

DEVELOPMENT OF THE STOCK MARKETS IN TRANSITION ECONOMIES

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Abstract: *This paper presents an overview of major changes in the stock exchange market caused by the transition. The expansion of stock market operations and its impact on economic and social sphere are also investigated, as well as the impact of financial institutions restructuring to develop new products and services. Financial integration of new member countries is a positive process that leads to additional trade opportunities, commercial gains, lower transaction costs, improved diversification, reduced capital costs, etc. Greater integration may result in political and social benefits, which may be of substantial importance.*

Keywords: *stock exchange, market, transition, development.*

1. INTRODUCTION

Stock markets are the symbols of the market capitalism. The level of stock market activity gives instant insight into the socio-economic health of the nation. It is natural that the markets are managed as dynamic businesses, enabling them to meet market demands quickly and with its own resources and skills.

The role of the stock market becomes qualitatively different after World War II, when it experienced a great expansion. In the last twenty years of the twentieth century, the stock trading in securities and derivatives begins to play a significant role in international finance. The expansion of the regulated financial markets coincides with the trend of public sale of the stock shares at the end of the 90s. Many stock markets have gone to the cooperative business structure with members of the brokers and banks, as owners, for profit companies with limited liability, including the external owners. For most members of the stock market business goals have changed according to the new form of governance. One of the reasons for the stock market expansion is business dynamics, and other considerations are the operation quality and efficiency of listing and trading.

Nowadays, the World Federation of Exchanges (WFE) consists of 54 members. The total market capitalization of shares at the end of 2003 amounted to 31 202 billion dollars, while the amount of the total stock trading in the same 2003 reached 33 330 billion dollars. The presence of increasing trading of futures, options, warrants and stock funds is evident.

Several reasons contributed to transformation of the stock market operations [1]:

- increase in business profitability,
- increase in the number of privatizations,
- increase in initial public offerings,
- growth of index and derivatives, as well as
- growth of the market trading.

In the past decade, increased reliance on stock markets in financing was one of the major changes in finance. In numerous parts of the world, tracking changes of the stock exchange index has become integrated into everyday life. There was an expansion of the specialized press. The names of market indexes received their social importance and achieved the effect on public opinion that is rare to any actor on the public scene. Reliance on the public capital markets is present in many countries and includes an increasing part of economic life. There was a spreading of share ownership and market forces that shape a better corporate governance practices.

For all products, stock markets have separate, market-neutral identity within the financial services sector. Stock exchanges are not insurance companies, investment firms, banks or brokers. The stock exchange job consists of managing regulated markets of securities and derivatives markets. Market determines the value of assets through efficient price discovery, which allows citizens to know the value of the company which is in line with the latest information and perspectives [1].

Combining the knowledge, know-how and technology for transparent trading assets, which is worth a large part of the domestic product gross, stocks are taking over a big risk. Respond to the challenges means establishing the prosperity. Regulated stock markets provide solutions by creating greater efficiency along the entire value chain of the public capital markets and the diffusion of better financial information to support the work of all stakeholders.

2. FIRST INDICATORS OF STOCK MARKET OPERATIONS IN 2004.

In 2003, the world's stock markets have increased by 31.4%, which was very difficult to repeat in 2004. Despite this, all World FTSE Index has gained in value by 12.3%, which represents the highest level since February, 2001.

Also, there was a change in the performance of the sector compared to 2003. Hardware Information Technology, which was the weakest performing sector, resized by 3%, while the media recorded an increase of only 6%. Defensive sectors have gone better, so that the action of electrical companies recorded an increase of 22.6% and the tobacco companies increased by 21.2%. The biggest loser was the pharmaceutical sector, because the public worry about the safety of the medicines drop of the price level by 0.3%.

While the resource costs burden on greater stock market, stock market associated with goods made a good performance. In terms of dollars, South Africa recorded a growth of 47.3%, 24% in Australia and 23% in New Zealand. The decline in dollar was the main topic in 2004, recording the reduction in currency index of nearly 5% during the year and 10.5% of the peak reached in mid-May. Gold has generated substantial benefits, as a means against the dollar. The maximum value of the leverage in the last 16 years, from 452.80 dollars per fine ounce, was recorded in November. Strong demand in China resulted in a rise in prices of many metals to multi-year maximum.

U.S. market has recorded an annual growth of 8.9%, UK 14.5% and Japan 10.1% [2]. FTSE Euro-zone index increased by 16.2%, while smaller countries like Austria and Belgium recorded a growth of 61% and 41%, overtaking France and Germany, where the gain was 14.6% and 11.4%. European emerging markets achieved a remarkable year, primarily Hungary with growth of 86.5% and the Czech Republic with growth of 80.1%.

European performance has shown an annual productivity growth of 1.5%. Higher productivity growth in Europe was sacrificed to the other economic policies, such as the increase in employment. The share of employment in the European Union has increased over the last decade to 0.5%, the highest growth in the past five years. Labor market reforms encourage labor force participation and flexibility in the European Union. In the short term, the reform increases the rate of unemployment, while in the longer term such reforms are essential to reduce labor costs and labor market rigidities. Categories of permanent and temporary employees are growing as a share of total employment throughout the European Union.

Increase of the European Union includes 10 new members with lower labor costs, which causes changes in the wealthier nations in tendency of corporations to dislocate services or moving production to new EU countries, in order to obtain benefits from reducing costs with longer working hours, and without extra compensation.

Many European companies have invested massively in information and communication technology and proven the tendency towards the completion of corporate restructuring in order to maximize the return on investment. Strengthening the euro, the EU encouraged the company to focus on productivity, while reducing the cost of additional investment in equipment and communication technologies.

Apparently, the review process and re-organization of European capital markets is taking root. In year 2000, the London Stock Exchange shareholders have rejected a takeover bid for it. The good side to block the bid is to maintain and encourage competition of markets, bearing in mind that due to the characteristics of network trade platform, there is a risk of monopoly. One of the disadvantages of rejecting the proposal is in the decreased ability to reduce transaction costs. The payable trading costs to the stock markets are not high, and are lower than post trade costs, but significant costs are taking an investment bank to transfer the fragmented European market.

3. THE DEVELOPMENT OF THE BANKING SECTOR IN TRANSITION COUNTRIES

In 2004, eight former socialist countries became members of the European Union. Restructuring and privatization of banks that started in the 90's resulted in modernized and sound banking systems. New systems are integrated into the European financial environment through a majority stake in many banks, found in the hands of financial groups within the European Union. In most new member countries, restructuring and privatization of banks that were once owned by the state, proceeded through consolidation, reducing the number of banks through mergers and acquisitions, and dissolution of smaller, private and problematic banks. The growing integration of banking and other financial services was done through cross-ownership of banks, non banking financial institutions and intermediaries in the capital market and the rapid development of new products and services such as mortgages, credit cards, e-banking, etc. The financial sectors in the eight new member states are still very small compared to the systems that exist in the 15 older member states, both in nominal terms and in relative terms in related to gross domestic product. The assets of the financial system of 15 senior members of the European Union exceed the gross domestic product of 5.6 times, while in eight new countries financial assets are 1.2 times greater than GDP. Aforementioned partly represents a result of higher development of non banking financial institutions and capital markets in the old 15

member states than in the eight new ones, where the financial sector is dominated by banks.

Development of non-banking financial sector should not be done in isolation from the development of the banking sector. Given their current dominance in the eight new EU member states and the predominance of universal banking in Europe, banks in these countries will remain major players in other segments of the financial system. While the total assets of the banking systems of eight countries grew rapidly in the last ten years, the growth rate of property has not significantly exceeded the growth rate of GDP. As a result, the assets of the banking system still accounts for less than 100% of GDP, compared with 300% in 15 developed countries, predicting that the difference in the coming years will not significantly reduce in the case where the banking systems of new member states grew faster than GDP. Banks play important role in financial intermediation in the older member countries, more important than in the new members. Thus, the aggregate bank credit to the private sector of eight countries, as part of GDP is stagnated. In Hungary, Estonia and Lithuania, these loans have risen significantly, but in the Czech Republic and Slovakia have declined or stagnated. In all eight new EU member states, domestic credit of the banking system remained below 40% of GDP, accounting for half or one third of the level most developed countries have. At the same time, non-bank financial institutions, although they achieved a rapid growth in recent years, continue to be poorly developed, making small but growing part of the aggregate total financial assets of the eight countries [3].

4. THE DEVELOPMENT OF STOCK MARKETS IN TRANSITION COUNTRIES

Stock markets in eight countries have achieved rapid initial growth, as a result of privatization of the corporate sector, while the growth of this segment in smaller countries of the new block was not stable, because a number of listing companies failed or have been taken over by strategic investors and privatized. Market shares have remained relatively small and underdeveloped in the eight new members despite the recent collapse of stock prices in 15 developed markets of the European Union. The share of market capitalization to GDP is one third of the values in developed countries. In 2002, in the group of new members, market capitalization amounted to 69 billion dollars. Poland, the Czech Republic and Hungary have the largest market. The market capitalization of developed states is generally between 10% and 120% of GDP. In eight of the less developed countries, liquidity is at a lower level, where the shares traded are less than 10% of GDP, while in developed countries of the Union this ratio amounts between 80% and 150%. Most of the stock market has been developed under the influence of the initial choice of privatization method. Countries that have used the method of voucher privatization (Czech Republic, Slovakia, Lithuania) began with a large number of listed companies insolvent from the beginning and gradually came to a massive off-list, since they were bought by foreign investors or sold to private owners.

In some countries, like Poland, the choice of privatization method (a combination of selling blocks of shares to a strategic investor with the sale of small investors) has proved to be suitable for the development of capital markets, although in some individual cases have resulted in the state remained a significant minority shareholder. Also, in all new EU member countries, the unique corporative problem has been created. Trend in the number of shares on the listing of the eight new member states, is different from the trend in developed markets. Generally speaking, share markets have not been in the position to take a stand as efficient mechanisms for financing the corporate sector. In some of these

countries (Lithuania and Slovakia) the market capitalization is smaller than the data suggest, since the shares of many companies are seldom traded or have a very small part in a free sale. In Poland, privatization through a sale of the large parts of capital to strategic investors in combination with small parts of the capital sold to individual investors, have resulted in low shares percentage in the free sale for the purposes of the public commerce. Low level of the share markets development partly resulted in the uneven structure of corporative sector in smaller countries of new block, which characterizes the presence of a number of smaller companies and small number of big companies. Middle-size companies have a little need for collections of funds that are considerably beyond the capabilities of these markets, opposite to the large companies. Such firms are often owned by foreign investor, so they can collect the money on the foreign market or across parental companies. Therefore, these large companies play small role on the home financial market of the eight new members. At the same time, domination of small companies demises chances for the capital markets development, mainly because it is too soon for such companies to come on market considering costs and requirements. With the development of middle companies and magnification of the more dynamic small businesses, home share markets in eight countries of European Unions are expected to grow along in next three to the five year. In spite of expectations of such growth, it is unlikely that the existing stocks in the region will be able to survive on their own. They are confronted with threats such as internalization of trading by large investment banks and brokers, who trade OTC and crossed listing, or migration of the largest companies in the major European financial centers. After the entry of eight countries in the European Union, these trends are gaining in strength. As a result, we can expect that many markets in new member states seek a solution in a strategic partnership with other EU markets (or possibly in other markets outside the EU), in order to survive. Such consolidation has already started in some of the quoted countries (Estonia and Latvia, where the Helsinki Stock Exchange has bought a strategic part of the stock exchanges in Riga and Tallinn). A number of exchanges in the European Union are integrating into larger trading platform to encourage turnover and efficiency. The development of the stock market can be stimulated by solving problems of corporate governance and accounting and auditing standards and practices in these domains. For larger countries (and/or in smaller countries on a regional basis) may be used to actively monitor the market development of small companies, possibly concurrently with the initiative to develop the venture capital industry.

Government bond market has evolved rapidly in most new EU members, but the conditions for the development of commercial papers and corporate bonds (for example, quality and reliable financial information, credit law and strong-functioning bankruptcy system) were not favorable, so that the corporate sector remained dependent on the banking system as the main source of credit. Debt markets in eight European Union countries (public and private sector), expressed as a percentage of GDP increased by 19% in 1996 to almost 35% in 2002., but that's just one-third the level in the 15 most developed countries, where the percentage is almost 100%.

Government securities market is dominated by the debt securities of which are traded in eight less developed countries of the Union. In fact the new member states, with fixed-income markets are still a significant source of revenue for the corporate sector. As for the private sector, as a significant amount of funds collected by the private sector in international markets and domestic markets. Until recently, the Czech Republic and Slovakia had the most developed corporate bond market, expressed as a percentage of GDP, which is partly a consequence of the limited growth of bank credit to the private sector (due to subsequent restructuring of the banking sector in these countries). While

Estonia has had active commercial market securities, in Poland and other smaller countries the corporate bond market is insignificant or nonexistent. In Poland, the availability of government securities made by high income contributed to this outcome. Market for government bonds should be a source of stable, though modest growth, in the next years since eight countries have to comply with the Maastricht criteria.

Growth in gross domestic product shows that sovereign debt will increase significantly in absolute terms and so it will create conditions for further development of commercial short-term securities and long-term corporate bonds, which needs liquid market for government bonds as a basis for pricing and infrastructure (clearing and settlement). Part of the volume of emissions can be placed on the more liquid markets of the European Union rather than the domestic markets of less developed countries, eight states, which is already happening today. A part of sovereign debt is in the form of euro bonds.

Further pension reforms that allow private pension funds to arise as important institutional investors, as well as the further development of the insurance sector, will contribute to market development by creating a strong demand for the securities of righteousness fixed income traded on the domestic market [4].

Poland - One of the best was the Warsaw Stock Exchange, which has attracted 36 companies on the listing, the highest in Europe after London Stock Exchange and Euro next. There are currently four foreign firms on the listing. Management hopes that the exchange will help the stock market to be able to surpass the results of the Vienna Stock Exchange, as the largest market. The huge event was the release of the stock market's largest bank PKO BP, in November. This is the partially privatized bank by the state. Selling it seemed supportive of the stock market and thousands of people standing in line to buy shares whose price rose 13% on the first day. Calculated in Euros, Warsaw Stock Exchange recorded a growth of 43% in 2004. Market capitalization of Polish companies amounted to 49 billion Euros, which was an increase compared to 29 billion Euros at the end of 2003. Officials said that the year 2004 was the best year in the history of the stock market [5].

Czech Republic - Prague Stock Exchange achieved a market capitalization of 31.6 billion Euros, which was an increase of 19.9 billion euro in 2004. Best stock index POX-50 has increased by 63% in 2004, and surpassed the 1000 points for the first time in history. Activities on the Prague Stock Exchange have received encouragement from significant dividends, as well as from two large issues of shares - secondary shares sale of the national telecommunications and initial public offering of shares of the pharmaceutical company Zentiva. Successful investments have attracted new investors and deepen the market [6].

Hungary – the year 2004 was also excellent for the Budapest Stock Exchange, where market capitalization increased by 35%, reaching 19 billion Euros. Almost the entire trading was concentrated on the actions of the four largest companies, reaching 90% of total market capitalization. Compared with rival regional markets, the Budapest Stock Exchange was faced with a less certain macroeconomic outlook in 2004 followed by an unstable currency under the influence of high budget deficits. Low liquidity budgets prevented the managers of funds to take a risk too. Average daily turnover was 50 million Euros. There were no significant initial public offerings in 2004, and no major IPOs planned for 2005, although the state announced several sales including any public sale of

national airline Maglev if a strategic partner was not found. Many analysts believe the shares are undervalued in Budapest rather than in Prague and Warsaw [7].

5. CONCLUSION

This paper presents the transformation of former socialist countries in the current market functioning, which has contributed to the development of stock markets and led to the increase of business profitability, the growth of privatization, the growth of initial public offerings and other positive changes. At the time when eight former communist countries became members of the European Union, there was restructuring and privatization of banks that started in the 90's and brought modern and healthy banking system in these countries. New systems are integrated into the European financial environment through ownership majority in many banks, which are found in the hands of financial groups with seats in the European Union.

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