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CAPITAL MARKETS UNION AND THE PROSPECT FOR BULGARIA

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Stefan Petranov. CAPITAL MARKETS UNION AND THE PROSPECT FOR BULGARIA

The article examines one of the main initiatives of the European Commission for the new programming period from the point of view of the Bulgarian economy. Initially it sets out the context and the reasons driving this initiative and the difficulties and problems it will likely encounter during the implementation process. Then the article focuses on the analysis of Bulgaria's readiness to benefit from this process and discusses the eventual impact of such union on the development of the Bulgarian economy. Particular attention is paid to the actions necessary to be taken to enable the country to fully utilize the opportunities that such a union could provide.

Key words: European integration, capital markets union, bank financing, market financing, financial markets regulation, corporate governance.

JEL: G18, G23, G28, F36, G34.

INTRODUCTION

In recent years, the economic policy of the European Union (EU) is dominated by actions aiming at the achievement of higher sustainable economic growth and job creation. This is a logical consequence of the observed low growth rates and high unemployment levels. One of the decisions in this respect is to improve the access to financing for the European economy, since after 2007 – 2008 crisis the financing from the banking sector has been significantly decreased.

Thus, more than 50 years after the Treaty of Rome has been signed, the European Commission sets the goal to stimulate the development of capital markets and, in particular, to create conditions for a high level of integration between them, the ultimate aim being a single capital market. This is in line with the basic idea when talking about European Union foundations – free movement of capital is one of the fundamental freedoms on which the Union is based.

What are the guidelines of the actions, planned by the European Commission, for the establishment of a single capital market? What difficulties have to be tackled? And what could be the impact of this process on the economy of Bulgaria? Is Bulgaria prepared to play its full part in this process in order to benefit from it? Although the process is still at an early stage and relatively few details are known, these questions are important. The present article considers them and is structured as follows. Section 1 presents data about the European economy for the last decade in comparison to data from other economies. Evidence is provided for the slow growth of the European economy. Section 2 relates the weak growth of the European economy to the structure of the financial system and excessive dependence on bank financing. Section 3 sets out the basic ideas for the establishment of a capital markets union. Section 4 discusses the possible difficulties that the creation of such union might face within EU and Section 5 estimates the perspectives for the Bulgarian economy in the context of a single European capital market. Section 6 presents the main conclusions.

1. EU ECONOMIC GROWTH IN A RELATIVE PERSPECTIVE

If the economic growth in the EU is examined in a relative perspective, recent years' data definitively is a cause of concern. It shows that the growth rates of real Gross Domestic Product (GDP) in the EU since 2005 are generally lower than these of US, Canada, Australia, Korea, Japan (see. Fig. 1). The average annual growth rate of real GDP in the EU for the past 10 years, during the period 2005 – 2014, is 0.93%. This is the lowest growth for the mentioned countries, except Japan.

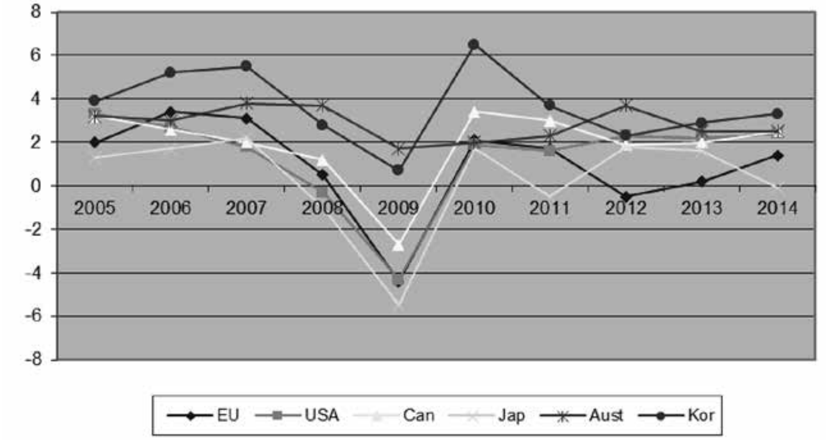

Fig. 1. Growth Rates of Real GDP for Selected Economies, (%)
Data source: Eurostat, World Bank.

And if EU growth rate is ahead of at least that one of Japan, the unemployment rates undoubtedly put EU in the most unfavorable position (see. Fig. 2 and Fig. 3). The average unemployment rate in EU for this period is 9.14%, which is more than two percentage points above the unemployment rate of the next country – Canada 7.06% and more than five and a half percentage points more than Korea, where this indicator during the period under consideration is 3.46%. Similar is the picture with respect of youth unemployment rate. Average for the period in EU is 19.69%, while 14.36% is the average for the USA (next country in the list for this indicator) and 7.59% is the average for Japan. The later has the lowest youth unemployment rate in comparison with the other countries in question.

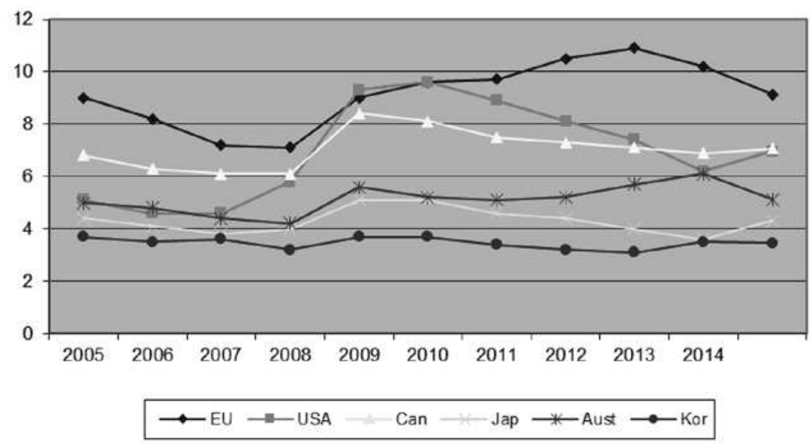

Fig. 2. Unemployment Rates for Selected Economies (%)
Data source: Labor Market Statistics, OECD.

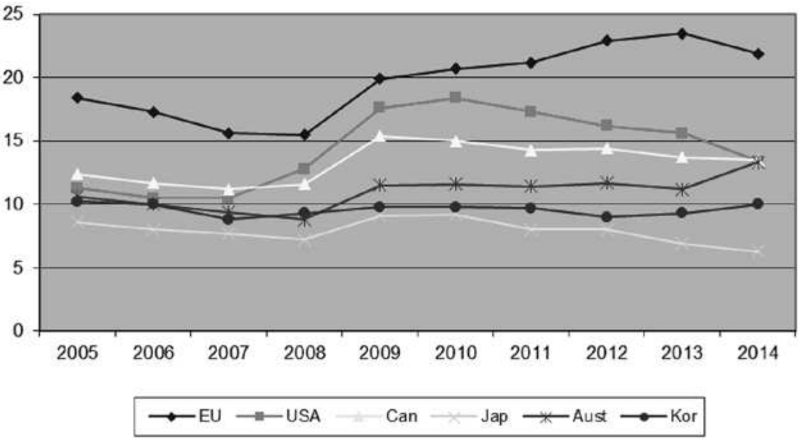

Fig. 3. Youth Unemployment Rates for Selected Economies, (%)
Data source: Labor Market Statistics, OECD.

Moreover, the investment levels in EU countries remain significantly lower compared to those from the period before the 2008 – 2009 financial and economic crisis. And while GDP and private consumption during 2014 have almost reached 2007 levels, the investment is about 15% lower compared to 2007 (EC, 2014a).

The reasons for this situation can be found in a variety of specific factors – such as the global financial crisis in 2008 – 2009 or the debt crisis in the Eurozone in 2010. But at the same time at least part of the explanation can be found in a systematic plan – the structure of the European financial system is too much bank oriented.

Traditionally, the European Union economies are financed in general by the banking system – as in the past and at present. Many businesses of all sectors and sizes remain heavily dependent on bank financing. Bank loans represent 75 – 80% of the total financing of the European economy (OECD, 2012). That situation creates problems at present as the banking system must respond to the new more restrictive requirements for capital adequacy. It has to increase its liquidity and to reduce its indebtness in the context and under the criteria of Basel III. This will inevitably lead to a reduction in bank financing and hence to economic slowdown due to reduced access to financing (see. eg. *Slovik, Cournède*, 2011). Taking into account that non-bank financing opportunities are very limited or missing for certain categories of businesses, this outlines an important structural weakness in the architecture of the European financial system. This explains one important factor influencing the slowdown of the European economy, relative to other economies.

The difficulties in bank financing primarily affect small and medium enterprises (SMEs). According to the European Commission (EC, 2014b) SMEs represent 98% of the European business units. They provide 67% of jobs in the private sector and 58% of gross value added (GVA) generated by the private sector in the EU. At the same time they totally depend on bank financing. The lack of other funding opportunities makes them and other important sectors of the economy, such as the infrastructure projects extensively vulnerable to the effects of the banking crisis and regulatory changes in the banking system.

Some may disagree with the understanding that the structure of financing affects economic growth at this stage of economic development. Such a disagreement may be based on the argument that financial resources are the same. Or said in another way, one and the same amount of funds that can support growth is distributed in different ways between those demanding such funds. In quantitative terms this may seem true, but the channels through which financing reaches businesses is of great importance too. The reason is that companies need different forms of financing for their growth, and the banking system may not secure all of these forms. For example, the start-ups, innovative SMEs or long-term and large infrastructure projects very often are not suitable for bank financing.

Many theoretical and empirical studies support the idea that better development of the financial system leads to higher economic growth. This thesis is supported in different forms. One form is when the impact of stock markets on growth is considered separately and another form is when the impact of the financial system a whole (banking and non-banking) is considered. A detailed review of these studies can be found in Levine (2006).

Although there are alternative views in the economic literature the understanding of the positive relationship between the development of stock markets and economic growth is well asserted. Channels through which this relationship is manifested might be different, but the main reason for it is that stock markets and capital markets more generally have a number of specific features that can not be effectively implemented by the banking sector only.

The empirical data supports this understanding in many cases. There are number of studies that prove empirically the existence of a relationship between the development of stock markets and economic growth, both in developed and in developing countries (see for example *Bakaert, Harvey*, 1998). Other studies, go further and address the issue of a possible causality, i.e. what is the direction of the relationship – from the stock market to economic growth or vice versa. In most of the cases the identified direction is from stock market to economic growth, but there are cases of two-way (bidirectional) relation.

Here are some indicative in this respect examples. Using Granger causality test Boubakari, Jin (2010) tested the causality between the stock market development and the economic growth in five EU countries (Belgium, France, Portugal, Netherlands, UK) based on data for the period 1995 – 2008. The results show that efficient and liquid stock markets influence positively the economic growth and vice versa. Capasso (2006) shows that the stock market development has caused statistically significant and positive impact on the economic growth of 24 developed member-states of the Organization for Economic Co-operation and Development for the period 1988 – 2002. Mohtadi and Agarwal (2004) explore the causality of the relationship between the stock market development and economic growth for 21 developing countries based on panel data for the period 1977 – 1997. Their results show that market capitalization and trading turnovers (along with other factors) are associated positively with economic growth, and that the stock markets have important role in the economic growth directly and through indirect channels as well.

Similar results are obtained in the study of the relation between stock markets and the banking sector on one hand and economic growth on the other. For example, Levine, Zervos (1998) have shown that the stock market liquidity and the banking sector development are positively correlated with the current and future values of economic growth rates, capital accumulation and productivity growth. I.e. the causality runs from the stock market to growth. This result supports the thesis that the improved possibilities to trade ownership of production assets (better liquidity) leads to a better allocation of resources, higher rates of capital formation and economic growth. The same study also concludes that the stock market offers various financial services different from those provided by the banking sector and that they are not interchangeable. The study covers 36 countries in the period 1976 – 1993 and includes both developed economies (UK, Netherlands, Italy, Japan, etc.) and emerging economies (Mexico, India, Argentina, Venezuela, Brazil and others.).

Another study (*Gerunov*, 2014) which is focused on the European Union (including Bulgaria), also shows that banking and non-banking financial markets, stimulate economic growth. It emphasizes that this relationship is particularly clear with regards to the capital markets. According to the same research, currently EU countries form two segmented groups separated on the basis of their financial development – old member-states and new member-states. The old member-states (EU15) have a highly developed banking sector and a comparatively well-developed non-banking financial markets, while the situation for the new members is different. Empirical data show that highly developed banking sector has a positive impact on growth rate but it also has the potential to affect growth negatively due to risk of over-lending. In this respect, the newer member states are relatively distant from that point of potential danger. On the other hand, financial markets have potential for further development which could support growth. In all EU countries (old and new member-states) nonbanking financial markets are relatively far from the point of potentially negative effects.

2. FINANCING OF THE EUROPEAN ECONOMY IN A RELATIVE PERSPECTIVE

Banks are not the only possible source of funds. If bank and market financing are considered as equal alternatives that should complement each other the structural problem of the actual European financial system clearly stands out. Compared with other parts of the world, businesses in the EU rely much less on market financing channels.

The European economy as a whole has approximately the size of the US economy, but markets for equity financial instruments in EU are more than twice smaller than those in US. SMEs in the US receive five times more financing from capital markets compared to the SMEs in the EU. The household savings in EU are concentrated in bank deposits two times more and twice less in investment funds and shares in comparison to the US. If the European risk capital markets were developed equally and were as deep as those in US, between 2008 and 2013 European economy would have EU90 billion more for financing businesses. If current levels of securitization of loans to SMEs could be recovered to even half of their levels in 2007, that would mean about EU20 billion additional financing for them (EU, 2015).

The situation of European capital markets is such that in practice financial instruments are issued mainly by large companies. Small and medium enterprises, infrastructure projects, innovative projects have problematic access to market financing. Also, financial instruments are offered primarily to larger markets, not to markets where financing business is the most difficult and needed. Almost all national markets in EU virtually have no significant volumes of liquidity and lack sufficient supply of instruments. This limits investors' base and choice of financial instruments, and the opportunities for risk diversification by investors (EU, 2015).

Meanwhile, the development of capital markets in the member-states is very heterogeneous. While the ratio of stock market capitalization to GDP in the UK is more than 120%, in countries like Latvia, Lithuania and Cyprus, this indicator is below 10% (EU, 2015).

Moreover, the home bias continues to dominate EU stock markets. Although in a smaller degree this characterizes the situation with debt financial instruments as well. This could be considered somewhat natural, given the historical development and the current political structure of the Union. Such bias could be considered as normal having in mind the specifics of investors' behavior. But at the same time this means that the potential risks and benefits remain within national borders which should not be the case in a single Pan-European market. In other words, practically there is no integration of the capital markets in the EU.

There is no question that the banking system and financing based on bank loans have their advantages. They are rooted in the stable relationship, which banks can develop with their client companies. But there also can be no dispute that the large proportion of bank financing now is a problem for the growth of the European economy (see. eg. the discussion in Wehinger, 2012). The recent financial crisis that has largely decreased bank lending has a very negative impact on real growth in Europe, precisely because capital markets are not developed enough and they cannot fill the gap left after the required withdrawal of banks. That is where EU lags behind compared to other regions of the world.

3. CAPITAL MARKETS UNION

Well-functioning and integrated capital markets in Europe in general could complement bank financing with new investment products suitable for the wide variety of needs of European companies. In the ideal case they could provide opportunities for more investments for all companies and particularly for SMEs and infrastructure. They could also attract more investments from other parts of the world and could make the financial system more stable by opening up more sources of funding. Under such circumstances, the financial system would be more flexible and more resistant to crises. This is not about to replace the banking sector but to achieve a better balance between bank and market financing of the economy. This is the context in which the initiative of the European Commission to start the process of establishing the Capital Markets Union should be considered (EC, 2015).

This initiative is quite on time. Once the construction of the Banking Union in normative and institutional perspective was completed the next natural step was the startup of capital markets union establishment. On one hand this is a formal step towards “more Europe”. But in essence, this is a process that aims to achieve a more balanced structure of the financial system, better intermediation between savings and investments. The aim is improved access to financing for European companies, which in turn should lead to the so needed increase in jobs and economic growth.

The European Commission considers that the establishment of Capital Markets Union is a long term project that will require extensive work in different directions. The goal is to have such fully functioning union in 2019, and its construction should be performed using “bottom-up” model. As main short-term priorities, the Commission considers (EC, 2015):

- Accepting the development of high-quality securitization with consequent free up of bank balance sheets for lending;
- Adoption of an updated Prospectus Directive in order to facilitate capital raising and cross border investing with focus on SMEs;

- Start working on availability of credit information on SMEs with the purpose to facilitate investors;
- Work with market participants to create procedures for Pan-European private placement of issues of various financial instruments in order to stimulate direct investments in small businesses;
- Support for the creation of new long-term investment funds in order to re-direct investments towards infrastructure and other long-term projects.

These actions should be followed by others in order the desired results to be fully achieved. Such measures could include for example, removing the bottlenecks for cross-border investment and capital raising, stimulating the development of markets for covered bonds, for instruments for mezzanine financing and the informal channels for equity financing of start-ups and innovative companies by private equity investors.

4. WHAT ARE THE POTENTIAL DIFFICULTIES AND OBSTACLES?

It is clear that such restructuring of the European financial system cannot be done quickly and easily. It will inevitably encounter many difficulties, which cannot be neglected. They are mainly result from the fact that the European Union is too heterogeneous in many ways.

On one hand there are the historical and cultural differences between the countries. The historical perspective shows that the traditional forms of financing, which in most of the European countries are mainly through the banking system cannot be easily replaced. However, the capital markets union establishment is not intended to replace the banking system. This is impossible and banks will continue to play an essential role in the European model of financing. But it will be "good for the health" of the European economy its dependence on bank lending to be reduced. By this companies will become more resistant to bank crises and the access to financing will be improved for economic projects, which for one reason or another are not acceptable and proper for bank financing like start-ups, infrastructure projects, innovative projects.

There are problems caused by differences in the cultural perspective too. From an economic point of view they can be observed in the very different business practices in the member-states. These practices, coming from formal and informal rules, are the basis of substantially different systems of corporate governance dominating in the different member states. These systems are essential for the proper functioning of the capital markets but their differences cannot be easily overcome (see. eg. *Petranov, Angelova*, 2012).

Besides the historical and cultural differences that give rise to certain difficulties for a capital markets union, there are also institutional, economical and legal obstacles. The most significant institutional and economical obstacles are rooted in the different regulations of the institutional investors, in the unsynchronized practices of the regulatory authorities and in the differences in the tax systems of the member-states.

In general it is clear that the development of a single capital market requires a tax system that is highly harmonized across member states. However currently, the structure of the tax systems in the different member-states varies significantly and, even more important – it is extremely sensitive to changes. It will be difficult to achieve tax harmonization at the present stage, although the topic is recently under discussion in EU bodies on different occasions. But tactically it would be better to consider this as a final step of the process of creating capital markets union. Harmonizing the regulations of institutional investors seems easier, but the harmonization of the regulatory authorities' practices will be another major challenge.

Not least the legal systems differences should be taken into account as well. They are of great importance for cross-border investing. Bankruptcy procedures and protection of investors' rights are just a few of them.

All these difficulties cannot be ignored. It will be very difficult to overcome some of them like the cultural differences or the differences in the tax systems. This gives grounds for the question – whether at the end this initiative could turn out to be just a good intention. Will the desired results be achieved and moreover – within the outlined relatively short time horizon? There are reasons for certain skepticism in this regard given the difficulty of the problems and the scale of the desired transformation. But in any case it is clear that considerable efforts will be made in this direction and that the European financial system will undergo certain changes in the coming years.

5. WHERE DOES BULGARIA STAND?

Many of the components of the planned union are still at purely conceptual level. The plans of the Commission at the present stage are focused more on the intentions and principles and do not include many details. Many aspects of the future market structure remain still unclear at this stage. The result will be one or another depending on the specific policies that will be undertaken. Various interested parties will not fail to act in their own interests.

How does this plan look like from the Bulgarian point of view? What is the Bulgarian perspective in this context? On one hand the European Commission initiative to create capital markets union can have literally transformational impact on the European financial system, given that it is implemented as conceived.

In that case in general it can have a positive impact on the Bulgarian economy. The reason is that many of the actions in it primarily aim at improving, in various forms, the access to financing for the small and medium-sized enterprises, as well as at raising funds for infrastructure and other long-term projects. Both areas are very important for the Bulgarian economy but they are not adequately financed by the banking system neither as volumes nor as prices. The same applies for the start-ups and the innovative businesses.

Moreover, the plan can stimulate the development in organizational, regulatory and product diversity aspects of the capital market, which still does not function properly in Bulgaria as a real source of funding and as an attractive alternative for investments. Said in another words, this plan of the European Commission gives certain potential opportunities to improve the financing of Bulgarian enterprises and the development of the Bulgarian capital market.

But on the other hand the integration of markets will increase competition for financing. The measures envisaged such as unification, standardization, new "tailor maid" investment products, liberalization, expanded opportunities for cross-border investment and others will undoubtedly stimulate capital flows. This can provide more options for financing the growth of Bulgarian companies in case flows come from countries with large savings to small and medium-sized Bulgarian enterprises or infrastructure. But there is the other possibility as well – Bulgarian savings to flow out and to be invested in other countries. Here is the important role of the interested parties in Bulgaria – to participate actively in the process of institutional and regulatory establishment of the capital markets union in a way that will minimize such risks and that will secure real benefits for Bulgarian economy in this process.

At this stage there is still no such activity. The process in general is little known in the country and there is no significant involvement by the relevant institutions or by the professional community. At this stage the Bulgarian capital market is still very young, there is no critical mass of liquidity and the overall investment environment is not favorable. The confidence in the capital market and its institutions is still weak, the IPO activity is not significant, corporate governance standards are relatively low, there are elements of "gold plating" regulation, which embarrass and hamper issuers, especially small and medium enterprises. Apart from that confidence in the judicial system is low as well. Its ability to resolve fairly and within a reasonable timeframe investment disputes or disputes concerning collateral is questioned by many market participants.

As a result the recently prevailing tendency is for capital outflow with respect to portfolio investors. After a strong bullish period (2003 – 2007) the market was hit by the international financial crisis and since then portfolio capital tends to flow out.

The empirical data shown in Fig. 4 confirms this view. It shows the net flows of portfolio investments on a monthly basis for the period 01.2010 – 12.2015. As can be seen, during the period under consideration capital tends to flow out. The financial flow that has left the country as portfolio investments of residents or as withdrawal of portfolio investments by non-residents exceeds the financial inflow by EU267.8 million. This is a relatively small amount. But this difference can be misleading. It is in fact due to the large volumes of debt issued by the state in 2012, 2014 and 2015, which attracted portfolio investments. If these funds are not accounted the portfolio investments outflow from the country is at the net value of EU 3,839.4 mil, which is quite significant amount for the size of the economy – about 9.5% of GDP.

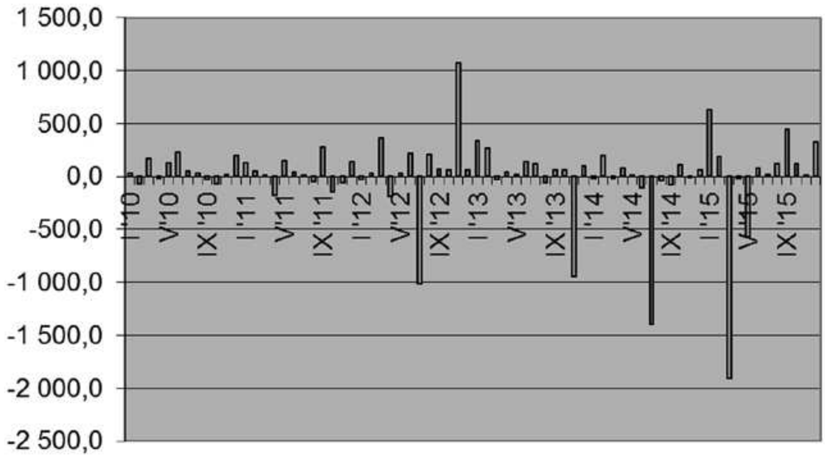

Fig. 4. Portfolio investments, net (mln. Euro)
Data Source: Bulgarian National Bank, Balance of Payments.

Without taking appropriate steps to resolve the above mentioned problems, portfolio investments would rather flow out of the country. In such a situation the country will not be able to take a full advantage of the potential opportunities created by a Capital Markets Union. Bulgarian investors (individual and institutional) will benefit from the availability of more financial instruments, better opportunities for diversification and better liquidity. But the possibility of Bulgarian companies to attract market financing will be limited and this will decrease their growth potential.

CONCLUSIONS

The European Commission is launching a focused process of establishing Capital Markets Union in order to improve the balance between bank and market financing in the European economy. This process is expected to involve significant administrative and financial resources and to lead to improved financing for the small and medium enterprises, infrastructure projects, long-term projects, start-ups and innovative businesses.

In general many of the planned implementation actions appear to be very useful for the Bulgarian economy. But this requires appropriate attitude and active position because the current situation of the Bulgarian capital market does not suggest that it will be fully integrated and completely benefiting from European capital markets integration.

Significant measures are needed to be taken in the area of investors' protection, procedures for seizing collaterals and more general in corporate governance. Tendencies for "gold plating" should be avoided by the regulators. Legislative proposals coming from the amended Prospectus Directive, proposals for establishing business growth funds supporting SMEs and for crowdfunding should be adopted without delay. A step in the proper direction will be the creation of a financial ombudsman position with a proper office which has to participate in the FINNET network. Together with the improvement of the market infrastructure the later will increase the trust in the Bulgarian capital market. Also, the relevant institutions should participate in the development and the support of EU information systems.

It is necessary that the interested parties and institutions to participate actively in the process of creating and providing conditions under which Bulgarian real sector will feel the benefits of a Capital Markets Union. Otherwise Bulgarian economy will remain aside from the opportunities that such union can create and therefore substantial funds systematically will continue to flow out of the country and consequently to restrict the growth of the Bulgarian economy.

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