

8 Outlook for the Joint Development of Stock Market Infrastructure in EurAsEC Countries

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Stock markets are an important element of any modern market economy. Along with banking systems, they facilitate the efficient distribution of resources between borrowers and lenders. As EurAsEC countries made the transition to market economics, they had to create new stock markets.

Prior to the current economic crisis, significant differences in the level of development of stock markets across EurAsEC had become apparent (see Tables 8.1 and 8.2). Russia and Kazakhstan were the clear leaders (in 2007, the capitalisation of their stock markets¹ was 111.8% and 39.2% of GDP, respectively; Kazakhstan's performance deteriorated in 2007 as the economic crisis in that country began to take hold. Russia's stock market not only has a higher level of capitalisation, but also demonstrates higher market liquidity: trade in all types of securities on leading national stock exchanges² in 2007 totalled 84.1% of GDP, compared with 19.2% in Kazakhstan.

By comparing the levels of development of the stock markets and banking systems of Russia and Kazakhstan, we are able to conclude that in recent years Russia has adopted the Anglo-Saxon financial model which is oriented towards the stock market, whereas Kazakhstan has adopted the continental European model which is focused upon the banking system. However, this is only a very basic characterisation.

Table 8. 1.
Stock market
capitalisation in
EurAsEC countries,
1999–2007
(% of GDP)

Source: EBRD 2008
Transition Report.

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Belarus	3.4	4.1	2.9	–	–	–	–	–	–
Kazakhstan	15.5	7.5	5.6	5.5	7.7	8.7	18.9	54.7	39.2
Kyrgyzstan	0.4	0.3	0.3	0.5	1.6	1.5	1.7	3.1	3.1
Russia	41.2	15.3	26	36.6	51.1	44.6	71.9	104.4	111.8
Uzbekistan	1.9	1	0.6	0.4	0.2	0	0.3	4.3	–

¹ We use the term "stock market" in the narrow sense, i.e., a share market.

² The Moscow Inter-bank Currency Exchange (MICEX) and the Russian Trading System (RTS).

	Shares	Government stock	Corporate bonds	Regional bonds	Total	Trade (% of DP)
Russia (MICEX and RTS)	614488.2	346734.4	107137	20615.7	1088975	84.1
Kazakhstan (KASE)	8924.4	6722.4	4302.5	0.2	19949.5	19.2
Belarus (BCSE)	3.7	4534.5	124.1	0	4662.3	10.4
Uzbekistan (Toshkent NSE)	89.2	0	0.4	0	89.6	0.4
Kyrgyzstan (KSE)	146.1	0.04	0	0	146.14	3.9

The stock markets of other EurAsEC countries are significantly underdeveloped compared with those of Russia and Kazakhstan. In Tajikistan, there is no organised stock market. In Kyrgyzstan and Uzbekistan, stock markets are very weak, although some positive developments were seen there prior to the global economic crisis (see Tables 8.1 and 8.3). Belarus has a robust government stock market³, but so far there has been no significant progress in the development of a non-government securities market.

	Shares		Government stock		Corporate bonds	
	2007	2006	2007	2006	2007	2006
Russia (MICEX and RTS)	44.2	245.1	1544.5	12.2	59.6	110
Kazakhstan (KASE)	121.6	287	26.9	38.5	42.7	75.7
Belarus (BCSE)	1133.3	-78.6	38.5	-24.5	8273.3	-65
Uzbekistan (Toshkent NSE)	-19.6	212.4	-	-	-50	166.7
Kyrgyzstan (KSE)	42.3	240	...	-	-	-

The financial crisis has affected all EurAsEC countries to some extent, but has had a significant impact upon the more developed financial systems of Russia and Kazakhstan, causing much greater fluctuations in their stock markets. The MICEX and KASE indices dropped by 67% and 65% respectively in 2008. In the same year, share trade on MICEX and KASE (denominated in \$) fell by 15.7% and 42.8%, respectively. The distribution of EurAsEC stock markets in terms of their level of development has not changed significantly, but the Russian market is still slightly ahead, albeit in conditions of overall decline.

Given the outbreak of the financial crisis, the prospects for interaction between the stock markets of EurAsEC countries must be reviewed. Whereas the main problem for developed EurAsEC stock markets before the crisis was the

Table 8. 2. Stock exchange trade in EurAsEC countries in 2007 (\$ million)

Source: 2007 Stock Exchange Statistics Bulletin. International Association of Stock Exchanges of the CIS (<http://mab.micex.ru/papers>). GDP data: EBRD 2008 Transition Report; www.gks.ru.

Table 8. 3. Increase in trade on the stock markets of EurAsEC countries (% of the corresponding period in the previous year), (\$).

Source: 2007 Stock Exchange Statistics Bulletin. International Association of Stock Exchanges of the CIS (<http://mab.micex.ru/papers>).

³ Trade on this market in 2007 totalled about 10% of GDP.

“drain” of activity from these markets to overseas markets (the London Stock Exchange)⁴, and less developed markets were principally concerned with their own development, now their main preoccupation is one of maintaining stability. Although it might be assumed, therefore, that the task of increasing interaction in this sector is now less urgent, the strategic importance of this goal has not diminished.

Two factors which favour this interaction are, firstly, that countries with developed stock markets (Russia and, to some extent, Kazakhstan) would be able to assist the other countries in this respect. Secondly, there is still scope for diversifying stock-market operations. If we examine the structure of trade on organised markets before the crisis (see Table 8.2), we see that only Russia had achieved a relatively balanced structure, whilst in the other countries trade was dominated by individual segments (shares or public bonds). But the issue of diversification is no less urgent for Russia: at the end of 2007, 5% of companies whose shares were traded most actively accounted for 94% of the total trade on MICEX and for 86% on RTS⁵.

In addition, the crisis itself creates opportunities to broaden financial cooperation. It should not be forgotten that major financial integration initiatives in post-Soviet countries were conceived in the wake of the 1998 crisis. In the current climate, foreign stock exchanges are becoming somewhat less attractive, and opportunities to utilise the region's own potential are emerging, even though the size of the latter has shrunk in material terms.

The interaction of the infrastructural organisations of EurAsEC stock markets would go some way to addressing the aforementioned problems, given the support of the regulatory authorities in the relevant countries. The participation of state bodies in this process is critical, since their role becomes more significant as the crisis continues. Just as importantly, these bodies are also shareholders in infrastructural organisations. For example, the principal shareholder of MICEX is the Central Bank of Russia (which owns nearly 30% of shares), and the National Bank of Belarus holds the controlling block of shares in the Belarusian Currency and Stock Exchange.

Such interaction will be driven not only by the need to address common problems, but also by the players' mutual penetration of each other's markets, which had intensified prior to the crisis. This is especially true of the Russian and Kazakh stock markets. For example, two of Russia's largest investment companies – KIT Finance and Renaissance Capital – are now listed on the Kazakh stock market. Russia's Troika Dialog investment bank also purchased Kazakh company ALMEX Asset Management.

⁴ Thus, in Russia in 2007, 44% of total IPO proceeds were generated on national stock exchanges, whilst Kazakh companies executed all their IPOs on the London Stock Exchange.

⁵ 2007 Stock Exchange Statistics Bulletin. International Association of Stock Exchanges of the CIS.

Similarly, on the Russian stock market, there are a number of investment companies which are owned by, or affiliated with, Kazakh banks. For example, the Russian companies TuranAlem Finance, BTA Finance and BTA Capital are members of the TuranAlem group of Kazakhstan; NBK Finance is owned by the Narodny Bank of Kazakhstan; Kazkommertsbank acquired 50% of shares in East Capital (now renamed East Kommerts); and Centras Capital is a member of the Kazakh investment group, Centras. However, the only prominent player is East Kommerts, which in 2007 was Russia's seventh largest investment company in terms of trade in securities.

Before the crisis, Russian and Kazakh companies had started to penetrate the stock markets of other EurAsEC countries, but this process has not yet gained momentum and there are few significant deals to cite. East Capital founded an affiliate in Uzbekistan, East Capital Invest; and Centras Capital, a member of the Kazakh investment group Centras, entered the Kyrgyz stock market, some of whose key companies are owned by Kazakh banking groups, namely Halyk Bank Kyrgyzstan, East Capital Management and Kazinvest.

There are also a few examples of cross-border provision of stock market services. In May 2007, Polesye Trading House, an affiliate of Pinskoye Promyshlenno-Torgovoye Obyedineniye Polesye (Brest Oblast, Belarus), placed bonds on the Russian market with a total nominal value of 500 million roubles⁶; Russia's Sudostroitelny Bank and the All-Russia Bank for Regional Development acted as underwriters.

It would appear that the global financial crisis has slowed down these trends as market size has shrunk and investment companies are faced with financial problems. In this context, however, infrastructural organisations can take the lead.

In CIS countries, stock market infrastructural organisations have acted as the main driving force of integration. They have set up associations to promote cooperation between their members and the stock markets of other countries; the most prominent associations are the International Association of Stock Exchanges of the CIS (CIS IASE) and the Association of Central Depositories of Eurasia (ACDE). Objectively, we would expect that the Moscow Inter-bank Currency Exchange (MICEX), Russia's largest stock exchange holding company, will make the most significant contribution to the financial integration process.

The International Association of Stock Exchanges of the CIS was founded on 20 April 2000. It comprises twenty infrastructural organisations (stock exchanges and depositories) in nine CIS countries, including thirteen EurAsEC stock exchanges (all the major national stock exchanges, the Uzbek National

⁶ *Prime-TASS, 17 September 2007.*

Commodity Exchange and certain regional Russian stock exchanges) and the Central Securities Depository of Kazakhstan.

At the beginning of the 2000s, a number of significant integration initiatives were proposed under the aegis of the CIS IASE. At a meeting on 29 September, 2002, in Bruges, its members discussed progress towards the implementation of a financial integration programme which would create unified operating mechanisms for currency and stock exchanges in CIS countries⁷. At present, no such far-reaching proposals have been taken up, and cooperation continues at a basic level of interaction. At a CIS IASE meeting on 3-5 March 2008, the Committee on Technical Policy was established to promote the development of information technology⁸.

The Association of Central Depositories of Eurasia was founded on 22 December 2004, in order to create a common "depository space". It comprises eleven depositories from CIS countries, including six from EurAsEC countries.

Bilateral cooperation relies mainly on memoranda of understanding and cooperation between stock exchanges and EurAsEC depositories. There are a few notable examples, in fact, of such memoranda being entered into by MICEX and a EurAsEC stock exchange, or the National Depository Centre and a EurAsEC depository:

- in December 2000, MICEX and the Belarusian Currency and Stock Exchange (BCSE) signed a memorandum of understanding and cooperation on developing stock exchange infrastructure;
- on 28 February 2001, in Moscow, MICEX and the Kazakhstan Stock Exchange signed a memorandum on cooperation on the creation of an integrated stock exchange space;
- on 14 November 2001, in Moscow, MICEX and the Tashkent National Stock Exchange (Uzbekistan) signed a memorandum of cooperation on the creation of an integrated stock-exchange space using advanced stock-exchange technology;
- in December 2005, MICEX, the MICEX Stock Exchange and Tashkent National Stock Exchange signed a trilateral memorandum of understanding;
- on 9 February 2006, the National Depository Centre and the Central Depository of Securities (Uzbekistan) signed a memorandum of cooperation;
- on 11 April 2007, the National Depository Centre and the National Central Depository of Securities (Belarus) signed a memorandum of cooperation.

⁷ http://rus.mab-sng.org/activity/actiondetail.php?id_action=72.

⁸ http://rus.mab-sng.org/news/detail.php?id_news=796&date=3_2008.

To date, stock exchanges in EurAsEC countries have not interacted on a deeper level. The only example of a EurAsEC stock exchange buying up capital in another stock exchange is the Kazakhstan Stock Exchange, which has become a shareholder of the Kyrgyz Stock Exchange. Meanwhile, the largest shareholder of the latter is an infrastructural organisation from a third country – the Istanbul Stock Exchange. A Kazakh subsidiary of Russia's Sberbank owns 1.3% of the capital of Kazakhstan Stock Exchange.

One very significant event has been the launch of the Eurasian Trade System (ETS) of Kazakhstan – a stock exchange founded jointly by RTS (60%) and the Regional Financial Centre of Almaty. ETS uses equipment supplied by RTS. Currently, ETS is a commodity exchange and did not form part of our study, but trade in futures and stock-index futures are to begin there⁹ in the near future. This may in turn prove an impetus to the development of the Kazakh derivatives market.

There are a number of formal integration agreements which define differently the objectives and mechanisms of financial integration in EurAsEC.

In the Agreement on EurAsEC Member Country Cooperation in the Securities Market, signed on 18 June 2004, the main goal of integration (Article 1) is to create a common international securities market, which is understood as being one in which all the securities markets of EurAsEC operate according to unified principles and state regulation. This goal requires a high level of integration, but the Agreement provides no mechanisms to achieve it.

In the Agreement on the Customs Union and a Common Economic Space (signed on 26 February 1999), one of the practical measures to develop financial cooperation between EurAsEC countries is to provide mutual access to each others' services markets (Article 37) based on national treatment systems. In the 2004 Agreement, this measure became a most-favoured nation system for other EurAsEC members (Article 7).

Likewise, in many other documents adopted so far on financial integration, long-term goals and the practical mechanisms to achieve them diverge greatly.

In Russia and Kazakhstan, projects are being implemented at national level to expand internal stock markets by attracting foreign investors and issuers. In Kazakhstan, such a project has already come to fruition with the launch of the Regional Financial Centre of Almaty, which is now the major shareholder of the KASE. In Russia, plans to create a regional financial centre have been drawn up and the first step towards their implementation have been made. In December 2006, the federal law On the Securities Market was amended to introduce a new type of security, Russian depository receipts (RDR). RDRs

⁹ *Respublika (Kazakhstan)*, 3 April 2009.

will enable foreign issuers to place their securities on the Russian stock market using a simplified procedure. In addition, some amendments are being discussed that will provide direct access to the Russian market for foreign securities listed in an OECD or FATF country.

A draft concept to create an international financial centre in the Russian Federation envisages that by 2010, this centre would act as the local centre for the CIS which, as a result of economic integration in the region, will attract securities issued by CIS issuers to Russian stock exchanges. However, this document does not specify how Russia should attract other post-Soviet countries to participate in this project. If Russia fails to link this project to financial integration in the CIS, other potential players may fear that their interests will not be properly taken into account, and that the “securities drain” will be diverted to Russia rather than to western stock exchanges.

So far, these projects are essentially “national”, their purpose being to open national markets to the global market; they do not provide any significant support to financial integration in EurAsEC, and in fact, on the contrary, compete with integration projects.

Another threat to joint development of stock markets in the region comes from third countries which are becoming increasingly active in the region. Close attention should be paid to infrastructural organisations, since these largely determine how national markets function. In the CIS context, Armenia is a significant example: the Scandinavian operator OMX acquired the Armenian Stock Exchange. Besides OMX, NASDAQ and the German, Vienna, Warsaw and Istanbul Stock Exchanges are showing interest in CIS markets. The current crisis can only serve to heighten this interest, as confirmed by the by the German Stock Exchange declaration that, in an effort to strengthen its competitive position, one of the Group’s key tasks in 2009 will be to enhance its interests in the investment infrastructure of the CIS, Russia and Central and Eastern Europe.

Russia’s sometimes dismissive approach to the poorly developed stock markets of Belarus, Uzbekistan and Kyrgyzstan and the practically non-existent stock market of Tajikistan, also gives cause for concern. In this connection, it should be remembered that ownership of practically all sectors of global and regional stock markets is widely distributed, and stiff competition exists where this is not the case. A key example of this is the Istanbul Stock Exchange which has become the principal shareholder of the Kyrgyz Stock Exchange and thus acts as one of the founders of the Federation of Euro-Asian Stock Exchanges, which comprises most of the stock exchanges in CIS countries.

In the light of the above, we have identified the following four potential scenarios for the development of stock markets in EurAsEC:

- retaining the status quo, which means that these countries will focus upon the development of national stock exchanges and therefore competition within the region will increase (between Russia and Kazakhstan in Central Asia, for example), especially once the financial crisis begins to ease. In the post-crisis period, large issuers will continue to move to global financial markets, whilst medium and small issuers will be able to operate on national or regional (in fact, expanded national) stock exchanges. National financial infrastructure may be acquired by global or foreign regional players;
- building an integrated financial infrastructure: i.e., creating conditions to allow securities from one EurAsEC country to be traded on the stock exchange of another country. This will require the harmonisation of regulations and standards. Since this process is most likely to be initiated by Russia, the latter should devise measures to develop national stock markets early on, rather than attract issuers by introducing Russian depository receipts. In so doing, Russia may find it has a competitive advantage: knowledge of local conditions and willingness to invest in projects which will not pay back in the near future. Some advances in this direction have taken place during the crisis, in particular the launch of the Eurasian Trading System in Kazakhstan (which should be counterbalanced by the launch of a similar entity in Russia), and the development by MICEX of a trading system for Ukraine's largest stock exchange, the First Stock Trading System¹⁰. Accordingly, this model of cooperation should be expanded to other EurAsEC countries;
- acquiring other countries' stock exchanges and playing by local rules. Most probably, MICEX will act as the consolidating player. This scenario is largely based on the "cost-benefit" approach and, if a large block of its shares is put up for sale, the most likely first candidate for acquisition is the Kazakhstan Stock Exchange. However, this model of cooperation may be viewed by national regulatory bodies as a threat to national security. In addition, under this scenario, Russian stock exchanges will have fewer competitive advantages compared with many western (and, possibly, eastern-hemisphere) players who are able to secure access to larger markets and advanced technology (e.g., OMX). This limitation will be especially pronounced during the crisis, which has had its strongest impact on the Russian stock market;
- gradual movement towards cooperation between stock markets: from information exchange to cross listing. This is a "softer" version of the third scenario, which takes into account all the stakeholders. However, as this scenario is based on purely practical considerations, it does not guarantee that this cooperation will be favoured by EurAsEC stock exchanges

¹⁰ *Interfax Ukraine, 2 March 2009.*

themselves, for the aforementioned reasons. Moreover it would appear that the financial crisis will serve to prolong the implementation period of such a scenario.

Each of the above options has its advantages and disadvantages, and the selected scenario will determine EurAsEC's future financial integration as a whole and the development of cross-border financial infrastructure.

Stronger cooperation between infrastructural organisations may become one of the first successful integration projects in EurAsEC, prompting countries to assume more active roles in regional economic integration. Meanwhile, cooperation between stock markets can provide a basis for regional economic integration in general, and the development of cross-border financial infrastructure. The crisis is temporary and does not in any way obviate the need to develop stock markets and even to explore new opportunities. The integration of stock markets allows the substantial reserves of some countries to be efficiently invested in other countries. The expansion of markets enables issuers to minimise their borrowing costs, and investors to reduce their risks by diversifying their financial portfolios. Finally, the resources of integrated stock markets can be used to finance cross-border infrastructure development projects in different sectors.