ROMANIAN CAPITAL MARKET: ON THE ROAD TOWARD AN EMERGENT MARKET STATUS

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Abstract. *Capital markets have become one of the drivers of economy growth in frontier and emerging economies and Romanian case is no exception. Bucharest Stock Exchange is the second capital market in Central and Eastern Europe by the number of IPO successfully concluded in 2017 and is the sixth in terms of the largest return among world capital markets. In recent years, Romania's capital market has made significant efforts in order to upgrade to the emergent market status in terms of development of market infrastructure, increasing the accessibility and attractiveness of the Romanian capital market through listing of public and private IPO's. Our research is focused on a quantitative approach – content analysis, by taking into consideration the ratings of FTSE Russell and MSCI considering Romania's country classification. The results of our study indicate that despite the positive changes, Romania's rating as a frontier market implies a set of challenges that Romania must face in order to become an emergent capital market: free and well-developed equity market- market accessibility and facilities for international investors and liquidity. A very important criterion for Romania to achieve the emergent capital market status is represented by listing new public (such as Hidroelectrica and the National Company Bucharest Airports) & private IPO. The evolution of BET and BET–TR as compared with the evolution of CDS over 2007-2017 shows that BVB is very sensitive to the country risk, which also influences foreign capital investments.*

Keywords: *frontier capital market; emergent capital market; Bucharest Stock Exchange; economic growth; Romania.*

Introduction

Capital markets have become one of the drivers of economy growth in frontier and emerging economies and Romanian case is no exception. Bucharest Stock Exchange is the second capital market in Central and Eastern Europe by the number of IPO successfully concluded in 2017 and is now sixth in terms of the largest return among world capital markets (PwC, 2018). Despite significant positive changes in terms of development of market infrastructure, increasing the accessibility and attractiveness of the Romanian capital market through listing of public and private IPO's, Romania will continue to be in 2018 a frontier market. This is due especially to the political and economic local context that on the long term can generate uncertainties or exposure to adverse business, financial, or economic conditions that could lead to the obligor's inadequate capacity to meet its financial commitments on the obligation (Standard &

Poor's, 2018). The evolution of BET and BET–TR as compared with the evolution of CDS over 2007-2017 shows that BVB is very sensitive to the country risk, which also influences foreign capital investments (PwC, 2018).

Our research is focused on a quantitative approach – content analysis, by taking into consideration the ratings of FTSE Russell and MSCI considering Romania's country classification. The results of our study indicate that despite the positive changes, Romania's rating as a frontier market implies a set of challenges that Romania must face in order to become an emergent capital market: free and well-developed equity market-market accessibility and facilities for international investors and liquidity. A very important criterion for Romania to achieve the emergent capital market status is represented by listing new public (such as Hidroelectrica and the National Company Bucharest Airports) & private IPO.

Frontier versus emerging markets: challenges and opportunities

"Frontier markets are among the fastest-growing economies in the world … In essence, they are the emerging markets of tomorrow" (Rowader, 2015, p.2). Frontier markets are a subset of emerging markets, with lower market capitalization and liquidity or more investment restrictions than more established emerging markets, or both, depending on the country under consideration (Bond & Dyson, 2016, p.147). Being variously described as "emerging-emerging," "next-generation emerging" and "frontier" (EY, 2017) or "pre-emerging markets" are more volatile than other stock markets and are defined by greater social or political instability (Barclays, 2018).

When it comes to the most important opportunities for private equity industry to invest in frontier markets, we can distinguish the following features: 1) Less competition and access to largely untapped markets carries the potential to deliver significant returns with proven business models. Frontier markets contain niches of high economic growth - the opportunity to generate strong returns investing 'off the beaten path', often in assets that are under the radar or not part of the geographic remit of mainstream investors *(Financier Worldwide Magazine, 2017)*; 2) Frontier markets tend to have little correlation either with developed markets or emerging markets and this can make them a possible portfolio diversifier (Barclays, 2018). This idea is also emphasized by Rowader (2015) that indicates that frontier markets offer growth potential and low correlations within markets and with other asset classes, along with relatively attractive valuations.

EY (2017) indicates a series of risks and challenges when determining which particular frontier markets to pursue for portfolio diversification: 1) *Regulatory and trading-execution risk – such as foreign ownership restrictions, currency limits, local custody rules, local funding and registration requirements; also, some markets even require foreign market participants to execute trades via local brokers; 2) Transaction costs:* high local transaction fees and commissions inflate trading costs; 3) *Currency risk:* investors that seek to build a frontier market portfolio need to be aware that they face a higher risk of investment exposure to potentially volatile currencies; 4) *Governance risk:* standards of corporate governance and financial reporting among listed companies in some frontier markets can be uneven; 5) *Sector and sovereign risk:* part of the attraction of frontier markets is their low correlation with developed and emerging markets. However, investors should be aware that frontier markets are dominated by a few sectors, thus a sizeable allocation can result in concentrated exposures to certain sectors. Frontier market equities are highly exposed to sovereign risk. 6) *Liquidity risk:* illiquidity is a feature of many frontier markets. Investors may be unable to execute trades when they want, or at the size they want. Bid-offer spreads can also be relatively wide. 7) *Operational risk:* in some frontier equity markets, investing entails increased operational risk. Failed trades may occur more frequently than in developed markets, as settlement processes may be less standardized, less automated and more prone to errors. 8) *Political risk:* many frontier markets have fragile systems of government that can be prone to instability. Turmoil can in turn lead to rapid declines in the market value of securities traded in impacted countries.

J.D. Stanford (2009) defines emerging economies as developing economies that have adopted market-oriented policies and have established stock markets in order to obtain foreign capital to increase economic growth. The defining characteristic of emerging markets is that their economies are still very much in the development phase; they typically boast very young populations, a rising middle class and some, but by no means all, are enjoying robust levels of economic growth and industrialization (Barclays, 2018). The most important features of emerging capital markets are: High growth rates and potential to become developed economies in the mid/long term; A unique risk profile; Lower per-capita income, with differences in consumption behavior when compared to developed economies; Either untapped talent pools or are undergoing specialized labor shortages (e.g. Brazil); Transparency, market regulation and operational efficiency under development; Unique economic and political environments which are still stabilizing (PwC, 2013).

The most important limits of emerging capital markets are: high volatility, the existence of bubbles, panic, speculation, anomalies, high-risk investment opportunities, a low level of liquidity, reduced capitalization, strong correlation with developed capital markets, reduced number of transactions, insufficient development of financial instruments, exchange rate instability (Birău, 2012). Most of the emerging markets lack the institutional strength to take full advantage of an open capital account; this is due to weak financial supervision and poorly developed domestic capital markets (sudden changes in capital inflows may result in significant current account reversals, crises and currency collapses (Edwards & Garcia, 2008, p.2). The challenges for emerging capital markets regarding the availability, diversity and pricing of capital are emphasized by McKinsey Report - *Deepening capital markets in emerging economies* (2017, p.5): 1) *Significant funding gap* - Primary markets are more volatile and less reliable sources of funds for issuers in emerging markets; 2) *Limited choice:* Emerging market issuers lack options to diversify funding and to match funding with their needs. For example, the absence of a long-dated bond market reduces the flexibility of corporate borrowers to align funding structure with assets and future earnings; 3) *Expensive capital*: Issuers in these markets face a more volatile and higher cost of capital compared with developed markets. For example, they pay roughly a 120 percent higher real cost for debt securities.

In comparison with frontier markets, emerging markets could grow around twice as fast as advanced economies on average by 2050 (PwC, 2017). According to J.P.Morgan -*Long-Term Capital Market Assumptions Report* (2018) - despite outperforming in 2017, emerging market equities remain attractive. These points of view can be correlated with the following reasons: 1) *Global growth remains robust* - rates of growth have slowed from their best levels in the first quarter, but the current pace of activity is still pointing to near double-digit annual gains in corporate profits; 2) *The dollar is unlikely to keep rising* - the U.S. dollar has reached a top for this cycle and could enter a multi-year bear market due to growing U.S. deficits and inflationary pressures; 3) *Commodities prices are going up* - Emerging market returns usually correlate with commodity prices. That hasn't happened this year, mainly because of surprising dollar strength, but it is expected that commodities and emerging markets to start trading more in sync as the dollar weakens; 4) *Capital spending is strong* - S&P 500 companies are continuing to spend on capital projects. That tends to benefit emerging markets, which often supply parts and raw materials for those projects; 5) *China-U.S. trade conflicts could be a benefit*- Long-term, no country wins from trade wars, but in the short-to-intermediate term, emerging markets could get a boost from any potential escalation in trade conflicts between the U.S. and China (Shalett, 2018). When it comes to emerging capital markets, Asia could dominate growth in global equity market capitalization over the next 10 years; at the same time, there is a rapid deepening of intra-regional bank lending, FX, rates and credit markets (Morgan Stanley, 2018).

Financial market development of Romania

Ioana Andrada Moldovan (2015, p.460) indicates that the real economy influences the market capitalization in Romania only on the short run, the financing function being performed almost exclusively by the banking system, while the capital market is small and does not fulfil properly the function of financing the real economy. When it comes to financial market development, The Global Competitiveness Report (2017) that comprised 138 countries - indicates that Romania was ranked 86 (with a score of 3.73), much lower than top 3 countries: New Zeeland (5.79), Singapore (5.69) and United States (5.64). Top 5 most problematic factors for doing business in Romania are: access to financing, inefficient government bureaucracy, tax rates, inadequately educated workforce and corruption. The most important indicators of the Financial market development pillar from the Global Competitiveness Report (2017) that ranked Romania between 125-121 out of 138 countries are the aspects concerning financial services meeting business needs, venture capital availability, financing through local equity market and affordability of financial services (*see the figure below*):

	8th pillar: Financial market development	86	3.7
8.01	Financial services meeting business needs	125	3.4
8.02	Affordability of financial services	121	2.9
8.03	Financing through local equity market	123	2.6
8.04	Ease of access to loans	110	3.1
8.05	Venture capital availability	125	2.1
8.06	Soundness of banks	90	4.4
8.07	Regulation of securities exchanges	114	3.5
8.08	Legal rights index 0-10 (best)	8	10

Figure 1. 8th pillar: Romania Financial market development
(World Economic Forum, 2017, p.305)

When it comes to the economic development of Romania, Bucharest Stock Exchange has an important role due to the potential of attracting foreign investments: "Romania is now sixth in terms of the largest return among world capital markets and third in the European Union. Moreover, the Romanian stock market is one of the very few in the entire world sharing consistency as regards the valuations of assets, being in `plus` also in three years' perspective backwards. The Bucharest Stock Exchange has come a long way from where it was five years ago and its continuing efforts to ensure the upgrade to the Emerging Market status are quintessential" (Sobolewski, 2017).

In the last years, the strategy of Bucharest Stock Exchange (2014, pp.4-11) has been focused on:
1) *Enlargement of the local investors' base*: The "Eight Barriers Removal" program served directly or indirectly the interests of local institutional investors, namely the pension investment funds;
2) *Enlargement of the individual investors' base:* initiatives relating to financial education (Investors Clubs, Fluent in Finance, Individual Investors Forums, Financial Expos, InvestQuests, Experts Call Center, Open Doors Day), to new transactional tools (ArenaXT), to the upgrade or release of new communication means (websites, mobile applications), to the creation of new market segment naturally dedicated to retail investors (AeRO), to the decrease of transactional costs and reliability of the dividends distribution and special schemes promoting day-trading (inactive);
3) *Transforming the BVB into a marketplace for financing of already listed issuers:* segmentation of the market, new indexes, including "total return" indexes", new obligations attached to the presence in the "premium" segments and for constituents of the BVB main index. Other initiatives that consisted of organizing investors' meetings with listed companies were arranged by the BVB, including a brand-new project of the "reverse road shows", engaging international investors coming to Bucharest.
4) *Transforming the BVB into a marketplace for financing of new companies:* BVB launched many initiatives aimed directly at potential new listings, both from the private sector and SOEs. The requirements for admission to trading of companies were simplified. Road shows and presentations involving candidates for listings and confronting them with potential investors, the creation of AeRO, are among them.
5) *Enhancement of intermediaries' efficiency:* Partnerships with brokers-members of the BVB in several educational and marketing-intense initiatives, new instruments designed for the brokers (market-making revenue schemes, issuers' market making), instruments giving outreach to retail clients (ArenaXT platform on mobile devices), institution of Authorized Advisors – marked the new approach of the BVB which consisted of real support given to brokerage industry. This line of actions will be continued and intensified;
6) *Modernizing the market infrastructure to face challenges and opportunities:* The most relevant envisaged the separation of trading and post-trading systems, the increased flexibility of settlement on gross basis, the T+2 implementation, and the introduction of two settlements cycles. The trading environment got improved with new market making programs, reduction of suspension from trading, elimination of the Odd-lot market, new tick size, new trading hours and new market stage, implementation of the auction models. The trading tools brought mobile apps and ArenaXT platform enhancements (Bucharest Stock Exchange, 2014, pp.4-11).

Ioana Andrada Moldovan (2015, p.447) indicates that "the development of capital market is a sine qua non condition for modernizing the Romanian economy, by increasing funding potential and enhancing competition in the financial marke". The author claims the need for government support and recommends economic policy measures in order to accelerate financial market`s expansion in the Romanian economy.

Discussions

At present, Standard & Poor's credit rating for Romania stands at BBB- with stable outlook (Trading Economics, 2018). An obligation rated 'BB' is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions that could lead to the obligor's inadequate capacity to meet its financial commitments on the obligation (Standard & Poor's, 2018). "The advance of the Romanian economy, focused on consumption, could generate wide external fiscal deficits and could increase the vulnerability of Romania's economy to a sudden drop in activity in the medium term. However, Romania's level of public and external debt is modest and the economy growth could remain solid for a considerable period of time" (Romania Insider, 2017).

When it comes to the FTSE Russell classification, Romania that was added to the Watch List in September 2016 for possible reclassification to Secondary Emerging market status from frontier markets, doesn't meet the criteria. Despite this, FTSE Russell acknowledges the efforts of the Bucharest Stock Exchange to bring IPOs to the market and to improve liquidity levels on the exchange (FTSE Russell, 2018, p.6). The indicators taken into consideration are: 1) *Quality of Market* – the quality of regulation, the dealing landscape, custody and settlement procedures, and the presence of a derivatives market would all be taken into account; 2) *Materiality* – a country needed to be of material size to warrant inclusion in a global benchmark; 3) *Consistency and Predictability* – a pathway to classification changes would be set out by announcing a "Watch List" of countries that were being considered for promotion and demotion as well as the criteria by which countries would be judged; 4) *Cost Limitation* – the cost of implementing a change would be taken into account when assessing a market for promotion or demotion; 5) *Stability* – a phased approach would be taken to the introduction of new countries; a new country would only join as an emerging market; and promotion would only occur in response to permanent changes in market status and global acceptance; and 6) *Market Access* – international investors should be able to invest and withdraw funds in a timely and secure manner at reasonable cost.

The main criteria that Romania doesn't meet are: *Free and well-developed equity market, Custody - Omnibus and segregated account facilities available to international investors*, *Liquidity* - Sufficient broad market liquidity to support sizeable global investment and *Off-exchange transactions permitted*. "An important criterion to be achieved is liquidity adequate to the implementation of large international investment," and in practice refers to the need to attract new companies to increase capitalization, free float and consequently share trading. Information is read as a harbinger of promotion of Romania to the "Watch List" by the international rating institutions" (Carpathia Capital, 2017). In comparison with Romania, Saudi Arabia (also included in the watch list from 2016) and Kuwait (included on the watch list from 2008) will be reclassified from September, respectively, December 2018 to Secondary Emerging Market Status (*see the figure 2*).

The MSCI Market Classification Framework (2018) consists of following three criteria: economic development, size and liquidity as well as market accessibility (*see the figure 2*). Romania is included by Morgan Stanley Capital International in the category of frontier markets. The MSCI Romania Index is designed to measure the performance of the large and midcap segments of the Romanian market; with 5 constituents, the index covers approximately 85% of the Romania equity universe: Banca Transilvania, S.N.G.N Romgaz, OMV Petrom, BRD Group Societe Generale and Electrica.

Developed	Advanced Emerging	Secondary Emerging	Frontier
Australia	Brazil	Chile	Argentina
Austria	Czech Republic	China	Bahrain
Belgium/Luxemburg	Greece	Colombia	Bangladesh
Canada	Hungary	Egypt	Botswana
Denmark	Malaysia	India	Bulgaria
Finland	Mexico	Indonesia	Cote d'Ivoire
France	Poland	Pakistan	Croatia
Germany	South Africa	Peru	Cyprus
Hong Kong	Taiwan	Philippines	Estonia
Ireland	Thailand	Qatar	Ghana
Israel	Turkey	Russia	Jordan
Italy		UAE	Kazakhstan
Japan			Kenya
Netherlands		Kuwait	Latvia
New Zealand		Saudi Arabia	Lithuania
Norway			Macedonia
Portugal			Malta
Singapore			Mauritius
South Korea			Morocco
Spain			Nigeria
Sweden			Oman
Switzerland			Palestine
UK			Romania
USA			Serbia
			Slovakia
			Slovenia
			Sri Lanka
			Tunisia
			Vietnam

Figure 2. FTSE classification of markets
(Source, FTSE Russel, 2018, p.1)

The most important sectors in terms of market capitalization are: financials (52,69%), energy (39,67%) and utilities (7,64%). According to MSCI (2018), Romania is included in the category small frontier, along with countries such as: Morocco, Argentina, Sri Lanka, Nigeria, Oman, Bangladesh, Croatia, Ivory Coast, Slovenia, Kazakhstan, Tunisia, Vietnam and Mauritius (MSCI, 2018). The main challenge for Romania in becoming an emergent market is low liquidity. In order for Romania to reach the status of emerging market it must comply with the following aspects: 1) *Size & Liquidity Requirements* – Number of companies meeting the Standard Index Criteria must be 3; company size: USD 1260 mm/ security size: USD 630 mm; security liquidity – 15% ATVR; *2) Market Accessibility Criteria* – openness to foreign ownership & ease of capital inflows/ outflows – must be significant; Efficiency of the operational framework must be good and tested; Stability of the institutional framework – Modest (MSCI, 2018).

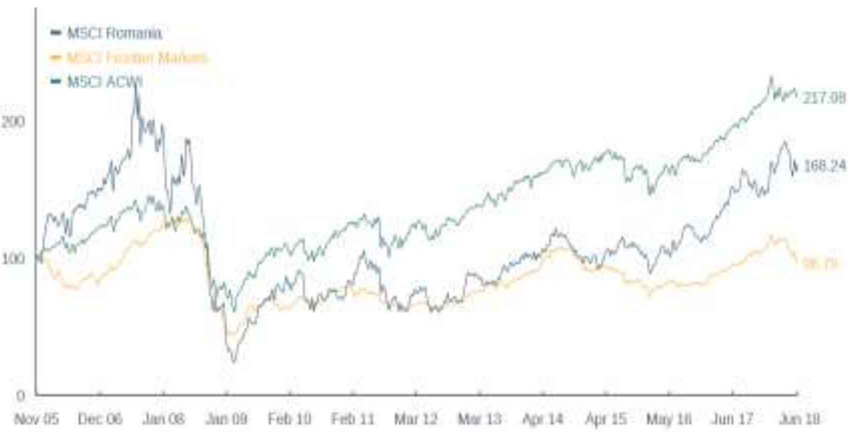
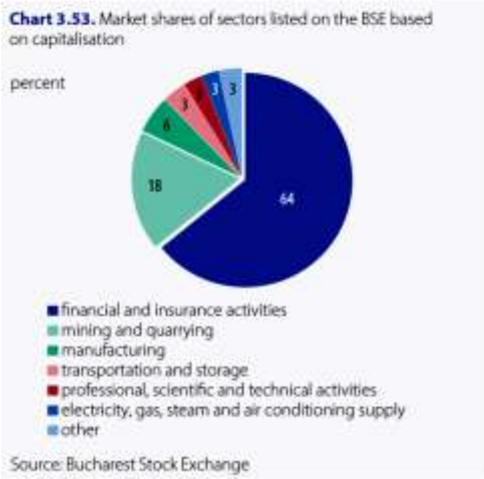


Figure 3. MSCI ROMANIA INDEX (USD)
(MSCI, 2018, p.1)

BNR (2017) indicates that the capital market posted an upward trend in 2017. The index of the top 13 most liquid shares listed on the Bucharest Stock Exchange, namely the BET, reached a nine-year peak in May 2017, followed by a slight correction in 2017 Q3, on the backdrop of uncertainties regarding the future of the Pillar II (private pensions). Nevertheless, the rise in the BET index was below the benchmark indices of the Hungarian and Polish stock markets, yet above the European average. In terms of volatility, evolutions on the Romanian capital market exceeded those recorded by some more developed markets.

January 2017 through September 2017, the most significant dynamics were posted by the BET-FI index, which increased by 26 percent in the first three quarters of the year compared with end-2016, followed by the BET-BK and BET-XT-TR indices, while the sectoral index for utilities, the BET-NG, decreased slightly starting with the second half of the year. Moreover, in August 2017, the average traded value of listed shares was 38 percent higher year-on-year. In order to support portfolio diversification, the local stock exchange could attract new companies to contribute to lowering sectoral concentration, while increasing representativeness in relation to the national economy (BNR, 2017, p.117).

Romania still aspires to advance from the status of frontier capital market to that of emerging market with increased visibility among the investors and implicit benefits in terms of depth and liquidity. In this regard, ASF (2014) developed *STEAM project – Set of Actions Toward Establishing and Acknowledgement of the Emerging Market Status* - a priority project the development of the capital market and its inclusion in the category of emerging market. The set of measures proposed through the STEAM Project are: increasing the accessibility and attractiveness of the Romanian capital market; streamlining financial instrument borrowing and short selling transactions; development of the primary and secondary local market of bonds (municipal and corporate); increasing liquidity and attracting new investors; increasing the visibility of the Romanian companies listed on the capital market, by listing them on other markets; increasing the implementation of corporate governance principles at the level of issuers, intermediaries, market operators, depositories, etc.; improving the accounting system of regulated and supervised entities - by aligning with IFRS.



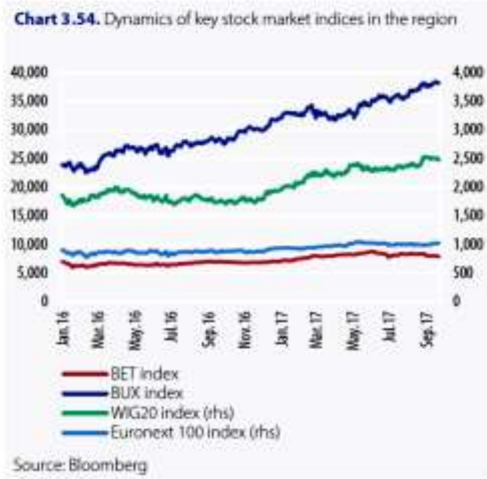


Figure 4. Market shares of sectors listed on the BSE & Dymanics of key stock market indices in the region (Source: BNR, 2017, p.118)

By now, BVB and ASF have improved the legislation through public bills (such as Alternative Investment Funds, Financial instruments etc.), modernization of the capital market infrastructure (merger of BVB and SIBEX, DC reauthorization, CCP in progress), development of bond market, increasing the number of emitents (transfer of the companies from RASDAQ on the principal market or ATS), programs of financial education (Negrițoiu, 2017). An important criterion in order for Romania to achieve the status of emergent market that by now hasn't been attained is represented by public IPO's: Salrom, Hidroelectrica and National Company Bucharest Airports listing are very important for 2018 (Țințeanu, 2018). STEAM project also implies listing other national companies where the state has majority shares such as Distrigaz Sud – GDF and Distrigaz Nord – E.ON, according to ASF (Negrițoiu, 2017).

Despite the significant initiatives taken by BVB and ASF through the STEAM project, liquidity remains an important challenge for the Romanian capital market and affects directly the market efficiency; it is not efficient in light of the fact that the stock price changes can be forecast (Oprean, Tănăsescu & Bucur, 2017, p.1680). The evolution of BET and BET–TR as compared with the evolution of CDS over 2007-2017 shows that BVB is very sensitive to the country risk, which also influences foreign capital investments (PwC, 2018, p.4).

Conclusions

Romania – BVB and ASF- has made significant improvements in order to upgrade from frontier to emergent market status: *Enlargement of the local investors' base*: The "Eight Barriers Removal"; initiatives relating to financial education (Investors Clubs, Fluent in Finance, Individual Investors Forums, Financial Expos, InvestQuests, Experts Call Center, Open Doors Day), to new transactional tools (ArenaXT), to the upgrade or release of new communication means (websites, mobile applications), to the creation of new market segment naturally dedicated to retail investors (AeRO), new indexes, including "total return" indexes", new obligations attached to the presence in the "premium" segments and for constituents of the BVB main index; launched many initiatives aimed directly at potential new listings, both from the private sector and SOEs; the separation of trading and post-trading systems, the increased flexibility of settlement on gross basis, the T+2 implementation, and the introduction of two settlements cycles. At the same time, the Romanian stock market recorded one of the highest dividend yields in the world in 2016 and 2017. BET total return index, which includes the dividends granted by the blue chips listed on BVB has increased by over 19% in RON terms in 2017 (PwC, 2018).

Despite the positive changes, Romania's rating by FTSE Russell inclusion in the Watch List and MSCI as a frontier market indicate the main challenges that Romania must face in order to become an emergent capital market: market accessibility and facilities for international investors, development of market infrastructure and liquidity. The evolution of BET and BET–TR as compared with the evolution of CDS over 2007-2017 shows that BVB is very sensitive to the country risk, which also influences foreign capital investments (PwC, 2018). Although the initiatives taken by BVB and ASF through the STEAM project are significant, liquidity remains an important challenge for the Romanian capital market and affects directly the market efficiency. A very important criterion for Romania to achieve the emergent capital market status is represented by listing new public & private IPO.

In order to accelerate change, Romania must continue the development of the capital market infrastructure, "so that it can offer a range of services that support financial institutions, companies, governments and investors in building businesses and contributing to growth in the wider economy" (McKinsey, 2017, p.6).

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