EMERGING CAPITAL MARKETS: OPPORTUNITIES AND LIMITS

FELICIA RAMONA BIRĂU*

Abstract

This theoretical study examines the concept of emerging capital markets in Europe from the border between certain opportunities and limits. The financial architecture of emerging capital markets has certain characteristics such as a high degree of instability and a sharp level of illiquidity which exposed the vulnerability of this particular type of market. Emerging capital market represents a main characteristic of developing countries and they are less efficient than the developed market given their deep functional, structural and institutional dysfunctions.

Keywords: *emerging capital markets, developed capital markets, dysfunctions, efficiency, investment, risk.*

Introduction

This article examines issues of current interest in the financial field, respectively the concept of emerging capital markets analyzed in relation to their opportunities and limits. It is well known that over the past two decades, capital markets in developing countries, known as emerging capital markets, have experienced a tremendous rise. Moreover, emerging capital markets represent a significant part of the financial markets area, extremely attractive and dynamic.

The importance of this study is to highlight certain aspects of great current interest, especially in context of the global financial crisis. Financial investors, both institutional ones, as well as individual ones, perceive emerging capital markets as a great chance to obtain significant benefits.

Metaphorically, this category of capital markets was perceived at one time as an unexploited financial oasis. Even in the context of the current financial crisis restrictive conditions, emerging capital markets remain attractive due to return opportunity and to the possibility of increase the portfolio return.

This article aims to emphasize the main features of emerging capital markets in Europe, being focused on their opportunities and limits. In recent past years, the economic literature has provided an extensive series of studies regarding emerging capital markets characteristics. In addition, this article tries to identify as well those characteristics which are seen only in times of financial crisis, but not noticed in terms of economic growth or stagnation.

Another important approach analyzed in this article is considering the concept of market efficiency in the context of emerging capital markets in Europe. It is considered in general that emerging capital markets are not efficient in semi-strong form or strong form. In the most optimistic case, empirical research studies have identified a weak form of efficiency. Emerging capital markets are less efficient than the developed capital markets given their functional, structural and institutional malfunctions and limitations.

Emerging capital markets opportunities - an exhaustive theoretical analysis

An emerging capital market is distinguished by certain key features such as : great return expectations, sharp volatility and various specific risks. In terms of investment opportunities that characterized emerging capital markets in Europe, statistical evidences emphasize significant performances on this particular type of capital market.

* Ph. D. candidate, Faculty of Economics and Business Administration, University of Craiova, Craiova, Romania, (email: birauramona@yahoo.com).

Before trigger the analysis, it is necessary to be made several additions. Therefore, according to the Financial Times Stock Exchange (F.T.S.E) evaluation criteria there are four categories of classification of national capital markets: developed markets, advanced emerging markets, secondary emerging markets and frontier emerging markets.

Advanced emerging markets category are: Brazil, Mexico, Hungary, Poland, South Africa and Taiwan, while the secondary emerging markets include countries such as China, Russia, India, Egypt, Colombia, Czech Republic, Peru, Pakistan, Turkey, Indonesia and Thailand.

F.T.S.E places the Bucharest Stock Exchange in the last category of quality of the four, along with the capital markets of: Bulgaria, Serbia, Tunisia, Cyprus, Estonia, Macedonia, Malta (September 2010), Slovakia, Slovenia, Croatia, Bangladesh, Botswana, Kenya, Nigeria, Sri Lanka or Vietnam. Also, Standard & Poor's (S&P) and Morgan Stanley Capital International (M.S.C.) evaluation criteria placed the capital market of Romania in the category of frontier emerging markets.

The global financial crisis that was caused by U.S. subprime crisis affected all the capital markets in the world. The negative impact was reflected by: reduction of the value and volume of transactions, significant reduction in the level of investment, the share price decrease and the unprecedented reduction of the profit opportunities.

The major stock markets indices of developed countries registers significant declines since the beginning of the financial crisis in the second half of 2007, as well as the advance emerging capital markets indexes that have evolved in close contact with mature stock markets in the U.S., Europe and Asia. Some specialists consider that there may be only an emotional connection between a relatively small capital market, like certain emerging capital markets in Europe and one characterized by extremely high volumes, because of the fact that institutional investors are unable to validate a significant packet of shares because of low liquidity and insignificant holdings of value compared to the case of developed capital markets.

Nevertheless, there are a number of counterarguments in favor of investing on emerging capital markets. First of all, there are real opportunities for increasing the financial assets portofolio return. It is also one of the reasons why foreign investors are attracted to invest there. Also, relatively low experience and not very high level of training of local professional investors are other opportunities to exploit by foreign investors.

Emerging capital markets are defined as transitional, being noticed an increase in both foreign and local financial investment. Based on the idea that an emerging economy is characterized by low to middle per capita income, is obvious that a consistent investment can decisively influence the stock prices.

In another train of thoughts, one of the main opportunities of emerging capital markets, which is important for both individual and institutional investors, is that this particular type of capital market is less informational efficient comparing to developed capital markets.

According to Eugene Fama : ”an efficient market is defined as a market where there are large numbers of rational, profit-maximizers actively competing, with each trying to predict future market values of individual securities, and where important current information is almost freely available to all participants”.

Efficient Markets Hypothesis suggests that since everyone has access to the same information, it is impossible to regularly beat the market, because that stock prices are efficient, reflecting everything we know as investors. In other words, a market in which prices always “fully reflect” available information is called efficient.

Capital market efficiency involves three dimensions : allocational, operational and informational efficiency. However, it has been noted that capital markets with higher informational efficiency are more likely to retain higher operational and allocational efficiencies (Müslümov et al, 2004). A market is efficient with respect to a set of information if it is impossible to make economic profits by trading on the basis of this information set (Ross, 1987).

Malkiel suggested the following definition:

"A capital market is said to be efficient if it fully and correctly reflects all relevant information in determining security prices. Formally, the market is said to be efficient with respect to some information set…if security price would be unaffected by revealing that information to all participants. Moreover, efficiency with respect to an informational set …implies that it is impossible to make economic profits by trading on the basis of (that informational set)."

Accordingly, a market in which prices always "fully reflect" available information is called efficient. One of the main aspects of Efficient Markets Hypothesis is represented by the degrees of efficiency issue. Thus, on a capital market, the degree of informational efficiency involves the following categories :

a) weak form efficiency
b) semi-strong form efficiency
c) strong form efficiency

It would be an illusion to believe that an emerging capital market is efficient in semi-strong form or strong form. As it was already suggested in the introduction to this article, in the most optimistic case, empirical research studies have identified a weak form of efficiency. Emerging capital markets are less efficient than the developed capital markets given their functional, structural and institutional deficiencies.

What is the importance of these issues for investors? In the case of emerging capital market, the access to information is delayed, distorted, difficult, incomplete, influenced and expensive. Although at first glance seem to be disadvantages, features mentioned above are actually investment opportunities. An intelligent investment strategy can provide significant gains from these certain malfunctions. One of the most important issue regarding efficient market theory is that it is not possible to outperform the market over the long-term. As it was stated previously, there are great opportunities to do so in the context of emerging capital markets.

Emerging capital markets limits

An emerging capital market is characterized by deep functional, structural and institutional dysfunctions. In other words, we can identify certain particularities such as : 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 and many others also.

A very important issue with major consequences is the concept of "liquidity" and its implications in the context of emerging capital markets. Liquidity is a sine qua non condition for a capital market to be effective, in the sense that its capacity to ability to ability to manage financial flows is significantly higher during periods when the market is more liquid. Especially in the case of emerging capital market, maintaining an optimal level of liquidity is very important. In the literature, the concept of market efficiency is the cornerstone of modern finance and also represents a significant advance in the financial field. a liquid market allows that a large volume of transactions to be conducted with minimum effect on price. At some point, it is crystallizes a very interesting connection between the concepts of efficiency and liquidity. Thus, the capital market liquidity contributes significantly to improve market efficiency. A high level of liquidity contributes substantially to enhancing the available information that is reflected in market prices.

Metaphorically speaking, the reverse of the medal is very dramatic. Destabilisation implications of the emerging capital market generated by insufficient liquidity are extremely severe. It is extremely important to distinguish between liquidity and trading volume. There is a paradox in time of financial crisis, respectively a lower liquidity level corresponds to a high volume of transactions.

Efficient market hypothesis have not reached the issue of liquidity crisis, or even the concept of liquidity itself. It assumes that investors are rational and they aim to select certain efficient financial assets to form an optimal portfolio as to achieve the highest possible returns over the long term, under the terms of a tolerable level of risk. However, in conditions of crisis, investors have a completely irrational behavior.

According to Peters : "If all information had the same impact on all investors, there would be no liquidity. When they received information, all investors would be executing the same trade, trying to get the same price."

It is significant to highlight the fact that investment decision is influenced in a large proportion by psychological and emotional factors. Human emotional complexity includes the following primary feelings: fear, panic, anxiety, envy, euphoria, greed, satisfaction, ambition or vanity. This cocktail of human emotions interferes in certain proportions in a financial investment decision making. Investors are people with many deviations from rational behavior, which often make illogical decisions. In the existing global financial perspective, the major influence of psychological factors in investment decision-making is undeniable.

Accordingly, chances that an investor to behave rationally in liquidity crisis conditions are extremely low. In such circumstances, obtaining a fair price is no longer a priority. Liquidity crises are a consequence of inadequate capital market functioning. In terms of emerging capital market it highlights the fact that they are characterized by severe institutional, structural and functional disequilibrium.

Conclusions

Emerging capital markets opportunities and limits complement each other to form a whole extremely attractive for investors.

In this article have been highlighted a number of issues of current importance such as the global financial crises. The vulnerability of emerging capital markets and its high degree of exposure to financial crises can be reduced by implementing some rigorous measures, such as : the adoption of relevant legislation, securities laws and regulations, the improvement of the trading infrastructure system, the establishment of appropriate supervisory structures, promoting transparency and fairness, discouraging short-term speculation in favor of long-term investments**.**

Acknowledgement

This work was supported by the strategic grant POSDRU/CPP107/ DMI1.5/S/78421, Project ID 78421 (2010), co-financed by the European Social Fund – Investing in People, within the Sectoral Operational Programme Human Resources Development 2007 – 2013

References

- Aguiar, M. and Gita, G., "*Emerging Market Business Cycles: The Cycle is the Trend*", Journal of Political Economy,vol.115, nr.1, 2007
- Aizenman, J., "*Emerging markets*", Santa Cruz, 2005 http://www2.ucsc.edu/econ /faculty/ aizenman/Emerging_Markets.pdf
- Aizenman, J. and Pinto, B., "*Managing Volatility and Crises: Overview, Draft chapter for Managing Volatility and Crises: A Practitioner's Guide*", Washington, The World Bank, 2004 http://economics.ucsc.edu/faculty/aizenman/ManagingVolatility.pdf
- Aizenman, J. and Powell, A., "*Volatility and Financial Intermediation*", Journal of International Money and Finance, 2003, vol.22 (5)
- Barberis, N. and Thaler, R, "*A survey of behavioral finance*", Handbook of the Economics of Finance, Elsevier Science B.V., 2003
- Birău Felicia Ramona – "*Behavioral Finance Paradigm And Its Implications On Investment Decisions*", International Scientific Conference „ECO-TREND 2011 - Exit From The Crisis And Revival Of Sustainable Growth", 8th edition, November 25-26, 2011, Tg – Jiu, Romania

- Birău Felicia Ramona, “*The meanings of efficient market paradigm in the context of emerging capital markets. An analysis of weak-form efficiency on the Bucharest Stock Exchange*”, The International Conference, „Competitiveness And Stability In The Knowledge Based Economy”, The Faculty of Economics and Business Administration, University of Craiova, Romania, 4 - 5 November 2011
- Chang, R. and Velasco, A., “*Liquidity Crises in Emerging Markets: Theory and Policy*”, Federal Reserve Bank of Atlanta, Working Paper 99-15, October 1999
- Eichengreen, B. and Mody, A., “*What explains changing spreads on emerging-market debt : fundamentals or market sentiment?*”, National Bureau Of Economic Research, Cambridge, 1998, http://www.nber.org/papers/w6408
- Fama Eugene, “*Market effciency, long-term returns, and behavioral finance*”, Journal of Financial Economics 49, 1998, pp.283-306
- Fama Eugene, “*Random Walks in Stock Market Prices*”, Financial Analysts Journal , 1965
- Malkiel, B., “*The Efficient Market Hypothesis and Its Critics*”, Princeton University, CEPS Working Paper No. 91, 2003
- Mandelbrot, B. and Hudson, R., “*The (Mis)behavior of Markets, A Fractal View of Risk, Ruin and Reward*”, Profile Books LTD, 2005
- Peters Edgar, “*Fractal Market Analysis: Applying Chaos Theory to Investment and Economics*”, New York: John Wiley & Sons, 1994
- Sharpe,W. and Alexander, G., “*Investments*”, 4th Edition. Englewood Cliffs, NJ: Prentice Hall, 1990
- Torre, A. and Schmukler, S., “*Emerging Capital Markets and Globalization - The latin american experience*”, A Copublication Of Stanford Economics And Finance, An Imprint Of Stanford University Press, And The World Bank, 2007
- http://www.nyse.com/audience/listedcompanies.html
- http://siteresources.worldbank.org/DATASTATISTICS/Resources/GNIPC.pdf
- http://www.ftse.com/Indices/FTSE_Frontier_Indices/index.jsp
- http://www.msci.com/products/indices/country_and_regional/fm/