FINANCIAL MARKET DEVELOPMENT IN TRANSITIONAL COUNTRIES

EMERGING CAPITAL MARKETS DEVELOPMENT, WITH SOME FOCUS ON SLOVENIA

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I. FOREWORD WITH SOME INTRODUCTORY THOUGHTS

According to Ribnikar (1994), the financial sector mirrors the real sector. You cannot have very developed financial sector and underdeveloped real sector at the same time. The formula simply does not exist; while, vice versa, to a certain extent it does. Nevertheless, a developed financial sector can efficiently support real sector. This paper will discuss and analyse the emerging capital markets development in general and in some specifics, and later with some focus on Slovenia. Slovenia represents a small and relatively successful transitional economy.

The main thesis of this paper is that there is no international without national although this situation sometimes might exist without any real rational reason to support it. There are reasons like culture, ethic, mentality, intellectuality etc., which are often beyond economic rational (or Smith's »Homo economicus«) paradigms. This paper is an attempt at establishing this thesis, which was often discussed also in some other circumstances such as when former countries of the Soviet Union, Yugoslavia, and Czechoslovakia broke up. There were no rational economic reasons behind it except the fact that the break-up partly happened because of the economic inefficiency of the communism and/or socialism. Yet, again, economic inefficiency was due to socialist non market-oriented economies. Once more, there is a problem. These countries might not have disintegrated, had they had market-oriented and efficient economies. However, many could not understand and probably still do not, how could such a small territory (from their point of view) like f.e. (former) Yugoslavia break up to many smaller internationally recognized countries. My claim is that in the future, most of these entities will be joined again under some or other rational economic reason, if not earlier than when they are all members of the European Union (EU). The same goes for the Czech Republic and Slovakia. Some other reasons might trigger the process in the ex-Soviet Union where not necessarily all ex-Soviet republics would join

together in any closer/tighter formation of economical and/or political union or even join EU in the long run at all.

The paper starts with different definitions on what the transitional or emerging countries and their respective financial markets are. The text continues with different groups of definitions concerning development problems (factors) that world and European transitional/emerging stock markets encounter. I try to answer why do the transitional economies need stock market and how and why to start a stock market. I am also trying to embrace some future prospects of these markets as well. Finally, there is analysis of the capital market situation and prospects of one of the world's most successful transitional economies of Slovenia.

II. TRANSITIONAL ECONOMIES, TRANSITIONAL FINANCIAL MARKETS

There is a relatively good and acceptable definition what are the transition or transitional, emerging or even middle and low income economies/countries. World bank, for example, defines middle and low-income economies. The adverb "transitional" is here used in the sense that such countries are transitioning from a low or middle income status to a high one (which means something above 10,000 USD GDP p.c. p.a. – precisely 9,656 USD GNP p.c. p.a., in 1997), although I claim that some other factors should be observed as well. Approximation, however, is relatively good (not in the case of Slovenia f.e., though – Slovenia is already in the world's high income bracket but still transitional and emerging). The adverb "emerging" basically stands for such countries, which are fast growing from non-desired (low and middle income) to desired (high income) status. Only 25 countries worldwide may claim holding such status (Emerging Stock Markets Factbook 1999). It has to be pointed out that not even all the OECD members are able to hold that claim. According to the IFC methodology, emerging stock (or capital) markets are those which fulfil at least one of the two following criteria:

- its country has been low or middle income for at least one in the last three years or
- its investable market capitalization is low if compared to its GDP figures (basically again for at least one in the last three years).

Investable market capitalization is the one which can be freely invested in by residents and non-residents.

These two criteria cannot work in all cases, but generally they are good and acceptable. The rule, however, does not function in the case of relatively important stock markets in less developed countries and in high income countries with the less developed financial markets, possibly in some other instances as well.

FIBV (Federation Internationale des Bourses des Valeurs; International Federation of Stock Exchanges) used to have and sometimes still has problems defining an emerging market and/or differing it from a developed one. Basically, it employs criteria similar to those of IFC although at the same time, also adding some more precise ones of its own as well. Next to rather

general IFC criteria, FIBV additionally includes the quality criteria of national and/or local stock markets (quality of regulation, clearing, settlement, management of the market, legal system, listing criteria, technological set-up, overall condition of the country, etc.), which are all very thoroughly examined by special independent reporters and on-the-spot inspections). GDP p.c. is with FIBV not necessarily being one of the paramount criteria. Very important factor is also volatility (International Federation of Stock Exchanges, 2000), although especially in 1999 and 2000, there was no telling whether or not it was capable to differentiate among the emerging stock markets' volatility and that of the developed markets. However, there are some countries which entered the FIBV developed markets scheme, but did not enter even the IFC emerging global indices IFCG nor investable index IFCI, not to mention the IFC developed countries schemes (Bermuda, Slovenia, Malta, Iran). On the other hand, there are few countries, which entered IFC indices but did not fulfil strict criteria to become full members of FIBV (China, Sri Lanka, Czech Republic, Hungary, Russia, Slovakia, Egypt, Jordan, Morocco, Nigeria, Saudi Arabia, Zimbabwe and to certain extent Cyprus).

Generally speaking, we could conclude that FIBV applies more strict and more quality based capital market criteria than IFC.

Fast growing emerging markets still do not play any really important role in the world of finances as a whole. Their equity market capitalization (end of 1998) was approximately 2,000 billion US dollars (7% of the world total); the developed market capitalization (28 countries) was app. 25,500 billion USD; world total market capitalization was app. 27,500 billion USD (Emerging Stock Markets Factbook 1999). Their highest share in the world market capitalization exceeded 10% (13% the highest spot) in certain years in the 90s. We get almost the same proportions if comparing the values traded (1998 – world – almost 23,000 billion USD; emerging almost 2,000 billion USD) – the highest being almost 20% world share and the lowest below 10%.

III. DEVELOPMENT PROBLEMS (FACTORS) OF THE WORLD AND EUROPEAN EMERGING STOCK MARKETS

1. WHY DO THE TRANSITIONAL COUNTRIES NEED A STOCK MARKET

European emerging stock markets derive from their emerging and/or transitional economies/countries. Today, transitional/emerging country in Europe is almost a synonym for an ex-socialist or even communist country, although there are also some exceptions to the rule (Cyprus, Malta, some regions in the most developed European countries/economies). The emerging financial, capital or stock markets all derive from that fact. More than ten years ago, there were not any. Now, they are growing fast, evolving from literally nothing. In many cases, governments, after starting (in many cases) from the scratch to start creating modern and more importantly, efficient economic systems, challenged stock exchanges to prove their strong attitude and desire towards (very) market oriented economies. Some of the stock markets and exchanges (bourses) created in this manner started with almost no trades and

listed companies. Models of mass privatisation schemes in almost all European transitional/emerging countries changed the situation notably. If there is mass privatisation going on in certain country, there is certainly need for an organized equities market. Furthermore, there are some other reasons why these European emerging stock markets are gaining on their importance. The reasons are:

- (mass) privatisation processes,
- creation of public debt,
- (to a certain extent) needs of the companies to raise fresh money,
- (partly and indirectly) development of the money market,
- attracting foreign (portfolio and direct) investments,
- the need to further deepen and enlarge financial markets (underlying and later derivative instruments, money market, banking sector, etc.),
- globalisation and securitisation as the world processes.

Almost certainly the most important factor is (mass) privatization and there is not much to be added here.

Public debt existed in these countries even prior to that, but with the development of the capital market, the latter gradually acquires its (securitised) form and shape, and it also gives further possibilities to governments to manage it better.

Primary market presents a problem in almost all European emerging markets because privatisation burdened supply on the market with the privatised companies. Some markets are better off with this factor (Poland f.e.) and some not (Slovenia).

Indirectly, stock market development can be advantageous to the development of liquid money market as well. Money market can be widely used by the central bank and the government's treasurer on one hand, and by the banking sector and the commercial legal entities on the other hand.

Transparent and efficient stock market is a good way of promoting not only foreign portfolio but (indirectly) also direct investments. The latter can enter the country and companies through the primary and/or later through secondary market and of course independently.

The development of the stock market generally also causes further development of the financial sector within the country. It can be a good basis for the development of other financial instruments such as derivatives, money market instruments, etc. It also stimulates banking sector to be more flexible and competitive.

Globalisation and securitization are global processes. Sooner or later, the emerging countries will be involved even deeper, which means that they should be already thinking about that.

The above-mentioned reasons and comments are really valid for most if not even all European emerging stock markets. However, there are few of them

which do not match the descriptions above. Where do these stock markets really belong, we might ask ourselves? The countries I have in mind are Greece, Portugal, Cyprus, Turkey, Malta and to a certain extent also Poland and Slovenia? IFC places them to the group of the most developed emerging markets (except Slovenia, which is in the group of the so called IFCG Frontier Composite Index countries – second group and Cyprus, which is in the developed countries' group), while with FIBV, they are in the group of its full members (basically, they belong to the most developed markets; except Cyprus). Au contraire goes for the Czech Republic, Hungary, Russia and Slovakia which are all in the group of the most developed emerging countries within IFC, while at the same time not being full members within FIBV.

The main problems of the world emerging stock markets are not necessarily the same as those of the European ones. Admittedly, some are the same, but many, in view of the above described situations (starting from the scratch ten years ago) are not. Likewise, the latter are also faster growing.

2. HOW TO START A STOCK MARKET

Small and/or emerging (in my Ph.D. thesis paper, I proved that some problems of the small developed financial markets were the same as those of markets which were perhaps big (or in a big country) but less developed; Veselinovič, 1998) national economies have to decide or better see, whether they need a stock market at all; is there going to be (mass) privatisation or not; is there proper regulation in place and similar. How developed and how powerful is the banking sector? If they reach a favourable decision, the important factors regarding how, why and when to start organizing stock market (including stock exchange, as well) are:

- type and timing of privatisation,
- (proper) regulation (neither over- nor under-regulation),
- status of banking sector (healthy, bad debt problems, expensive, governmental support(ed), etc. or not),
- clearing and settlement procedures (dematerialised, immobilized or materialized environment),
- on and off exchange trading and/or central market place,
- market segments, listing requirements (basic concept: strict and/or loose requirements in different segments or not),
- quote (price) vs. order driven, continuous vs. »fixing«
- market making,
- available technology.

Do small and/or emerging countries need (an organized) stock market at all? J. E. Stiglitz (1995) claimed that stock market is irrational and inefficient (by definition) in the emerging economies. The savings put through the stock markets are irrationally allocated, and consequently, negatively contributing to the GDP growth. Stiglitz's idea was partly introduced in the Czech Republic (V. Klaus, 1994; D. Triska and M. Simoneti, 1994) together with the complete liberalized economic and political model of almost everything. At the beginning, there was »no need« for a stock exchange at all. However, later on things changed substantially for the Czech Republic introduced a stock

exchange and tried to introduce some regulation as well. Liberalized model of everything was trying to move towards a more controlled and regulated one. Several problems started popping up, though. Longer period of disorganized and non-regulated or to put it differently, partly organized and just partly regulated equities trading through the so-called OTC market (RM system) left many negative consequences in mid-nineties, and these have not been completely repaired. Naturally, there are also many other famous economists who, unlike Stiglitz, think that stock market is needed for the emerging economies. (See, for example, the old book issued in honour of E. S. Shaw and edited by R. I. McKinnon (1976)).

According to W. Bishop (1989), there are many important factors to be considered when taking a decision on the model of a stock market (exchange). Let us analyse the most important ones. If there is going to be mass privatisation scheme (vouchers or any other form of the so- called mass privatisation methods; Pirie, 1991) introduced in the country then any organized forms of the stock markets are advisable if not even necessary. In the long run, there is a question whether such markets are necessary after the privatisation is completed, and similarly, also ownership restructuring and/or concentration. In that case, of course, the organized stock markets have to perform their fundamental functions (primary market, proper signals to the national and international investment community). We will return to that issue later on.

Some stock markets tend to over regulate themselves at the beginning, and this may kill the market, while others do not regulate the market properly, and what is more, do not regulate it enough. This can cause several irregularities which, again, can cause mistrust in the market and even in the financial system. It is impossible to formulate exactly what optimal <u>regulation</u> is. Each market has to have a certain regulatory governmental or quasi-governmental body with every possible right to intervene at the market if necessary (agency, commission); also at a stock exchange which should likewise have some regulatory authorities. The self-regulating role of the market (stock exchange, central depository and/or registry, associations of brokers, dealers, investment societies, and similar) can grow with its overall development. Similarly, the overall regulation must also grow with the market. It has to prevent the irregular behaviour of market participants but, once again, it should not kill the market.

Furthermore, status of the <u>banking</u> sector is a very important factor. Usually, it represents the traditional way of national saving; investments in the country are being financed through banking credits. This sector is usually very slow in changes, it needs governmental help in its restructuring (bad debt problem), it is inefficient (in absolute and international terms) and expensive. It is not against stock market but in fact it does not really support it. Sometimes it can be quite corruptive as well. When starting a stock market one has to be aware of this factors regarding banking sector, which can be very influential.

Proper <u>regist(e)r(y)</u> of securities has to be in place as well. One has to win the confidence of the public through proper registration and transfer of securities.

Dematerialization of all issued securities is highly recommended. If this is not possible, be it due to whatever reason there is, at least the issued securities should be immobilized. Materialized environment is, of course, traditional and irrational.

The emerging markets should regulate the off-exchange trading strictly, there being several many good reasons. The virtual central market place for listed securities gives better liquidity and transparency of the market which are so badly needed. The discussion of to what extent do the electronic communications networks (ECN's) and/or alternative trading systems (ATS's) and to what the stock exchanges control markets is in this context maybe artificial and not so important. Rice (1999) claims new technology brings also new financial instruments but new emerging markets should focus on basic instruments and their (centralised) liquidity first. The question of alternative ways of trading applies later.

How to organize different market segments within one single market in a country?
The experience shows that there should not be many different organizers of different market segments. This, namely, additionally burdens the cost of market infrastructure of the country which usually does not have proper capital market infrastructure in the first place. Clearly enough, there must be instruments in place which prevent monopolistic pricing of infrastructure organizers. Infrastructure should be single but divided to different market segments, varying from very strict to more flexible (listing requirements) ones. The idea is about a central market place with proper infrastructure which should be divided to different market (listing) segments. Disclosure of information should be relatively strict for all listed companies in different segments. Small emerging countries which doubled or even tripled their infrastructure and their organizers actually increased the costs of trading (Croatia). An interesting and a very demanding study was made by M. Malkamaki (2000) who proved that not necessarily does the so-called relative efficiency of individual stock exchanges increase with size. The Irish Stock Exchange is very efficient although being relatively small, the same goes for New Zealand SE, while AMEX is the most inefficient although being a relatively big market.

The way trading itself is organized depends on many circumstances. Two obvious methods are price- or quote-driven on the one hand, and order-driven on the other hand. It seems that the official quote- or price-driven system somehow loses its ground due to the revolutionary technological changes (internet), although the informal methods are still in use in many markets (London f.e.). Direct order-driven system is simpler, easier to handle and probably more transparent. Whether it provides better or worse liquidity is still to be established. Theoretically, both extreme ways of trading can have continuous or one or many auctions per day version. There are maybe also ways to combine both methods and thus perhaps achieve some extra value. Developed and liquid markets may have more options what to do and what kind of system to choose. They are able to analyse some details that might be irrelevant for smaller emerging markets. Read R. A. Schwartz (2000) about

dilemmas on how to build a better stock market with (possible) call auction alternative in the United States of America. Advice for smaller and/or emerging markets would be a continuous trading system for liquid stocks, one auction (fixing) per day for illiquid stocks and for those in between maybe few auctions (fixings) per day. Whether to go for direct (order) or indirect (quote or price) way of trading is still to be determined. It also depends on some other circumstances such as sophistication and risk taking awareness of financial intermediaries, financial soundness of the intermediaries, small or big investors market, etc. Nevertheless it seems that direct trading system has more advantages (FESE, 1999).

The system of market making might provide better liquidity of the market but it is usually very difficult to get (and consequently to be active) market maker on a volatile emerging market.

When you reach a conclusion about all other factors and decide on how to construct them, technology is the final decision to be taken. It comes as a result of all previous decisions. Since technological revolution is, undoubtedly, taking place this is not an easy decision to take. You have to take into account also technical conditions in a particular country (especially telecommunications, programmers, etc.) compared to requirements of different technologies. Electronic trading is, without any doubt, the right decision and almost the only one nowadays; the dilemma might be whether to trade electronically on the »floor« or to employ the remote method. This question goes together with the telecommunication infrastructure quality in the country, logistical and other customs of a financial community.

3. PARAMOUNT PROBLEMS OF THE EMERGING STOCK MARKETS

The biggest problems of the world emerging markets are:

- volatility,
- liquidity,
- companies and capital drain,
- generally instable economic conditions and bad (instable) macroeconomic performances,
- accounting and auditing standards,
- inefficient legal and ethic environment, corruption, mistrust in the financial system,
- integration in international environment.

The biggest problems of the European stock markets are, apart from those pointed out above, several additional issues regarding the embryo stages of development of those markets and their relatively inexperienced environment. As already mentioned, these markets started from the scratch less than ten years ago (officially, the first was Slovenia, in 1989). Their development was a very fast one (compared, perhaps, to several times ten years in developed countries) but nevertheless, the continuous tradition, knowledge and experience are simply not there.

I would like to comment now on the above-mentioned factors in some detail. Volatility is always a problem in the small and/or emerging markets. Due to the above reasons, markets are volatile which additionally brings mistrust of the people. However, in 1999 and in 2000,volatility has been also the problem of the developed and even the most developed markets (NASDAQ f.e.).Volatility and liquidity have to be observed each next to each other. Developed markets may be volatile but liquid, while emerging markets might be volatile also because they are illiquid which is a very important distinction.

Bigger and internationally important local companies usually claim that the local markets are too small (volatile, illiquid) for them so they seek original listing, parallel listing or the so-called global depository receipts (GDR) programmes abroad. There are some studies that are trying to establish that foreign listings and GDR programmes are benefiting local markets with additional liquidity. Such studies were done by the (G)DR organizers such as the Bank of New York (Depositary Receipt Issuers' Guide for Central and Eastern European Companies, 1998), and the Bankers Trust Company (Liquidity Analysis – Case Study of the Effect of DR Issuance on Home Market Liquidity, 1998). However, universal unbiased judgement would be that (G)DR programmes are actually “sucking” liquidity out of local markets. On the other hand, there are also cases about (G)DR's returning back home (Oyens, 1997). One such typical example is Malta's Telecom originally listed in Malta and being GDRed in London. It originally started with 20% of the all listed capital in London, while there is today less than 10% left in London. There is also a capital drain effect present in emerging countries, due to nearly all reasons mentioned above. However, there is also capital inflow occurring the other way round (foreign portfolio investments seeking opportunities). Some countries set some restrictions for portfolio inflows even prior (Slovenia) to the world turmoil in late nineties and some afterwards (Malaysia).

Some macroeconomic instabilities and generally instable macroeconomic conditions prevent faster and more efficient development of the local stock markets. Nothing particular to add here.

Proper and trustful accounting standards and auditing practices in accordance with the international standards are an absolute must for the development of a stock market. In many countries, however, this might prove to be a problem.

Legal issues might be problematic in many emerging countries. This goes sometimes with local ethic(al) standards as well (Steinmann and Veselinovič, 1999). Corruption is an even more serious problem (Meško, Anžič et al., 2000). Some of the emerging countries top the corruption list.

Integration to the international environment is, in the long run, probably the crucial issue for all small and/or emerging countries. It all seems this is extremely important for all (developed and developing) European countries and markets. In year 2000, the developed European markets are intensively focusing on allying, merging and cooperating. London - Frankfurt (with Vienna, Dublin) and Paris – Amsterdam – Brussels (Luxemburg) to mention

only the already – as it seems - concluded deals. Others also seem to be thinking of joining soon any of the options. Luxemburg teamed with Brussels and Amsterdam, Vienna and Dublin with Frankfurt, Scandinavians seem to be comfortable on their own (the Baltic countries likely to join), Milan and Madrid probably joining London – Frankfurt ox, etc. We might end up with one big »superbourse« or »paneuropean network«. The developed Europe (especially countries within the European Monetary Union (EMU)) is catching up with the United States of America as far as the financial markets developments are concerned (Bourses for courses, 1999). However, according to P. Camus (1999), all the discussed teaming up of different important European stock exchanges does not meet enough new technical and/or technological factors, and it is due to the new technologies that the future of any stock exchange might be in question. On the other hand, even authors somewhat orthodox such as Rice and Oyens, do not see the future of stock exchanges in such terms. Technologies might differ but selection, listing, disclosure, certain regulation, and information will still be required. All these and more will be provided by the stock exchanges.

3.1. EUROPEAN EMERGING MARKETS' INTEGRATIONS

European emerging markets must be very flexible and be able to adopt to these »European« circumstances which will not be an easy task. Many of them have quite a lot of existential problems of their own. And, as pointed out before, there are many matters that have to be sorted out before reaching a status of development. How can you team up with a developed exchange on an equal basis if you are objectively not equal (you are less developed) to it? There is a problem more on the side of emerging markets. For one thing, they can perhaps intensify mutual cooperation while, at the same time, each of them competing against each other in acquiring favourable position in joining the developed sooner or later. Such relations exist, for instance, among the so-called Vishegrad group of countries (Poland, Hungary, the Czech Republic, Slovakia and Slovenia) which also teamed up in the common CESI index, and even more in the CESI movement which is only just taking shape. Most of them (except Slovakia) are the first round candidates for full membership in the EU. In contrast, there is wider political initiative called SECI (South – Eastern Cooperation Initiative) which involves certain countries from that part of Europe. Bear in mind also the SEE (South - Eastern Europe) initiative or the so-called Stability Pact (also "nicknamed" the new Marshall plan for SEE which includes Albania, the ex-Yugoslavian countries with the exception of Slovenia, it also includes Bulgaria, and Romania) and (again) a wider initiative within FEAS (Federation of European - Asian Stock Exchanges) which focuses on east Balkan, the southwestern territories of the ex-Soviet Union, western Asia and even some parts of Middle East. Turkey is trying to widen its sphere of influence here. Slovenia is playing very important role in SEE or the Stability Pact (Škoda, 2000) and partly in SECI, as well. There are some other initiatives like the Austrian attempt to act as the regional centre for the most important public companies from the southeastern European region – the role so far quite successfully cast by London, and partly also by Frankfurt.

We can divide stock exchanges to three different types: global, regional and local. Global are big international exchanges in international financial centres attracting the biggest part of local, regional and global capital and companies. Regional exchanges are those who are too small to be global and too big to be only local. They are able to attract regional capital and companies. Local exchanges are usually very national in case of small countries or very regional in case of bigger countries. They are small players which focus on the local scene.

3.2. FUTURE FACTORS OF DEVELOPMENT OF ANY STOCK MARKET

Emerging markets in Europe will be either regional or local. They will have to integrate sooner or later into the globalised (European) markets. It depends on what kind of position they can achieve or they can have. This depends on their local or regional status. Possibly, they will lose some global companies and remain regional, local financial centres or/and networks. However, there are a few factors, authored by Malamaki and Topi (1999) which have to be recognized for the development of, I believe, any future stock market:

- increase in cross border investment activities and enhanced competition between marketplaces and providers of financial services;
- the growing involvement of the biggest institutional investors in direct trading, which is leading to efficient and cost effective trading infrastructures;
- a tendency towards a more integrated trading and settlement infrastructure via mergers, alliances, links, agreements or other forms of cooperation;
- the emergence of new electronic exchanges and alternative trading systems operated by members of stock exchanges or off-exchange companies;
- the emergence of internet brokers.

I think it is very important to deepen cooperation between emerging markets in order to earn a superior position in later integration into the developed markets. However, there should be parallel cooperation processes among the developed and the emerging markets as well. Typical influence of the developed market on the emerging market would be, nowadays, the electronic system (trading and/or clearing, settlement and registry) and to a certain extent the (drain of) listings.

3.3. EUROPEAN COMMON MARKET MODEL

Where is Europe headed (FESE statement 1999)?
The developed European markets accepted the so-called European common market model, which includes:

- continuous order-driven trading with at least an opening and closing auction and possibility of interauctions (if necessary),
- harmonized access of all investors to the market,
- pre-, inter- and post-trading anonymity,
- harmonized functions of continuous trading,
- possible hidden (»iceberg«) orders and block trading,

- common prevention of price manipulations (surveillance is done by each market /country individually),
- access to the market is equally fair, no matter where does the market participant geographically comes from.

This European common market model answers quite a few questions regarding what kind of (electronic) trading systems should be adopted in any European emerging stock market! T. Noguchi (1999) believes that those who opt out for the electronic means of organized trading (preferably even as part of the global network later on) have a chance to survive in the long run. He compares it to the railway. Historically, the cities without railway eventually died out. This goes for the emerging markets as well. Perhaps even more so.

3.4. THE GREATER EUROPEAN AREA OF STOCK MARKETS

We can see that the developed capital markets benchmark (of course) in relative terms (according to the statistical data from the table) is relatively fulfilled by Island, Cyprus, the Czech Republic, Hungary and Poland, and to a certain extent Slovenia and Estonia. The latter have relatively low absolute figures while the progress of the Czech Republic is burdened by its not very well regulated and structured market. It seems that only Poland and Hungary (according to the analysed data above) relatively fulfil the picture of the developed capital markets (benchmark). Let me take a quick look at the Euromoney's country risk rankings of the markets discussed above (March 2000). Island ranks the highest, Cyprus is second and Slovenia third, with Malta following very closely on the fourth place. Hungary, Poland and the Czech Republic are ten ranks

Table 1
Market performance of some emerging capital markets

Country	***Market Cap End of 2001 in USD million Of domestic companies***	***Turnover in USD million***	***Turnover velocity***	***GDP in USD million (2001)***	***Market capitalisation as % of GDP***	***Number of listed companies***	***Country risk Rankings (Mar 02)***
1	**2**	**3**	**4**	**5**	**6**	**7**	**8**
Russia	77,000.0	4,500.0	0.06	309,951	24.92%	235	98
Czech Republic	8,150.1	3,488.6	0.42	56,424	15.8%	47	37
Hungary	10,312.9	4,838.1	0.49	52,361	19.70%	56	36
Poland	26,155.0	9,886.3	0.38	174,597	14.98%	230	41
Slovakia	543.5	953.2	1.75	20,522	2.65%	9	46
Estonia	1,482.6	233.8	0.15	5,281	28.07%	17	45
Latvia	697.0	164.1	0.23	7,549	9.23%	63	52
Lithuania	1,196.4	210.0	0.18	11,834	10.11%	45	62
Bulgaria	82.2	1.3	0.02	12,714	0.65%	27	74
Romania	1,103.1	119.1	0.11	39,714	2.78%	60	79
Malta	1,356.9	46.2	0.03	3,565	38.06%	12	32
Cyprus	5,851.7	3,435.6	0.58	8,698	0.07%	120	27
Iceland	3,975.1	1,344.7	0,33	7,542	52.71%	63	21
Slovenia	3,461.3	1,195.4	0.31	18,810	18.40%	151	33
Macedonia	13	42.84	3.3	3,445	13.01%	94	136
Yugoslavia (Beograd SE)	32.4	1.01	0.03	10,883	0.3%	7	176
(NEX Montenegro)[1]	n.a.	3.27	n.a.	-	-	280	-
Croatia (Zagreb SE)	3,127.5	117.3	0.04	19,821	15.78%	63	58
BIH (Sarajevo SE)[2]	n.a.	2.9	n.a.	4,769	n.a.	n.a.	128

(Banja Luka)[3]	45.7	1.3	0.03	-	-	231	-

Comments: **Turnover** of main and parallel markets, including investment funds. **Capitalisation** excluding investment funds, domestic companies only. **Turnover velocity** = Total turnover of shares / market capitalisation of shares

Sources of data: FIBV ANNUAL REPORT AND STATISTICS, 2002, WORLDBANK, http://www.worldbank.org/data/databytopic/GDP.pdf, EUROMONEY, March 2002, London, Issue no 395 THE EUROMONEY GUIDE TO WORLD EQUITY MARKETS 2002

1 Turnover for period March to August 2002, free market, companies are not listed all are traded on free market, no data about capitalisation, only shares of 46 companies (out of 280) were traded in that period.

2 Turnover for period April to August 2002, free market.

3 Turnover for period April to August 2002, free market, all companies are traded on free market, only shares of 30 companies (out of 231) were traded, market capitalisation is calculated for those 30.

lower; further ten places behind are the Baltic states. Croatia and Slovakia go lower almost ten ranks, and Bulgaria, Romania and Russia much further behind. The high country ranking is obviously not necessarily a guarantee for the capital market development.

Comparisons to some other countries from the ex-Soviet Union or ex-Yugoslavia, might be of some interest, for example, Kazakhstan holds the 88th place in the world, Azerbaijan the 103rd, the Kyrgiz Republic the 118th, the FYR Macedonia the 120th, Turkmenistan 132nd, Ukraine 134th, Belarus 140th, Moldova 142th, Armenia 144th, Albania 146th, Yugoslavia 175th, and Tajikistan 172th.

So what are the odds for all these stock markets of succeeding first to play an important local and/or regional role. and later survive and/or get its piece of the global financial market(s) pie, or rather cake? Stock markets from the above table already exist. They are developing relatively fast and are gaining more and more importance within their national borders. They do not play any really important international role yet; to a certain extent, some of them actually do, but it is not a really important one. Many of the countries from the above text (not included in Table 1) will have to focus first to really organize and develop themselves and thus put their markets on the map within their respective countries; many of them are yet to start with the organized way of trading securities, privatisation and the like. I do not think that globalisation is possible for certain markets before they are even formed. So, first it is national and than international development or first local, than regional and finally global (at least partly) role. For some of them, there is still a long way to go.

IV. SLOVENIA

Slovenia is a typical newborn transitional country with a transitional, emerging financial market. It is one of the most developed if not even the most developed transitional, emerging country (see Table 2).
The Slovenian financial market development, however, lags behind the development of the Slovenian economy and the whole country (compare some figures from the Table 1 and Table 2). Slovenia could probably even improve its already relatively high and stable growth rates if the financial market was more developed. The financial sector in Slovenia was not exposed to any major changes (except successful banking rehabilitation process) so far. It is traditionally banking oriented; insurance subsector also plays an important part. Investment banking departments of banks, brokerage houses, different types of investment (closed - and opened end) funds and some other institutional investors are still seeking their place within Slovenian financial sector. Capital market is burdened with the mass privatisation process. Ljubljana Stock Exchange (LJSE) acts as a very well organized secondary market. Primary market is underdeveloped; companies (except the government, central bank and financial sector) cannot raise fresh money at the market. Slovenian savings are relatively high compared even to the high European standards but are also rather short termed. The particular type of privatisation (of the so-called social ownership) also made it possible that in

90% of the Slovenian companies insiders (employees, that is workers and management) have the majority. The remaining 10% of the Slovenian companies going through the privatisation process where outsiders (public and investment funds) are major shareholders are those which are public and listed on the organized market (bourse). If the company is public (its transferable securities of any kind) it is automatically traded on the stock exchange (the so called free market segment). For the listed section there are many requirements (quantitative, qualitative) to be fulfilled. The most important one is, undoubtedly, disclosure although far from being the only one.

What are the main problems of the Slovenian capital market (developments)? I have already mentioned mass privatisation which caused the oversupply of equity securities on the market. Slovenia combined two extreme methods of privatisation (Pirie) – buy out (with 50% discounts) and give away (vouchers). There were also privatisation closed end funds introduced to the scheme of privatisation of each company.

Table 2: Some macroeconomic figures of Slovenia

Year	*Real GDP growth*	*Budget deficit as in % of GDP*	*Public debt as in % of GDP*	*Inflation*	*Unemployment (ILO)*	*Current account (USD mill.)*	*External debt (USD mill.)*
	1	2	3	4	6	7	8
1995	4.1%	- 0.0%	n.a.	8.6%	7.4%	- 99	2,970
1996	3.5%	+0.3%	22.8%	8.8%	7.3%	+ 31	4,010
1997	4.6%	-1.2%	23.2%	9.4%	7.4%	+ 11	4,176
1998	3.8%	- 0.8%	23.6%	6.5%	7.9%	-147	4,959
1999	5.2%	- 0.6%	23.8%	8.0%	7.6%	-782	5,491
2000	4.6%	-1.4%	2[illegible]%**	8.9%	7.0%	-611	6,217
2001	3.0%	-1,5%	26.9%	8.4%	6.4%	-67	6,717
2002	2.2% (Q1)p.a.	n.a.	n.a.		6.9% (Q1)	+82 (Q1)	7,259 (Q2)

Sources of data: Monthly Bulletin of the Bank of Slovenia: April 2000, April 1998 and April 1996, June-July 2002
Economic Mirror, Institute of Macroeconomic Analysis and Development, February 2000
(Ministry of Economic Relations and Development of the Republic of Slovenia)
* approximate value; Slovene Statistical Office
** author's own calculations, based on published data

Consequently, 10% of the companies according to the privatisation model went to the National Pension Fund, 10% to the Restitution Fund, 20% to the Development Fund which auctioned these equity blocks to the privatisation closed end funds, further 20% went to insiders (employees) and the remaining 40% could be bought out by insiders (employees again) and/or outsiders (public). Foreigners were not allowed to participate directly in the privatisation process in Slovenia. The ownership structure of the Slovenian companies is not advantageous to the development of the capital market. Financial behaviour of the Slovenian companies is still lacking efficiency, which is considered to be a remnant of the socialist system this country practiced for nearly 50 years. LJSE plays an important and effective role in ownership post-privatisation restructuring (concentration of ownership).

On the other hand, the demand is not following the supply. Institutional investors (funds, insurance, pension funds) are not in the position to form stable demand on the market yet. Mutual funds are fast-growing but not fast enough, privatisation closed end funds are not yet in the position to form any substantial demand on the market (lack of cash surpluses), while private pension funds scheme just started (year 2000).

The crowding out effect is present; government and central bank are both offering relatively attractive and safe financial instruments on the market.

Fiscal policy is advantageous to savings through the banking subsector.

Slovenian financial market still retains some minor restrictions for foreign portfolio investors. Foreign investors represent 1,5% of all volume of LJSE and less than 5% of the total market capitalization of LJSE or Slovene capital market.

However, some of the functions of the financial system as defined by the Nobel laureate Robert Merton (M.S. Scholes, 1999) are present or at least present in part. Not so efficiently as in the United States, for example, but still (partly) there.

Slovenia's market capitalization, volume of trading and turnover velocity represent average international figures in relative terms. Concentration of the market is relatively high. Liquidity is focused on a few most active stocks. All privatisation closed end funds are listed in the free market section on LJSE. Closed end funds are relatively liquid financial instruments. All in all, there is still some potential in development of the Slovenian capital market although some Slovenian macroeconomists (Ribnikar, 2000) claim it will cease to exist in a few years' time. Prašnikar (2000), for instance, believes that all bigger companies will be listed abroad. He also claims that companies' managers will be not willing to accept their rewards in equities and/or equities options if local (emerging) stock markets are too underdeveloped (illiquid), which is interesting fact. The biggest listed Slovenian company is Krka (pharmaceutical, which is worth approximately less than a half billion USD (market value, May 2000, LJSE Statistical Report). There are two Slovenian

companies listed through GDR programme in London. They are both relatively illiquid – both in London as well as in Ljubljana. Nevertheless, it is expected that the primary market (since privatisation is over) will start to function (LJSE is considering to open the so-called »new market« for fast growing companies) while all the factors of success mentioned in the paper will probably also come into force. General and especially financial opening up while nearing the full membership in the EU (Slovenia is the first round candidate) and some other internal factors will help the market to play its role more effectively and more complex than so far.

V. MAIN CONCLUSIONS

There are several definitions of the transitional (emerging) countries/economies and financial markets, but the combination of the World Bank's IFC and World Stock Exchanges Association (FIBV) definitions seem to be the most appropriate and pragmatic one.

Transitional (emerging) countries/economies need organized stock market because of (mass) privatisation process, public debt, primary market, money market, foreign investments, deepening of the financial market, globalisation and securitisation.

The factors which influence the decisions when, why and especially how to start (an organized) stock market in certain transitional/emerging environment, are the type and timing of privatisation, regulation, banking sector, registry, clearing and settlement procedures, on and off exchanges trading, market segments together with listing requirements, price-or order-driven trading system, market making and technology.

The biggest problems of the worlds transitional/emerging markets developments are volatility, liquidity, companies and capital drain, instable economic conditions and bad macroeconomic performances, accounting and auditing standards, legal environment, corruption, mistrust in the financial system and integration in international environment.

The future of the local, regional and global securities business will be defined by increased cross border activities, competition, involvement of large scale institutional investors, integration processes within financial institutions and new technological solutions. In Europe, the so-called European common market model will be playing an important role as well.

The most developed transitional/emerging financial markets are the Polish and Hungarian ones. The figures look good for Island and Cyprus as well, although the stock exchange of Cyprus has not fulfilled requirements for any important association of stock exchanges yet. Also Island is not yet full member of the world associations of stock exchanges (FIBV).

There is no international (global) without national (local, regional) first.

Slovenian capital market is facing some very typical transitional/emerging problems although, at the same time having the highest technological infrastructure level. Slovenian country/economy displays very good and stable macroeconomic results, meaning that a developed (although transitional) country does not necessarily have pretty developed financial market, as well.

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