STOCK EXCHANGES DEVELOPMENT: THE CASE OF BULGARIA AND ROMANIA

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Abstract

The main objective of the research paper is to analyze the development of the stock markets of Bulgaria and Romania. The research will aim at identifying the factors that influence the stock market development process in the two EC member-states following seven years of full EU membership, to outline the existing barriers at micro- and macro levels and draw conclusions. The Bulgarian capital market remains financially underdeveloped as compared to the Romanian one. The alternative for the stock market development in Bulgaria is to follow an evolutionary path similar to the Romanian stock market. The research methodology will include comparative and economic analysis on the basis of European financial integration theory and drawing of conclusions regarding stock market development tendencies.

Keywords: stock markets development, European financial integration

JEL classification: G19, G23, G29

1. Introduction

The integration processes on the capital markets of EU offer advantages as increased profitability and effectiveness, spreading and diversification of the risks and decreasing the level of information asymmetries among the parties. This process requires gradual movement to uniform and integrated financial infrastructures and strict application of the requirements of EU legislation (especially in the field of competition and tax treatment), thus leading to increased harmonization in the financial markets practices and instruments.

The Bulgarian capital market has made significant progress in the implementation of EU norms and requirements in the field of financial integration and has formulated a clear strategy for further EU integration through privatization of the Bulgarian Stock Exchange and the Central Securities Depositary. Thus, it is expected to achieve the set goals of increasing the effectiveness of the Bulgarian capital market and the supporting infrastructure. Yet this process is currently facing a retarded pace due to the political situation in the country and the various barriers that need to be overcome at institutional and microeconomic level.

Regarding the Romanian capital market it should be outlined that it is characterized with advanced structure than the Bulgarian market, with separately functioning derivative market as well, offering diversified base of traded financial instruments. The adopted strategy for the development of the capital markets in Romania has clearly articulated the way ahead for increasing the attractiveness of these markets for investors and raising the visibility of these capital markets at regional and world level.

2. Description of the Problem, Methodology and Data Sources

The research paper will aim at analyzing the current state of development of the stock markets of Bulgaria and Romania, to outline the main problems at micro and institutional level and the strategic priorities of the two markets for deepening their EU integration. The potential model for future development of the two stock markets points toward boosting the process of regional cooperation. The research methodology will include comparative and economic analyses of quantitative and qualitative aspects of the development of the two stock markets; statistical regression analysis to test for integration between the two markets as well as analysis of main factors influencing their development. Major factors for the successful development of stock markets generally relate to economic stability, predictability and growth; innovative potential; high degree of investors' protection; preferential tax treatment and favorable social environment requiring low level of corruption. The data sources for analysis of the issues include publications of the two stock exchanges, Eurostat data and information from the database of the Black Sea Trade

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and Development bank, as well as other international institutions as World Economic Forum, the International Monetary Fund, the World Bank, the European Central Bank etc.

3. Results obtained

3.1. The Bulgarian Stock Market Development

3.1.1 Current State of Development of the Bulgarian Capital Market

According to a report by the World Bank (The World Bank, 2011) the Bulgarian legislation has achieved high degree of harmonization with the EU regulations and directives in the field of capital markets. In 2014 the process for implementation of the new EU legal framework is completed (regarding short sales, OTC derivatives, central counterparties and registers of transactions, alternative trade systems etc.). This process is an important priority for the Bulgarian regulatory body The Financial Supervision Commission and for the market participants in the country.

By 2013 the Bulgarian capital market remains limited in size and insufficiently well developed as compared to the Eurozone countries and Central and Eastern European member-states. A report by the IMF (IMF Working Paper, WP 2012/131) outlines the necessity to continue development of the capital market in Bulgaria in view of accelerating economic growth and productivity through further structural reforms. It should also be emphasized that while most of the CEE countries (especially Hungary and the Czech Republic) are undergoing an intensified convergence process toward the EU economic structures, the expectations for Bulgaria are divergences from the average EU indicators to remain significantly pointed (Economic Research Institute at BAS, 2012).

The most recent report of the World Economic Forum (WEF, 2013-2014) places Bulgaria at 57th position out of 148 countries in the world according to global competitiveness index (being followed by Hungary – 63, Slovenia – 67, Croatia – 75 and Romania – 76). On the other hand, according to financial development index Bulgaria ranks 73th, after Romania (72 position), the last position in CEE being occupied by Slovenia (134 position out of 148 countries). The main problematic factors in front of competitiveness and financial development for Bulgaria remain the high corruption levels, the insufficient effectiveness of the institutional framework and the constrained access to financing. The National Programme for Development of the Republic of Bulgaria encourages overcoming these weaknesses by further optimization of the institutional capacities, active implementation of EU financial instruments for startup and growth-oriented SMEs and application of diverse policies to boost competitiveness in accordance with the principles for sustainable development. Main priority for Bulgaria will be maintenance of the macroeconomic stability and high rate of growth in the medium-term (Kalaidjieva Zh., 2012).

In the wake of the global financial crisis by 2013 the market capitalization of the the Bulgarian Stock Exchange – Sofia AD (BulEx) as a share of GDP continued its downward development and reached 12.75 %, while for 2012 it stood at 12.67% (Financial Supervision Commission, 2013) yet it remains at considerably low level as compared to the Eurozone average (for 2013 standing at 58.1% - ECB Convergence Report, 2014). In comparison, the stock market capitalization of Romania in 2013 stood even lower at 11 % of GDP. The low liquidity is the chief shortcoming of the capital market in Bulgaria. It is explained with the low volume of free float as well as with the outflow of foreign investors from the Bulgarian capital market in the aftermath of the developments of the global financial and economic crisis.

In 2013 continued to predominate secondary public placements. The main reasons for the prevailing secondary public placements continue to be the high costs relating to fees and commissions, the requirements for disclosure of information under the Law on Markets in Financial Instruments and the Law on Public Offering of Securities, as well as the lengthy procedures for approval of prospectuses. In 2012 BulEx amended its Rulebook and introduced new segmentation of the markets, operated by it. On the one side, by 2013 **BSE market** includes *Premium shares segment* (7 issues), *Standard shares segment* (90 issues), *Shares of Public Companies with special investment purposes segment* (14 issues), *Collective investments schemes segment* (43 issues), *Compensation instruments segment* (3 issues), *Bonds segment* (60 issues) and *Structured products segment* (2 issues). On the other side, **BaSE market** is designated for trades in low liquidity shares which do not meet the set requirements regarding liquidity and corporate management quality. This market is composed of two segments: *Shares segment* (226 issues) and *Shares of Public Companies with special investment purposes segment* (50 issues).

By 2013 the turnover on the regulated market of BulEx registered a rise by over 43 % as compared to the same period of 2012 due to the rise of turnover with traded shares and shares in collective investment schemes. The two main stock exchange indices SOFIX and BGTR30 marked a further push-up by 43 % and by 27.98 %, respectively as compared to 2012. As from 2012 the BulEx introduced lengthened trade sessions schedule to achieve further synchronization of trades' terms to that of European capital markets.

The implemented amendments in the National Corporate Governance Code (BulEx, 2012) are intended to reach harmonized corporate practice to that in the other EU countries through application of the "comply or explain" principle. The principle requires in case of non-observance of some of the recommendations contained in the Code, the respective public entity to outline the reasons thereof. The good corporate governance guarantees strict abidance by the requirements for transparency, public disclosure and business ethics as well as safeguarding equality of all shareholders.

3.1.2. Main barriers at micro and institutional level

Regardless of the high degree of harmonization of the legislative framework and the market practices to EU levels the capital market in Bulgaria still faces a number of barriers hindering its effective functioning after seven years of full EU membership. More specifically, **at a microlevel** can be outlined some of the following limitations: low quality of publicly listed companies taking the form in low levels of free float, low capitalization; the companies which achieve higher capitalization levels are leading players in their respective industries and sectors and are often targets of interest for large national or foreign institutional investors; low liquidity which leads to higher costs for execution of deals with predetermined volumes and rising price volatilities.

On the other hand, **at institutional level** continue to exist limitations as: lack of established adequate clearing infrastructure, which incapacitates the development of a derivative market in Bulgaria; the deliberately retarded process for integration of the central securities depositary to the European settlement infrastructures; the appreciable differences of the Bulgarian capital market as regards the developed European markets, the lack of political will for reforms of the capital market of Bulgaria etc.

The successful removal of these barriers is contingent on the leading role of market stimuli and forces through an adequate evaluation of expected costs and benefits. The institutional structures are called upon to eliminate the still remaining legal, tax, regulatory and other limitations in front of the capital market and to execute an ongoing monitoring over the market and its participants in view of preserving financial stability and prevention of systemic risks.

3.2. The Romanian Stock Market Development

3.2.1. Current State of Development of the Romanian Capital Market

In regional aspect Bucharest Stock Exchange (BSE) is an average in size stock exchange, in market capitalization being followed in Central and Eastern Europe C(EE) by Ljubljana Stock Exchange (EUR 5,1 billion) and the Bulgarian Stock Exchange (EUR 5 billion). By the same indictor ahead of BSE are Budapest (EUR 14,3 billion), Prague (EUR 21,9 billion) and Vienna (EUR 85 billion) stock exchanges (FESE, 2013). The highest market capitalization in the region for 2013 marked the Warsaw stock exchange (EUR 149 billion), while at EU level the leadership position is held by Deutsche Boerse Group with market capitalization of EUR 11,7 trillion.

In 2013 the trading turnover on BSE reached EUR 171 million, the highest being the turnover volume on regulated market (86%), followed by that on RASDAQ (5%), the bonds markets (4.5%) and the turnover on the structured products market (3.8%). As from 2011 the BSE introduced short sales transactions and increased further the number of traded derivative financial instruments aimed at adoption of hedging or speculative strategies. More specifically the issues of index-based and turbo certificates contribute to boosting the attractiveness of the structured products market.

The BSE organizes and supports the following **markets (**Bucharest Stock Exchange, 2013)**:**

- regulated spot market – encompasses trades in equities, debt securities, corporate and municipal bonds, government bonds, units in collective investment schemes and structured products;

- regulated derivatives market – offers trades in futures contracts based on equities, indices, commodities and currencies;

- alternative trade system – provides trades in foreign equities listed on other markets and securities issued by Romanian companies which do not meet the criteria for being listed on the regulated market;

- RASDAQ – offers trades in equities and rights in Romanian companies, issued under privatization programmes.

Besides the main regulated market, operated by BSE since 1997 in Romania has been functioning a derivative market SIBEX (Sibiu Stock Exchange), organized initially as a commodity exchange. The derivatives market offers trades in futures, options, binary options and contracts for differences. The futures segment includes over 15 products as futures contracts over petrol, DJIA index, currencies contracts based on EUR/ROM and on gold.

As from 2011 BSE has been added to Dow Jones Global Exchanges Index which allows juxtaposing developments in the value of shares at BSE against other regulated equities markets. Important aspects of the international cooperation of BSE are the roadshows undertaken by it to London, the USA, Canada, Austria, Egypt, Czech Republic etc. It has signed memoranda for cooperation with the stock exchanges of Bulgaria, Aman, Moldova, Vienna, Thessalonniki, Athens, Tokio, London and the BSE has been a member of the Federation of the Euro-asian Stock Exchanges since 2009. More specifically, the memorandum for cooperation with the London Stock Exchange Group involves incentives for the development of the cash market in Romania and wrapping up regular investment fora in order to increase the level of information of English investors regarding investment opportunities provided by BSE. It provides for regular seminars, tuition courses etc. for the members of the BSE as well as for access to the markets operated by the London Stock Exchange Group. The memorandum outlines the potential for development of a particular group of indices based on FTSE and prospective cooperation also in the field of clearing and settlement with the central securities depository of Romania and CREST.

The central securities depository of Romania provides settlement cycle T+3 and as from 2010 it has established operational link with US central depositories while starting from 2012 (under signed cooperation agreement with the Bulgarian central securities depository) it has been in process for the development of direct access link with Bulgaria. This link will allow possibilities for dual listings and cross-listings of equities on the two markets.

In 2012 BSE introduced the first Romanian exchange traded fund for collective investments in transferable securities on the regulated market and the fund tracks the development of the leading stock exchange index BET (Bucharest Stock Exchange, 2013). As from the middle of 2014 the stock exchange of Bucharest expects to implement the calculation of two new indices. On the one hand, BET Total Return Index will take into account the dividend payments of companies by encouraging issuers to follow a stable and foreseeable dividend policy and increasing the attractiveness of the local capital market. On the other hand, BET Plus Index will track the performance of issuer companies which from the point of view of their liquidity have lower value than those companies, included in the main stock index BET, and an important requirement will be these issuers to maintain minimum freefloat of at least EUR 1 million (Bucharest Stock Exchange, 2013).

3.2.2. Main barriers and micro and institutional levels

Irrespective of the high degree of harmonization in the regulatory and legal framework with EU requirements after seven years of membership of Romania in EU still exist various barriers in front of the effective integration of the Romanian capital market which basically relate to market practices and tax treatment. The institutional investors have an obligation to submit significant volume of documentation in opening of account for trade in securities. This leads to additional transaction costs and impacts negatively the size and the market liquidity (Bucharest Stock Exchange, 2013).

Apart from this, tax procedures in appointment of tax agent, tax registration and disclosure are very burdensome, irrespective of the fact that Romania has concluded and maintains active double taxation agreements with over 80 countries. The tax procedures are complicated and give rise to problematic issues connected with their interpretation. On the other side, there exist linguistic problems and complexities in the communication between foreign investors and the local tax authorities (Diaconu I., Tudor M., 2014).

The Romanian capital market remains one of the most expensive in CEE from the point of view of fees and commissions, imposed by the stock exchange and the Financial Supervision Commission. This leads to direct tentative effect on the establishment of market prices. The existence of such costs further encumbers the process of restructuring and diversification of investors' securities portfolios.

3.3. Factors Influencing the Development of the Romanian and the Bulgarian Capital Markets

According to a research (IESE Business School, 2010) the six most important factors which determine the relative attractiveness of the capital market of a given country for investors (domestic and foreign) relate to the following:

1) ***Economic activity*** – this includes level of economic growth and GDP, inflation, net flows of foreign direct invetsments etc.

Over the period may 2013 – April 2014, 12-month average rate of HICP inflation in Romania was 2.1 % (above the reference value of 1.7 % for the criterion on price stability). Real GDP grew by 3.5% on average in 2013 after a very moderate 0.6 % in 2012. Net flows of FDI progressively fell after the start of the global financial and economic crisis and by 2012 stood at USD 2,071 million according to data from the Black Sea Trade and Development Bank. The government budget balance showed a deficit of 2.3 % of GDP, below the 3 % reference value. The general government gross debt–to-GDP ratio was 38.4%.Long-term interest rates were 5.3 % on average for the above-stated period.

In Bulgaria The Currency Regime introduced in 1997 guarantees the preservation of financial stability. The reported budget deficit for 2013 amounted to 1.5 % of GDP and remains sufficiently below the EU reference value of 3 %.The ratio gross domestic debt to GDP by 2013 stood at 18.9 %, sufficiently lower than the EU reference value of 60 %. The long-term interest rate in 2013 stood at 3.5 % staying sufficiently below the EU reference value of 6.2 % according to the criterion for interest rate convergence. The same applies for the level of inflation, which kept falling down from 3.4 % in 2011 to 0.4 % in 2013. Real GDP groth rate overcame the negative tendency of -5.5. % in 2009 and gradually started rising from 0.6 % in 2012 to 0.9 % 2013.

2) ***Entrepreneurial culture*** – capacity of the country for innovations, R&D costs, etc.

R&D expenditures in Bulgaria for 2011 were 0.60% of GDP and according to this indicator Bulgaria lags behind the average EC-28 value of 2 % for 2010, and according to the National Framework Programme Europe 2020 this indicator should reach between 1.4 % and 2 %. Romania plans to increase R&D expenditures to 2 % of GDP by various stimuli for boosting private investments in science and research and along the lines of the utilization of EU funds. According to EU Innovation Union Scorboard (2011) Bulgaria and Romaina are in the goup of “modest” innovators. The share of innovative enterprises in the total number of SMEs in Bulgaria is 27 % and is the lowest among EU-28 member-states, the highest share of innovative SMEs in EU-28 being in Germany (79.3%).

3) ***Depth of the capital market*** – relates to the existence of well-developed capital market measured by the market capitalization or the number of listed public companies. The predominance of bank-based financing is a sign of weakly developed capital market, which restricts the entrepreneurial activities due to the conservative approach of banks to financing.

The market capitalization of the Bulgarian stock market shows progressive decline in recent years from a peak of 48.2 % of GDP in 2007 to just 12.7 % at the end of 2013. By 2013 the number of listed companies on regulated market was 24. Bulgaria’s financial sector is bank-based with credit to non-governmnent residents increasing very rapidly between 2004 and 2009 and amounting to 70.8 % of GDP in 2013.

In Romania stock market capitalization stood at 11.6 % of GDP in 2013, compared with 17%-18% that Romania generated during the period 2005 – 2007 in view of the financial expansion prior to the global financial and economic crisis. By 2013 the number of listed companies on regulated market stood at 84. Bank financing as measured by credit to non-governmnent residents being 34.8 % of GDP in 2013 points to a more balanced structure between bank-based and stock market generated financing.

4) ***Protection of investors and corporate governance*** – the presence of stable legal framework which safeguards the rights of investors and high corporate culture. The stock markets of both Romania and Bulgaria have established well-based market practices for protection of investors through adopted and maintained Corprate Governance codes, which is an important factor for boosting the competitiveness of these capital markets.

5) ***Taxation*** – the low tax rates of corporate tax and more tax preferences are also significant factor for encouraging the investments on the capital market.

In Bulgaria the uniform tax rate of 10 % (equally applied to personal income tax and to corporate income tax) is lower compared to other EU countries.The capital gains tax is 10 % accrued to non-resident entities and there is 5 % withholding tax on distribution of dividends to residents and non-residents (excluding for EU/EEA entities). In Romania there is uniform capital gains and dividend witholding tax of 16 %.

6) ***Social envirnoment*** – level of corruption and size of unregulated (grey) economy etc.

According to the Global Perception Index, which measures the perceived level of public sector corruption on a scale of 0-100, where 0 means a country is perceived as highly corrupt and 100 means a country is perceived as highly clean, Romania occupies 69th position (score 43), followed by Bulgaria on 77th position (score 41). Ahead of them in CEE are Czech Republic (score 48), Hungary (score of 54), Slovenia (score of 57) and Poland (score of 60).

In a research (The Shadow Economy in Europe, 2013) of Visa Europe among all 31 countries Bulgaria has reported the highest share of grey economy of 31 % of GDP, while Romania has achieved 28 % share (similar to that of Slovenia,Turkey and Lithuania). The lowest share of grey economy in CEE maintain Slovakia (15 %) and the Czech Republic (16%), whereas the European average share is 18.2%.

According to conducted correlation and regression analysis (Stefanova J., 2014) of the stock exchange and economic indicators of the capital markets of Bulgaria and Romania for the period 2007 – 2013 regarding the existence of integrational dependencies on the two markets (see Table 1 below), it has been established as follows:

1. There exists significant degree of correlation between the Bulgarian stock exchange index SOFIX and the Romanian index BET (correlation coefficent of 0,69) and up to 48 % of the changes in the SOFIX can be explained by variations in the Romanian leading index.

2. During the seven-years' period of membership in EU, the market capitalization of the Bulgarian stock market progressively falls (from EUR 15 billion in 2007 to around EUR 5 billion in 2013) and by 2013 represents around 10 % of the market capitalization of the Bucharest stock exchange (for 2013 it stood at EUR 69 billion).

3. The long-term interest rates of 10-years' government bonds of Romanina and Bulgaria also show strong correlation links (correlation coefficient of 0,94) and 1 % change in the Romanian long-term interest rates is associated with less than 1 % variation in the Bulgarian long-term interest rates, respectively.

4. Foreign direct investments in Bulgaria and Romania follow falling trend as from 2007 onwards and by 2012 in Bulgaria they stood at USD 2 billion, while in Romania – USD 2,1 billion according to data from the Black Sea Trade and Development Bank.

Table 1

Main Economic Variables

Foreign Direct Investments			Long-term interest rates (yield on 10 years' government bonds)		Real GDP growth		Bucharest Stock Exchange	Bulgarian Stock Exchange
Year	**Romania (USD million)**	**Bulgaria (USD million)**	**Romania (%)**	**Bulgaria (%)**	**Romania (%)**	**Bulgaria (%)**	**BET Index**	**SOFIX Index**
2007	10.290	13.875	7,13	4,54	6,30	6,45	9,825	1,767
2008	13.849	10.296	7,70	5,38	7,30	6,19	2,901	3,580
2009	4.926	3.896	9,69	7,22	-7,10	-5,50	4,690	4,290
2010	3.204	1.866	7,34	6,01	-1,10	0,40	5,268	3,620
2011	2.557	2.096	7,29	5,36	2,20	1,80	4,336	3,220
2012	2.071	2.046	6,68	4,50	0,70	0,80	5,149	3,450

Source: the author according to data from the Black Sea Trade and Development Bank

From the above-stated it can be concluded, that the stock markets of Bulgaria and Romania are strongly correlated, yet the Bulgarian capital market remains insignificant in terms of market capitalization and volume of traded financial instruments. According to a research (Armeanu D., Burca A.M, 2013) for the period 2007 – 2012 is confirmed relatively strong correlation between the Romanian index BET and EUROSTOXX, while another study (Minjina D., 2010) for the period 2004 – 2009 also established increasing correlation between BET and the Polish WIG (correlation coefficient 0,59 for 2009), the Czech index PX (correlation coefficient 0,60 for 2009) and the Austrian index ATX (correlation coefficient 0,54 for 2009), which can be explained by the rising presence of foreign investors on the Romanian stock market.

The status of a public entity of BulEx is part of the strategy of the stock exchange for its development, raising the transparency in its operation and last but not least for further provision of market liquidity. This process is in accord with the tendencies in Western Europe for transformation of stock exchanges in public shareholding entities mainly along the lines of their privatizations. The increased state share from 44 % to 50 % plus one share aims at blocking attempts from hostile takeover of the stock exchange. The public flotation of the shares of BulEx is driven by an incentive for raising transparency and enhancing liquidity of its own shares. The prospective strategic alliance of BulEx with foreign-owned stock exchange can be expected to lead to improved public wellbeing and raised consumer surplus in the long run in accordance with public well-being theory.

The adopted conception for integration of BulEx and the central securities depositary of Bulgaria for further integration through initiated privatization procedure in 2012 aims to increase the effectiveness of the Bulgarian capital market through «...its consolidation with a world or European leading exchange operator or exchange alliance» (BulEx, 2012).

On the other hand, the strategy for the development of the Romanian capital market (Bucharest Stock Exchange, 2014) identifies seven systemic barriers for the creation of modern capital markets in Romania among which are difficult access to the market, complicated requirements for fiscal compliance of investors, unclear taxation issues relating to capital markets transactions etc. The successful removal of these barriers would increase investors' confidence and raise their interest in the Romanian stock market, thus leading to greater visibility of the market on regional and world level and to potential reclassification of this market by Morgan Stanley Capital International from Forntier to Emerging Market.

4. Conclusions

The Bulgarian and Romanian capital markets remain limited in size and insufficiently developed as compared to Central and Eastern European capital markets. Main problematic factors in front of their competitiveness and financial development remain the high level of corruption, insufficient effectiveness of the institutional structures and the restrained access to financing. Irrespective of the high degree of harmonization of the legal framework to that of the EU, seven years following membership in EU there continue to exist numerous obstacles in front of the effective functioning of these capital market at micro- and institutional level.

The potential model for the future development of the Bulgarian and the Romanian capital markets passes along an evolutionary organic overcoming of their intrinsic limitations through various forms of regional cooperation and integration. Main prerequisites for the success of such an integration model is the high degree of legal harmonization with EU requirements and the potential for implementation of unified market practices, establishment of links between the exchanges' trade systems, introduction of common quotation rules, clearing and settlement processes.

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