

BUCHAREST STOCK EXCHANGE – THE EFFECTS OF THE CURRENT FINANCIAL CRISIS

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Abstract

The current financial crisis had an important impact on economies all over the world. Romania – one of the Eastern European countries, considered just one year ago to have a good growth potential – is also absorbing the shock waves of this crisis. As expected, the first to respond to those shocks was the Bucharest Stock Exchange. The paper will present Bucharest Stock Exchange evolution before the crisis started to manifest and will try to identify the main factors which influenced its explosive growth; the paper will continue with the investigation of the current financial crisis influences on Bucharest Stock Exchange – with an emphasis over the factors which might have deepened the descendent trend for the Romanian stock exchange market. The final part will present the effects of the current financial crisis on the future development of Bucharest Stock Exchange, taking into consideration the position of the Romanian capital market in Eastern Europe.

JEL classification: G22, G31

Key words: capital market, capitalization, evolution, Romania,

Introduction

The current financial crisis influences all the economic sectors. Capital markets are the most affected since they have a peculiar position in any economy – their main role being that of providing instruments for a better/ more efficient allocation of available (financial) resources. But where to invest during periods of distress? As follow, all over the world investors – either institutional or private – redrew their resources invested through capital markets and reoriented their portfolios toward what is considered safe: insured bank deposits, Treasury bonds, gold, and other (traded) commodities.

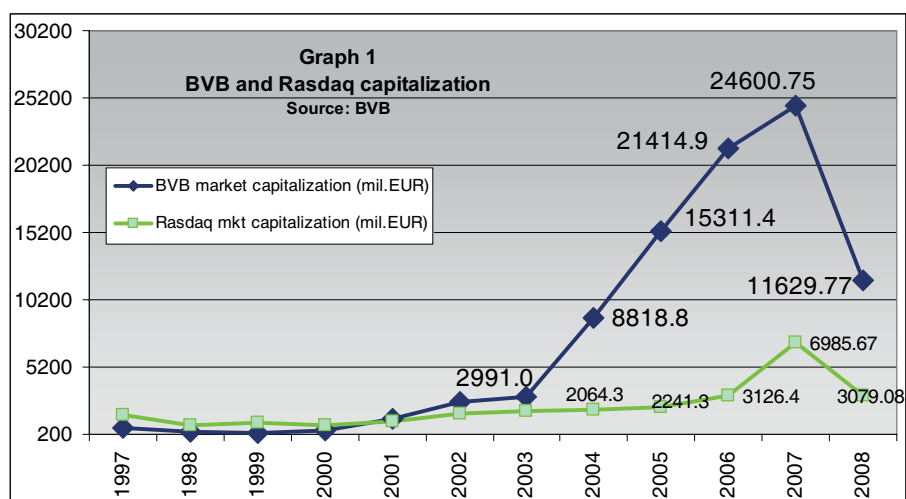
Small capital markets, like Romania's, were immediately affected by the change in investors' mood. The following pages will present the short and volatile success of Bucharest Stock Exchange (BVB) and its perspective for the future.

BVB evolution

The Bucharest Stock Exchange opened for transactions in November 1995. Only companies which fulfilled the imposed conditions were listed. The maximum number of listed companies at Bucharest Stock Exchange was 132, reached between 1998 and 1999. With higher liquidity and transparency, the Bucharest Stock Exchange (BVB)¹ became the main capital market in Romania.

The Rasdaq market was established in November 1996 as an OTC market, following the NASDAQ's model. The Rasdaq market was necessary to intermediate the transactions of privatized companies' shares which did not fulfill the conditions to be listed on the Bucharest Stock Exchange. During 1998, the highest number of listed companies was reached: over 5000. Due to Rasdaq's relatively poor results combined with several scandals involving theft of shares and price manipulation, the Rasdaq was transformed, with the hope of a change in image, in the Electronic Exchange Rasdaq in 2003. The situation slightly improved. The decision of a merger with the main Romanian capital market, Bucharest Stock Exchange (BVB), was taken during 2004. The merger took place in December 2005 and since then Rasdaq market became part of the Bucharest Stock Exchange. The reports for this market segment remained separate from the main market (BVB), but as graph 1 shows, its capitalization is very low and it is expected that companies traded on Rasdaq will be either transferred on the main market, while the remaining ones will be traded on an alternative trading system.

The capitalization of both markets and its importance in Romanian GDP are presented in table 1.



¹ To avoid any confusion with the Budapest Stock Exchange, the abbreviation for Bucharest Stock Exchange used in this study is BVB, the initials of its Romanian name.

Table 1 BVB and Rasdaq capitalization in GDP (%)

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008 (9 m)
7.60	3.47	4.16	3.28	5.68	9.07	9.39	17.83	22.01	25.10	25.54	30.02

Source: Based on BVB and NIS data

As it can be observed in graph 1, Romania's market capitalization increased with a rapid pace between 2003 and the mid of 2007.

The evolution is confirmed also by the 3 main indexes reported for BVB:

- BET - including in its portfolio the 10 best traded companies (considered a blue chip stock),
- BET-C(omposite) - including all the companies traded at BVB except the 5 companies for financial investments known as SIFs,
- BET-Fi(nancial) – a sector index including only the 5 SIFs.

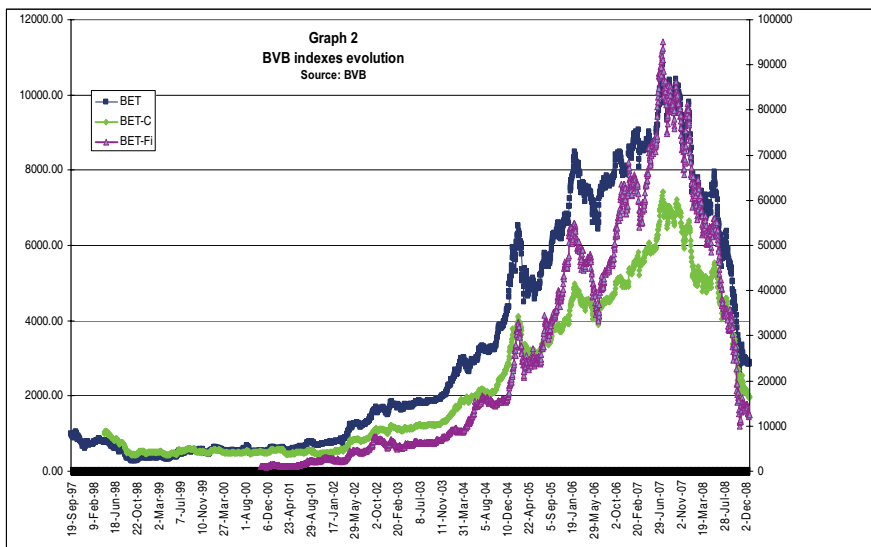
As graph 2 shows, all the 3 indexes are strongly positively correlated. The correlations between the absolute daily values at close are:

- ✓ for BET and BET-C = 0.9936
- ✓ for BET and BET-Fi = 0.9733
- ✓ for BET-C and BET-Fi = 0.9821

The correlations remain important and positive when the daily return series were analyzed, as follow:

- ✓ for BET and BET-C = 0.8864
- ✓ for BET and BET-Fi = 0.6155
- ✓ for BET-C and BET-Fi = 0.6204

It is not the subject of the present paper to analyze further the relations that exists between these 3 market indexes, but it is clear that they follow the same trend and the downward trend was the steepest for BET-Fi



The interest for BVB became obvious during 2002, when it was announced that Romania became a NATO member. Since the announcement was made, the foreign capital confidence in Romania's stability increased, combined with the gradual improvement of Romania's sovereign rate from B to BBB. The second wave of interest for BVB was registered in 2004, when the announcement of the country's accession to European Union indicated that, at latest in 2008, Romanian will be accepted as EU member. Meanwhile, Romania and Bulgaria became member of EU starting with January 1st 2007.

The pick of the positive evolution was reached at the mid of 2007 – when the announcement regarding the problems spreading through the American residential market were made known world wide through media channels.

One of the reason why BVB was considered 'a rising star' in 2002 were the improvements registered in the economic growth which triggered the investors' interest, as the next table shows.

Table 2 GDP growth rate (%)

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008 (9 m)
-6.1	-4.8	-1.2	2.1	5.7	5.1	5.2	8.5	4.2	7.9	6.2	8.8

Source: RNB (Romanian National Bank)

The efforts made under European Union supervision, for accession process, became visible in 2004 and 2005. During that period (2004-2005) the population consumes started to be strongly supported by credit and mortgage loans became affordable – due to the availability of financial resources, combined with a raise in wage level at country wide. This situation formed the basis for the growth in 2006-2008; the growth was also generated by the government spending was also high, mainly during the last part of 2007 and entire 2008 – an election year (Radulescu, E., 2009²). With a growth considered unsustainable at economic level, BVB could not keep the interest of investors during time of distress, like the current financial and economic crisis.

The estimation of Romanian Commission for Prognosis consider that for the entire 2008, Romania's GDP growth rate will be 7.9% and it estimates a growth rate for 2009 of 2.5%, while Romanian National Bank estimates a GDP growth rate for 2009 of 2.2-2.3%, without eliminating the possibility of a recession period.

In 2001 and 2002 not only the Romanian economic outlook attracted foreign investors, but also the obvious undervaluation of Romanian traded shares, as the following table shows. Foreign investment funds – open-end, closed-end, hedge and private equity – entered Romanian market triggering a buy signal for domestic investors (mainly individuals) also. When the foreign investment funds started to exit the market – during the second half of 2007 and entire

² Cited by Business Magazin, February 11-17, 2009, pg.11-17. Mr. Eugen Radulescu is consilier of Romanian National Governor.

2008, most domestic investors followed their behavior and the market ratios are comparable with those registered in 2001, but with a pessimistic perspective regarding 2009.

Table 3 BVB's PER and Price/Book value* ratio

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
PER	10.7	8.22	8.82	3.98	4.92	9.12	13.10	35.18	24.05	18.03	19.21	4.11
P/B	n/a	0.38	0.62	0.41	0.45	0.84	1.01	2.29	3.28	2.72	3.03	0.76

*Considered the book value

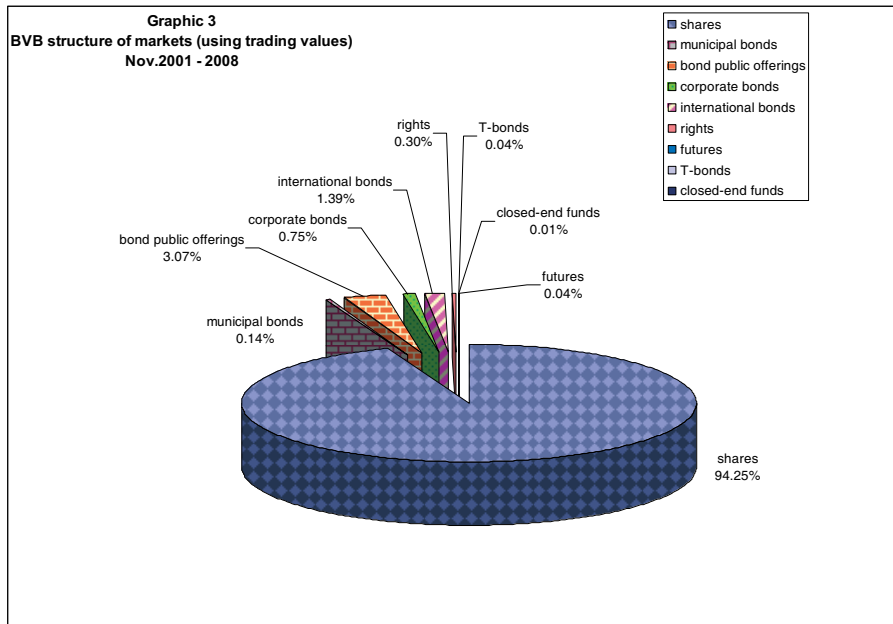
Source: BVB data

Between November 1995 and November 2001, the only securities traded at BVB were the domestic shares. Since 2001, BVB made constant efforts to improve and diversify the offer for its investors. Those efforts made for BVB offer diversification, generated the following:

- municipal bonds begin trading November 26, 2001;
- corporate bonds are traded since May 20, 2003;
- rights start trading January 17, 2005;
- the first international bonds, issued by the International Bank for Reconstruction and Development, start trading September 13, 2006, followed by a second issue – made by European Investment Bank – traded since June 8, 2007;
- futures contracts on BET and BET-Fi index start trading September 14, 2007;
- futures contracts on 10 BVB stocks, of which the 5 SIFs, (single stock futures as BVB call them) and currency futures contracts (on EUR and USD) start trading April 14, 2008
- the first international company, Erste Bank – Austria, starts trading February 14, 2008
- Romanian T-bonds start trading August 4, 2008
- the first Romanian closed-end fund to be traded at BVB – since September 22, 2008.

As the graph below shows, despite the diversified offer, Romanian companies' shares remained the main type of security traded, due to their higher liquidity compared with bonds, rights and future contracts. For the products offered for trading during 2008, no clear conclusion can be drawn due to the particular

situation generated by the financial crisis and its acute phase reached during the Autumn of 2008.



While the bond trading increased gradually since 2001, only during the last quarter of 2008 international bonds manage to represent about 8% of total traded value at BVB and this situation was generated by the investors who looked for a safer investment alternative. Romanian T-bonds were to new and their market lacked liquidity, as follow those securities did not manage to attract investors' interest.

Since the equity market is dominant, a brief analysis of it is appropriate. The structure of BVB equity market, by trading categories, is presented in graph 4. The 3rd category/ tier was introduced since November 19, 2007; currently only one company is listed inside this category, but it is expected that a number of companies transferred from Rasdaq market section to be listed here.

The international category/ tier became active since February 14, 2008 – when the Erste Bank starts trading at BVB.

The shares listed inside the 1st category are dominating the trading by concentrating 80% of turnover. Currently there are 21 companies listed at 1st category, including the 5 SIFs, 3 Romanian banks, one brokerage company, 2 utility companies – which start trading during the last 2 years, 2 pharmaceutical companies, and 2 companies from the chemical sector.

IPOs have a low presence in BVB's turnover. Between 2004 and 2007 only one or two IPOs were registered every year, while in 2008 a number of 4 IPOs took

place. As expected, due to the market declining trend, those IPOs did not generate the expected interests among investors.

Graph 4

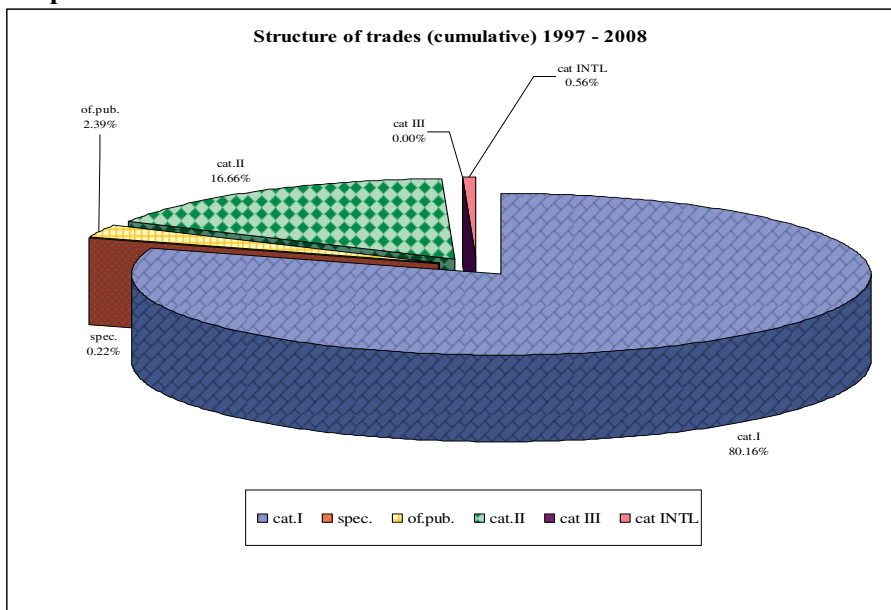


Table 4 Average daily values at BVB

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
trades	2949	2283	1611	1968	1416	2680	1776	2494	4664	5789	6112	5317
volume (mil. shares)	2.87	4.30	4.08	7.10	8.95	16.14	15.39	51.20	68.18	54.93	55.33	50.03
turnover (mil. ECU/ EUR)	1.16	0.85	0.34	0.37	0.59	0.91	1.05	2.34	8.62	11.27	16.47	7.54

Source: based on BVB and RNB data

As the table above (4) shows, the average number of trades/ day became significant only since 2005, while the average volume/ day increased during

2004. Despite these, the average daily turnover overpass 10 million EUR only in 2006 and 2007 when the Romanian share prices reached record levels. The financial crisis did not affect, in an important manner, the average number of trades/ day or the average volume/ day, but the steep decline in prices generate an average daily turnover below the level of 2005.

Table 5 BVB equity market performances

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
inflation rate (%)	59.1	45.8	45.7	34.5	22.5	15.3	11.9	9.00	6.56	4.84	7.85
market dividend yield (%)	10.66	7.84	7.48	6.70	4.97	2.00	1.45	0.94	1.72	2.18	9.12
BET annual return (%)	-49.4	15.21	18.25	35.71	117.52	27.13	93.15	42.47	18.09	16.29	-69.68
BET-C annual return (%)		-4.99	7.39	-6.47	124.02	22.62	98.29	31.63	25.07	26.27	-69.68
BET-FI annual return (%)				109.92	113.14	24.72	106.94	151.32	24.66	14.95	-83.62
average interest rate for bank deposits (%)	38.3	45.4	32.44	26.16	18.39	10.78	11.34	8.34	6.51	6.70	9.18

Source: BVB data and RNB data

Table 5 presents the BVB's performances as they are reflected through the 3 indexes³ mentioned above, compared with the inflation rate and the average interest for bank deposits. Starting with 2001, BET and BET-Fi showed positive performances, above the inflation rate or the average interest for bank deposits. BET-C started to show the same positive level since 2002. The 2002

³ Since March 2005 ROTX index is reported; this index is calculated by Vienna Stock Exchange and it is used as an underlying asset for a future contract; the data in RON for ROTX are not available before 2004. During 2008, BVB launched 2 new indexes: BET-XT which portfolio includes 25 blue chips, among them the 5 SIFs, and BET-NG – and index with a variable number of companies in its portfolio, concentrating those companies in the energy sector or those directly connected with that sector.

BVB annual report showed (pg.3): ‘The BSE achievements of 2002 were noticed by the international financial community and highlighted in the Standard & Poor’s Fund Research analysis, which indicated the BSE as the world best performing stock market of the year, in sterling terms, with a rise by 93.6 percent’. Exceptional results were also achieved during 2004, the year of accession to European Union of Romania’s neighboring countries. 2004 performances might have been induced through a contagion effect, while no relevant studies were made on that subject regarding Romanian capital market. As expected, for 2005 and 2006 the performances of BET and BET-C were lower than those of 2004; the exception was represented by SIFs – included in BET-Fi – which for the second year in the row reported a price increase of over 100%. Romania’s accession year to European Union was 2007, but it not yielded the expected results – while the maximum values⁴ of those 3 indexes were reached at the end of July 24, 2007 – due to the steep decline of the market which started in August 2007. The worries expressed during the second half 2007 regarding the problems that might arise in the American market due to the announced problems in the subprime sector, started to combine with opinions regarding the lack of sustainability of Romanian economic growth. The year 2008 began in a pessimistic mood and it was enhanced by the acute symptoms of the world financial crisis. By August 2008, BVB was the 3rd in the world (after Bosnia and Vietnam) – loosing more than 50% of its indexes value from the beginning of the year (Chirileasa, 2008a). Some sources indicate a correlation coefficient between BET and DJIA of 0.87 – for the last 3 years (Crihana & Ciobanu, 2008)

As it can be observed also from table 5, the market dividend yield was also low or very low starting with 2001. This situation indicated the lack of importance given by most of Romanian companies to dividend policy. The market dividend yield of over for 2008 is due to the steep decline in Romanian share prices.

Comparative evolutions

When compared with Budapest Stock Exchange, Warsaw Stock Exchange and Prague Stock Exchange, BVB has the lowest capitalization level.

Despite the impressive growth rate in BVB capitalization registered during 2001, 2002 and 2004 – which only showed the huge gap between Bucharest and the other main capital markets in the region – the level of BVB capitalization remained low, mainly due to the relative lack of diversity in the portfolio of listed companies and, also, to the relative lack of transparency at company’s level (which improved over the years, but not enough to attract more investors). Another often mentioned reason is the lack of market liquidity, the free float of most companies being low, while no figures are mentioned (Zavoianu, 2007 and Chirileasa, 2008b). The volatile environment of Romanian economy was also reflected by the highest decrease pace registered by BVB capitalization compared with the other 3 markets from the region.

⁴ Those maximal values were (indexes expressed in RON): 10813.59 for BET, 7432.63 for BET-C and 95111.01 for BET-Fi.

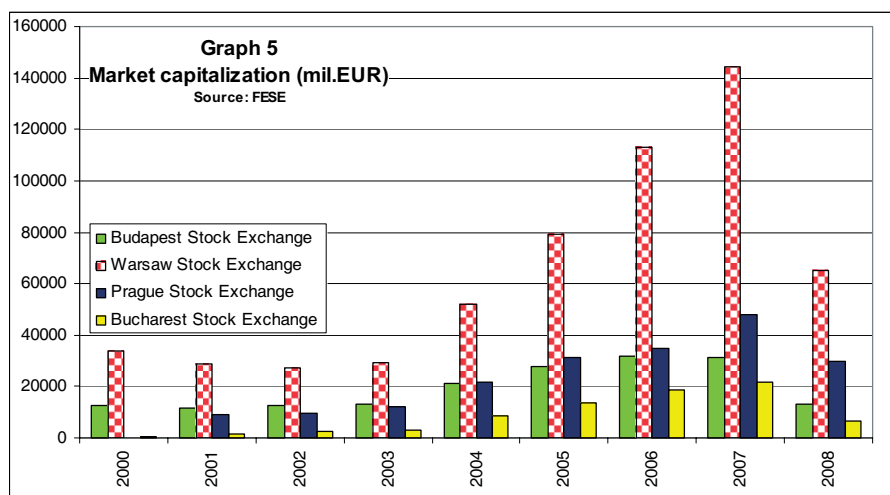


Table 6 The growth rate of market capitalization (%)

	2001	2002	2003	2004	2005	2006	2007	2008
Budapest Stock Exchange	-9.72	8.03	58.80	59.05	31.12	14.86	-0.58	-57.70
Warsaw Stock Exchange	-14.56	-6.21	8.48	76.79	52.93	42.18	27.81	-54.80
Prague Stock Exchange	n/a	8.86	25.43	76.76	42.99	11.70	38.35	-38.30
Bucharest Stock Exchange	202.12	94.44	13.02	194.84	53.48	39.32	14.06	-69.90

Source: FESE and BVB

Table 7 Performance of capital market indexes

	2001	2002	2003	2004	2005	2006	2007	2008
BUX for Budapest Stock Exchange	-9.16	9.36	20.28	57.17	40.99	19.53	5.51	-53.30
WIG Total Return for Warsaw Stock Exchange	-21.99	3.19	44.92	27.94	33.66	41.60	10.45	-51.10
PX-Glob for Prague Stock Exchange	n/a	17.02	41.63	50.89	46.94	9.72	14.22	-51.70
BET-C for Bucharest Stock	-4.84	126.95	26.04	103.50	38.22	28.49	32.64	-70.34

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Source: FESE and BVB

Table 7 shows the comparative results between the 4 capital markets considered in this paper. BVB is the only one which yielded results of over 100% in 2002 and 2004, but also is the one with the lowest performance for the 2008 reflecting its higher volatility compared with its neighbors. This situation only reflects that BVB has to improve both its image and its offer in the future through better listed companies, new IPOs which can only improve the market liquidity and capitalization.

Conclusions

The supervision body of Romanian capital market – the Romanian National Securities Commission – made efforts to implement the MiFid Directive in Romania, and some media sources announced that in Romania the new regulations in concordance with EU directive were in place since the end of January 2007 (Barbureanu, 2007). While the new regulations were supposed to enhance investors' confidence in the capital markets – from transactions, to transparency, to an improved quality of intermediation – the effervescence of the first half of 2007, and the dominating bad news regarding the subprime market during the second half of the same year, made the implementation efforts of the MiFid Directive almost invisible and ignored. During the market turmoil that followed in 2008 and the pessimistic attitude of the investors during the last 6 months (since September until March), almost no investors thought about the existing new regulations because the capital market was under the effect of the current financial crisis.

The future will tell if MiFid Directive will be changed accordingly to the new evolutions triggered by the current financial and economic crisis and how those changes will be implemented and will affect Romania's capital market.

While BVB board tried to diversify the offer (as mentioned in pages above) and to improve transparency at the market level, but also at listed companies level, the number of important and interesting listed companies remain relatively low due either to the fact that some companies, mainly those with foreign majority shareholders, choose to be delisted, or to the fact that the promised made by successive governments to privatize and to list several big Romanian companies, were not kept. As graph 3 shows, the importance of Romanian bond market and futures market, is low and both segments need time to develop.

Also, when the equity segment is taken into consideration, the absence of short sellings, of stop orders on some market segments, and the almost inexistent level of buying on margin (launched during 2008 by several brokerage companies) did not make BVB more attractive for investors (Zavoianu, 2007 and Chirileasa, 2009).

2008 was the worst year in BVB's recent history – the steepness of the downward trend probably being enhanced by the downgrade of sovereign rating for Romania from BBB (investment grade) to BB (non investment grade) at the

beginning of November 2008. This action of lowering Romania's sovereign rating came from all the 3 main rating agencies (Standard & Poors', Fitch and Moody) in almost the same period of time. The economic outlook for Romania, as expected, was considered negative, and the combined information had a further negative impact on investors' attitude toward BVB.

The steep decline registered at BVB during 2008 was induced by the financial crisis that started to show its first acute signs during the first quarter of 2008 and generated the world market turmoil since September. As expected, foreign investment funds redrew most of their money invested in Romania (considered a small emerging market or a frontier market) and the domestic investors followed their behavior. The absence of important domestic institutional investors (Chirileasa, 2009) is seen as one of the secondary causes that contributed to the highest decline registered by a stock exchange in the region. The private pension funds began their activity only since 2008 and Romanian mutual fund industry is very small, combined with the fact that during 2008, most mutual fund investors redrew their money due to poor performances. The insurance companies that are present on the Romanian market almost ignore BVB as an alternative for investing some of their available funds. The number of Romanian individual investors is also small – some sources indicate between 90.000 and 100.000 persons that have open accounts with Romanian brokerage companies (Chirileasa 2009); those figures could not be checked while no official reports include the information. As expected, the Romanian individual investors are not trend setters, but trend followers and their behavior generated an increased pressure on the descending trend at BVB.

BVB's perspectives for 2009 are pessimistic. As the financial crisis evolved in an economic crisis, Romania's economic outlook looks poor. The foreign investors' attitude toward the Romanian capital market is excessively prudent and influenced by the fact that the country is not in the 'investment grade' category by the main rating agencies. Domestic investors attitude replicate that of foreign investors and despite the fact that stock market ratios indicate opportunities for (long term) investments, the macroeconomic predictions (mainly the RON depreciation against EUR and USD) are not encouraging on short to medium time horizon.

Also for 2009 a number of companies are expected to give up BVB listing and IPOs are almost absent during the current incertitude. If the number of listed companies will decrease, the future development of BVB will be difficult, despite the diversified current offer which includes bonds (domestic and international) and futures contracts.

As the other stock exchanges around the world, BVB became a PLC in 2006. Its shares are owned by number of around 100 shareholders and any takeover can become a difficult one due to the fact that a limit of 5% is imposed on voting rights of any shareholder. The only stock exchange that expressed an interest regarding BVB was Vienna Stock Exchange. During 2007 and 2008, both Prague Stock Exchange and Warsaw Stock Exchange announced that

important percentages of their shares will be sold and for both important stock exchanges like New York Stock Exchange, London Stock Exchange or Deutsche Boerse expressed their interest.

Without alliances with the neighboring stock exchanges, BVB will remain a small capital market which can easily disappear in the years to come due to the expected integration process of capital markets at European level. The process can create better trading platforms for companies and more efficient investment alternatives for various investors. If BVB can not keep the pace or join one alliance between the capital markets in the region, its future does not promises too much, taking into consideration the current difficult economic environment which is expected to last longer than predicted during 2008.

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