

The impact of joining the European Union on the Romanian capital market

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Abstract: *This paper approach the theme of the development of the Romanian Stock Exchange Market (BVB) during the process of joining the European Union. The first goal is to illustrate the stage of the BVB in the years before the accession to the Union and what were the perspectives of joining the EU at that time. The second goal is to highlight the effects the accession had on the neighboring markets: the Polish, the Hungarian and the Czech markets who joined EU in 2004 and to analyze the correlation between the indexes from these stock markets and the Romanian stock index. The last goal is to show the impact of joining the European Union on the Romanian Stock Exchange Market.*

Key-words: *stock exchange market, stock exchange index, capitalization, emergent markets*

1. Introduction

Stock markets are present in all market economies, where securities are being traded according to special procedures. Joint stock companies can finance their activity based on two external sources: *commercial banks* and *stock markets*. Regarding their participation in the stock markets, the first step for the companies is to do the conversion from "closed companies" into "open companies" by making a public offer for sale of securities (stocks, bonds) that is authorized by the National Securities Commission. The most important objective of such a public offer is to attract financial resources on the stock market, from investors who are interested in buying securities.

The market value for securities shows the public perception on the issuer activity. The potential creditors of the issuer have the possibility to compare the book value per share to their market value.

By studying the evolution of the Bucharest Stock Exchange Market (BVB) from the beginning until Romania joined the European Union in 2007, it reveals a number of distinct phases in its development: early stage of formation (1995-1996) led slowly to accelerated and generalized growth in the first half of 1997. In the second half of 1997, 1998 and 1999 followed a period of regression and generalized

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restriction of activity. In 2000 happened an interesting phenomenon: the decrease stopped and it started a documented development on long term.

2. The analysis of the Romanian Stock Market before joining the EU

In the years before joining the European Union, the Romanian Stock Exchange Market (BVB) was following a maturation process, after long time the stock price levels had chaotic evolution that led to spectacular gains or losses. The year 2004 is considered the best in the history of BVB after 1990, the average earnings of listed shares led to the doubling of the investor's money. Since 2005 important steps have been made towards institutional strengthening through the merger with the RASDAQ Electronic Exchange. The increases in the market have started to become more selective - the shares didn't grow all simultaneously as it did in the previous years. Only 31 of the 65 listed shares, which represent less than half, brought total gains above inflation in 2005. The situation in previous years was completely different, for instance in 2004, 89% of the listed shares brought gains above inflation, while 61% of the listed shares brought gains above inflation in 2003. In 2005 this new trend is visible through the big difference between the performances of the stock market index such as BET (+ 50.90%), BET-C (+ 38.22%) and BET-FI (+ 175.24%), compared to quite close variations of the three index in the previous year: BET (+ 100.96%), BET-C (+103.50%) and BET – FI (+ 115.48%).

The year 2006 is remarkable for a large number of positive events that were important for the BVB future development, such as:

- the completion of the merger with Rasdaq;
- the introduction of the transactions in margin for spot market (shares);
- the successful public bond issues for the World Bank and the Romanian Commercial Bank,
- the setting of the Central Depository
- the successful listing of shares for Transelectrica, the first issuer in the utilities listed on the Romanian Stock Exchange Market.

Only 4 of the 21 shares of Class I brought total gains over 50% in 2006, and another 16 of them have made gains above inflation. Although after the summer of 2006 when stock market crashed and nobody bet on spectacular yields on BVB, the year 2006 brought investors good returns of over 100%. But 2006 was not anymore the year for financial investment companies (SIF), but for other companies, less known to the general public. In late 2006, the entire community of investors was ridden by the question what will happen to the stock market in 2007?

2.1. The perspectives of the Romanian Capital Market after joining the EU

At the time of accession to EU, both stock market indexes: those related to capitalization as well as those related to the value of transactions, were recording still very small levels, compared to those from the neighbor stock markets, so there were expecting quite sudden jumps on the stock market indices.

The most hunted stock shares were expecting to remain even after joining the EU all SIFs, pharmaceuticals, banks and companies in the oil sector.

The perspectives on the capitalization of BVB was to triple in the coming years, following the increase of confidence in the investment environment in Romania after EU accession and as a result of increasing interest in the stock market of large companies in Romania. The stock market was expecting to reach 40 and then 60 billion Euros in the coming years, given the EU integration and the changing in the Romanian investment culture. This development was considered a necessity as other stock exchange markets reached capitalization of 150 billion Euros - Turkey, or 1.000 billion- Russia. The Romanian Stock Exchange Market didn't have very strong companies listed at the time of accession the EU or they had small packages listed, leading to a little exposure.

With a total of 58 listed companies, BVB reached a market capitalization of over 21 billion Euros, with an increase of 2.4 percent over the past three years before joining the EU. In the same period, however, liquidity ratio (the ratio of market capitalization and value of transactions) had no significant progress but it remained below 20 percent. About 75 percent of the total capitalization was owned by five companies, and public listing of companies on the market, were extremely rare. The perspectives for the stock market were to grow as a result of EU accession, in the same way as it could be observed in countries which joined the EU in 2004. Of course, this development requires the listing of large companies or the growth of listed packages, as well as other measures such as raising the holding limit in the SIFs, which was currently a maximum of one per cent.

The main obstacle to increase the stock market was considered the low liquidity.

Also, the banking system was not very attractive for investors because the bank shares are traded on the stock to levels of price / earnings well above the banks in neighboring areas such as Serbia and Turkey. However, accession will give new rise to the capital market in Romania. The president of East Capital, Elam Hakansson, stressed that "The competition among Stock Exchange Markets in Eastern Europe is very strong. Especially in emerging markets where the expectations of investors are very high and they look very closely both on the return on investments, as well as the amount of time they are obtained in. I think that, from this point of view, Bucharest market is still a land worth discovering, especially for those companies that conduct business actions in Europe and for which membership brings business development'. Foreigners were anticipating at that time, that with

our integration in the European Union, we will progress more rapidly to higher levels of living standard, so we get to consume more products and services that have higher quality and are more expensive, so we get to spend more and more money from which will ultimately benefit the Romanian companies that offer these services or products. This is the reason why foreigners continued to buy shares on the Romanian Stock Exchange Market at prices that seem slightly exaggerated from the present point of view.

3. The impact of joining the EU on the Central and Eastern Europe (CEE) capital markets

I present below the effects of EU accession on the stock exchanges in Poland, Hungary and the Czech Republic, countries that joined the Union before us, on the 1st of May 2004. The evolution of capitalization of the three exchanges (in billion dollars) is as shown in Figure 1:

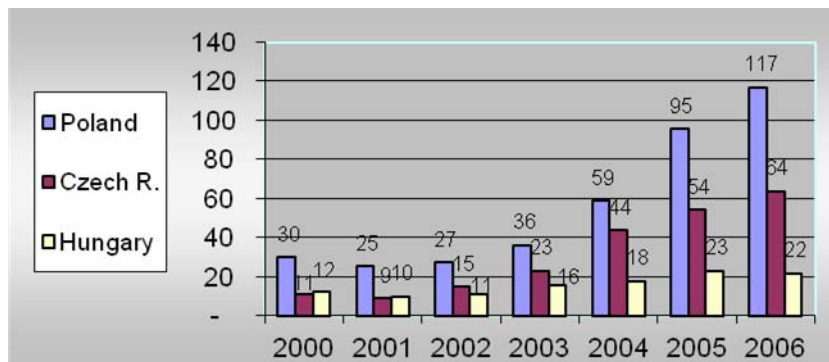


Fig. 1. *The evolution of the market capitalization in CEE, before and after joining the EU*

As can be seen right away from the chart, the period around accession was extremely beneficial for capitalization. In the first year after accession (2004) it was registered the largest increase in capitalization of the analyzed period. Also, the first year before accession (2003) and the second year after (2005) showed significant increases.

Next, I performed the same analysis in terms of annual value of transactions with shares (in billion dollars) as shown in Figure 2.

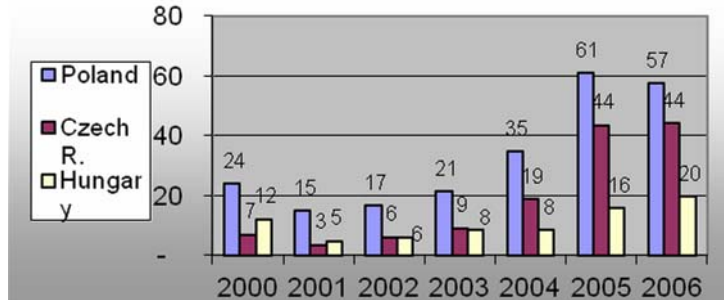


Fig. 2. *The evolution of stock exchange transactions in CEE, before and after joining the EU*

Again, the effects appear to be favorable in the years after accession the Union, especially the first two, when was noticed significant increases in the value of transactions.

Finally, the third analysis which I present below shows in Figure 3 the increase of the official stock market indexes (WIG in Poland, PX in Czech Republic and Hungary BUX):

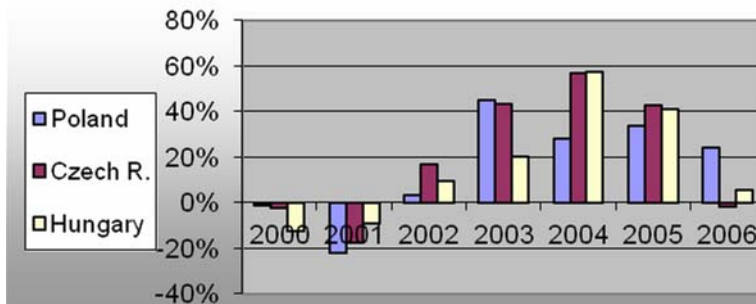


Fig. 3. *The evolution of stock market indexes in CEE, before and after joining EU*

3.1 The correlation between the Romanian stock market index and the CEE stock market indexes

Since long time the Stock Market in Romania was immature, but the year 2006 changed this perception of the foreign institutional investors, who started to consider it as belonging to the Central and Eastern Europe area that was dominated so far by the markets from Czech Republic, Poland, Hungary. The evolution of the Romanian capital market was correlated to a great extent with the other major markets in the region (PX - Czech Republic, WIG – Poland, BUX - Hungary) as shown in Figure 4.



Fig. 4. *The correlation of stock market indexes in the CEE markets*

The causes of these correlations are based on similar strategies of the strongest institutional investors on the markets from a particular region. Thus, although the purchase value of shares listed on the BVB from non-resident investors accounted for only 30% of the total purchases (a proportion that has been relatively constant for many years), they ended the year with a net purchase position (buying higher than sales), while local investors ended 2006 with a net sales position. Thus, they represent a smaller share in transactions, the non-resident investors who typically invest on longer-terms, often trigger major trends in the market to buy or sell; Local investors that follow generally shorter term speculative investment, follow the trends established in the market.

4. The impact of joining the European Union on the Romanian stock exchange market

The Romanian Capital Market seem to follow the same pattern of evolution after Romania joined the European Union as the markets from Central Europe did, after joining the EU in May 2004. While the local currencies of the countries that joined the first wave of EU, recorded continuous appreciations in the first 12 months after accession, the capital markets have reacted later, but the increases were substantial. In Romania, accession hasn't brought immediate growth for stocks listed on the main stock exchange. The BET index of the most important companies fluctuated from January to May between 8,000 and 9,000 points. This situation was about to change from the beginning of June when entering on a strong growth trend and reach almost daily new historical highs. After accession, the investors had to do a proper analysis on the market in order to take the decision to invest. They had to

look on the market, on the legal aspects, on the regulatory issues so it was required a period of time to pass. SIFs, the most liquid companies on the stock exchange, but with the higher fluctuation above the market, had lost almost 20% in value in the first three months afterwards, and later to exceed the January barely five months after accession. Probably at first, upon accession the expectations are too high and the market is currently applying corrections. Subsequently the foreign investors start purchasing, but at low volumes, since they need to observe the market and need to do their analysis on the market before investing. Later on, when the market starts to increase, higher levels of investments are being expected.

5. Conclusions

For our neighbors, the Hungarians, the Poles and the Czechs, the first year before accession and the next two years after accession, were the most profitable on the stock exchange markets. The highest level of capitalization was recorded in the year of accession (2004) and both the previous year, as well as the next year after accession the Union, brought significant increase in capitalization. The same trend could be seen for the values of transactions. Of course, all the above developments are influenced by many factors, such as the situation in the international markets, the foreign investors' attitudes, the country-specific elements.

It can be said that the Bucharest Stock Exchange in the first year after accession to the EU responded to international crisis as a sign of integration in the international circuit, while political domestic crises affected the stock only to a small extent, which was sign of maturity of Romanian investors.

The beginning of the year 2007 was marked by investor euphoria linked to Romania's accession to the European Union, anticipating a similar development as in previous years on companies' financial results, which brought the great appreciation of the BVB indexes. In late February held the first wave of the stock market decline, due to the indexes depreciation from China. This fall has affected most of the international markets, including the Romanian market. Depreciation was reinforced by domestic political instability in January, taking place in Parliament on the suspension request of the president. Towards the end of March a new general decline occur in the US market, that affected specially the banking sector (around 8% loss in the most important actions), and SIF (3- 4%).

Although BVB was affected by the international situation, something that could not be foreseen, the evolution of the main stock market was positive compared to 2006, and very close to the National Prognosis Commission estimates on the regulated market. Another feature is that the evolution of the BVB indicators was more uniform than in previous years, avoiding the corrections that usually happened in spring.

The increasing oil prices, the losses of large international banks, the review of the rating of Romania's country from "stable" to "negative" by Standard & Poor's, were so many negative elements on this background that affected the capitalization. A positive element was the IPO of Transgaz, expected with great interest by investors. This offer has recorded the highest level of oversubscription and brought a new element for the Romanian market, namely "allocation rights" being a particularly good target for big investors.

When we talk about emerging markets we must take into account that what attracts strong investors is not only the relationship between the price and the fair value of shares determined based on its current financial, but also the potential for growth and the development of the business they estimate will have in the next 5-10 years. However, the situation of the majority of Romanian companies is that, upon accession the European Union although they were correctly assessed market or even overstated in some cases, the long-term potential of development was much higher compared to that of large companies, who were operating on mature markets in Western Europe, North America or even in some parts of Asia.

It is expected in the future as those who invest in the Stock Exchange Market, considering a time horizon of 2-3 years, to having more to gain (in real terms, thus taking into account the inflation rate and / or exchange rate currency) compared to keeping their money in a bank account for interest rate.

6. References

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