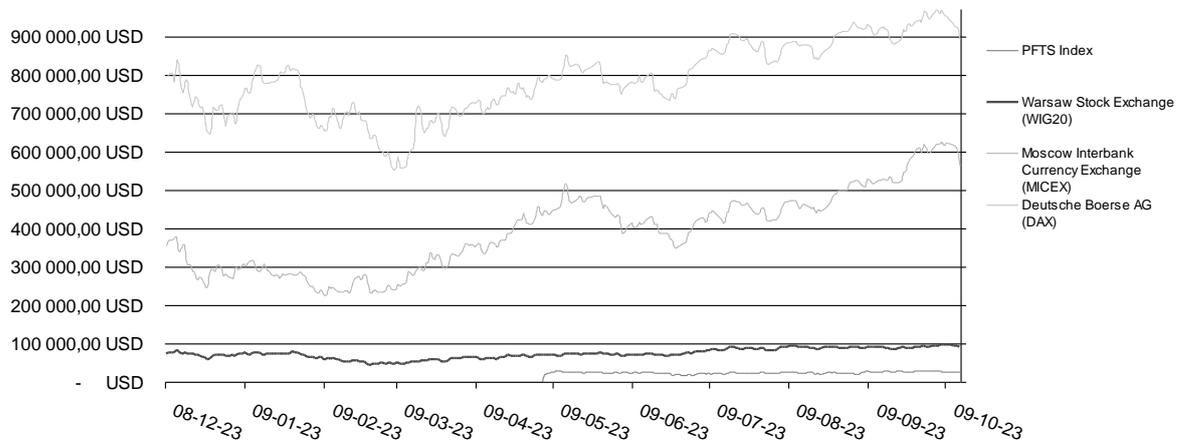
Analysed period: 28-10-2009/30-12-2008	NYSE EURONEXT	CEESEG (Vienna)	PFTS (Kiev)	WIG20 (Warsaw)	DAX (Deutsche Boerse)	MICEX (Moscow)
Average weekly rate of return	0,00544	0,01408	0,02379	0,00843	0,00521	0,02497
Risk	0,03965	0,06405	0,07973	0,05552	0,04612	0,07078

Source: PFTS, Reuters, own elaboration.

⁸Vide: Table 5.

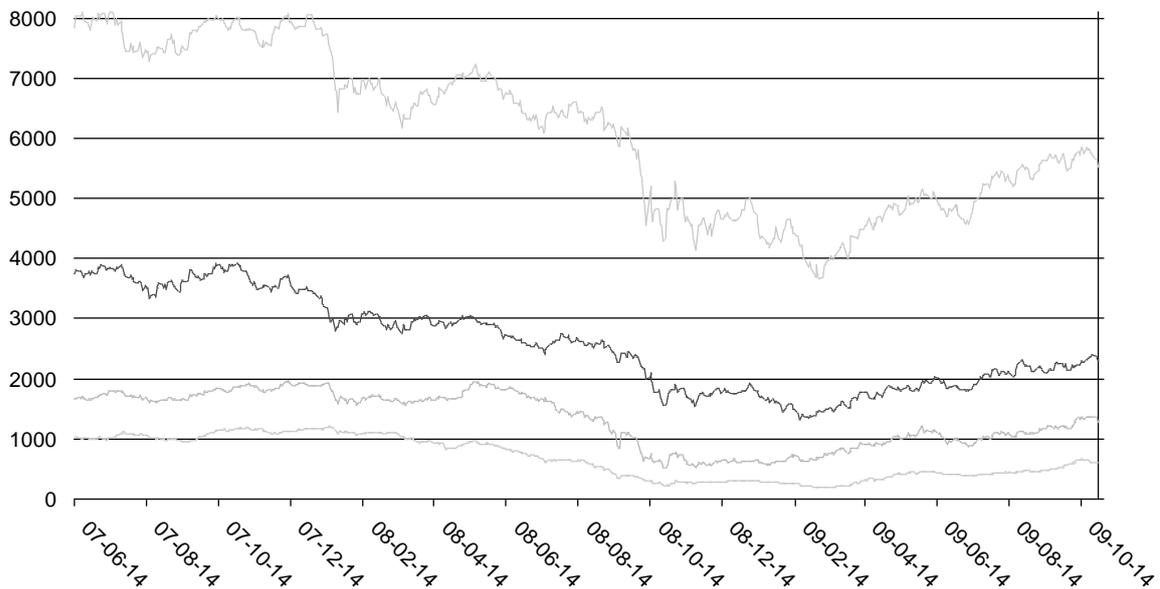
⁹Vide: 'Warsaw City Agenda 2010' ,Polish government report.

The pictures below show how the some of CEE’s stock indexes reacted on the global crisis and how they are recovering . The picture below shows how the market capitalization was changing.



Picture 1. Changes of market capitalization of regions exchanges main indices trough out time (in millions).
Source: PFTS, Reuters, own elaboration

The capitalization of PFTS is showed only from 09-05-19 due to earlier data unavailability. The picture 2 shows how the value of analyzed indexes was changing.



Picture 2. Changes of value of regions exchanges main indices trough out time (in base points)
Source: PFTS, Reuters, own elaboration.

Table 5. Number of Initial Public Offers (IPO) at European exchanges in third and second quarter of year 2009

	Number of IPO	Offer value in million EUR	Number of IPO	Offer value in million EUR	Number of IPO	Offer value in million EUR
	in IIIQ09	in IIIQ09	in IIIQ08	in IIIQ08	in IIQ09	in IIQ09
London Stock Exchange	5	873	19	945	3	258
Luksemburg	7	817	4	40	4	22
Oslo	1	84	2	19	-	-
Athens	1	10	-	-	-	-
Warsaw Stock Exchange	9	8	13	14	7	126
Spain (BME)	2	7	1	292	-	-
NYSE Euronext	14	-	20	260	6	1
NASDAQ OMX	2	-	3	15	2	28
Swiss Market	1	-	2 *	12 *	1	-
Borsa Italiana	1	-	2	9	2	16
Deutsche Börse	1	-	2	-	3	5
Irland (ISE)	-	-	1 *	- *	-	-
Wiener Börse	-	-	-	-	-	-
Europe	44	1.799	68	1.606	28	456

*The offer of Aryzta company was included whose IPO took place at two markets simultaneously - swiss and irish stock exchanges. The data in division to single markets are presented with allowance double quotations, in case of aggregate data concerning total number of IPOs and total number of double quotations, data concerning double quotations were excluded.

Source: "Ipo Watch Europe September 2009" report by Pricewaterhousecoopers.

In these charts we can observe that markets are recovering from earlier falls and are currently growing consequently.

5. State owned companies privatisation plans. In year 2010 only polish Ministry of Treasury plans to sell state owned companies of value 8,9 billion USD¹⁰, plus ukrainian and russian governments plan to privatise some of the state owned companies. If these plans would succeed it would mean a large inflow of foreign capital into local markets. Many companies could be privatised through stock exchanges which would mean larger number of companies quoted and more foreign investors on the local market. Not only the companies with private owner are supposed to become more competitive, the privatisation is also supposed to improve the meaning of capital markets in the economies. This mechanism works already and can be observed for instance at WSE, which is one of European leaders in terms of number of initial public offers (IPO) in a period. The table below shows how many new companies were noted on european exchanges in second and third quarter of 2009.

We can see that WSE was in third quarter a second european exchange in terms of number of IPO. This is derived partly from realisation of governments privatisation plans. The exchange with the highest number of IPO is NYSE Euronext which was described earlier, as a model of stock exchanges consolidation.

¹⁰ According to average USD/PLN rate from 27/11/09 - 25 million PLN for more informations see Ministra of Treasury privatisation plans for 2010.

Conclusions

Over year from the global crunch of financial markets the CEE stock indexes are again growing. This growth is derived from the size of local economies. In order to sustain that growth and draw foreign investors to the economy, the local stock exchanges must be able to compete with markets from all over the world and the global leaders. In order to do so the decision makers must firstly work on simplifying the local tax systems and invest on infrastructure, in these areas CEE countries are far behind the rest of the world according to mentioned reports. Another factor influencing the development of financial markets is the general competitiveness and access to international markets, examples of successful mergers and acquisitions of stock exchanges in Europe show that they lead to improvement of mentioned factors. The fact that Deutsche Boerse seeks to build a strong group of stock exchanges in the CEE creates a possibility of improvement of local capital markets quality.

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