THE CAPITAL MARKET IN THE CURRENT ECONOMIC CONTEXT

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Abstract
For nearly a century now, economists have studied the advantages and disadvantages of financial systems based on either banks or financial markets in their attempt to forward economic growth and a better capital resources allocation. Nevertheless, the effects of the financial crisis that began in 2007 over the capital market are not only numerous, but also affect financial institutions, the stock exchange volume and list, the behaviour of market investors and not least such generate the need for capital market regulations to be amended. Even so, due to measures that have been taken, in Romania the stock exchange works on profit, while the effects of the financial crisis over such still fail to occur.

Keywords: *capital market investments, institutional investors, financial crisis, financial instruments, regulations.*

Introduction

For many years, economists from all over the world are examining the advantages and disadvantages of financial systems which are based either on the preponderance of the money market (namely the banking system) or on the financial markets, in their attempts to forward economic stability and a better capital funds allocation within the current economic and financial crisis. We are trying to demonstrate below which structure of the financial system better promotes inward investments. Also tests are made on whether the structure of the financial system has independent influence on inward investments by controlling the level of financial development. Economic studies have concluded that the level of financial development, namely the economic development, is the one that influences the investment decisions and not the structure of the financial system. So, in this case what could be the investors' option in conditions of economic crisis?

Two questions emerge regarding the impact of financial mediation on the real economy. The first question is whether the development of the financial sector affects the economic activity. The second question is whether the structure of the financial system weighs in obtaining some results in the economic sector. Many studies embrace the idea that the development of the financial system has a positive effect on the real economy, including investments, employment, productivity and sustainable economic growth.

Until recently, economists[1] have stopped on the role of financial system structure on economic activity based on some case studies regarding the advantages and disadvantages of either bank-based financial systems (Germany and Japan) or the capital market (U.S. and Great Britain). Studies in Germany and Japan have examined the banks playing a leading role in corporate management and the role of banks-firms relations in granting credits, allocating capital efficiency, productivity, namely on the whole economy. The economic research in U.S. and Great Britain have emphasized the role of the financial markets in providing information on corporate activity, mergers and acquisitions and their impact on economic efficiency. It is difficult to assert that a structure of the

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[1] Asli Demirguc-Kunt and Ross Levine - Bank-based and market-based financial systems: cross-country comparisons, Development Research Group, The World Bank, and Finance Department, University of Minnesota, 2000

financial system is better than the other, especially since these studies have been made on some countries (Great Britain, Germany, Japan and the U.S.) that have similar performances on long-term economic growth.

New studies[2] have concluded that both banks and financial markets play an important role in supporting economic growth and that they are complementary. There were two new approaches in economic literature: (1) the role of financial services and (2) the role of law and finance.

The first approach emphasizes the role of the financial system in reducing market imperfections and providing key services to the private sector, thus increasing economic performance. Financial systems improve economic performance through a better assessment of investment opportunities, by exerting corporate control, minimizing the risk management, as well as capital allocation costs. As the financial system develops, it becomes more efficient in providing financial services, with direct implications on the economic growth. According to this approach, it is irrelevant to the economic activity whether the economy of a country is based on the financial system or the capital market.

The second approach which is based on the role of law and finance emphasizes the role of the creditor and investor rights for the development of financial intermediation. In countries where the legal system enforces these rights effectively, the financial system also becomes more efficient in providing services to the private sector. The quality of the legal system is one of the most important predictor of financial development. These studies wish to emphasize the role of the legal environment that will facilitate the development of the banking system and capital markets, which in turn will support economic growth.

Paper content

The banking system can influence investments in several ways[3].

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First, banks help to increase the funds available for investments by attracting deposits. Financial intermediaries are thus saving by reducing costs to attract savings and to collect and process information on debtors. Thus, for a given level of income per capita and for a potential saving rate, the current level of savings and investment should be higher in countries with a more developed banking system.

Second, banks facilitate investments by reducing liquidity risk. Generally, investments imply the mobilization of large amounts on a long-term. Private investors are reluctant to long-term fund immobilization, because they have a higher preference for liquidity. Banks can achieve the liquidity-profit balance by attracting the population's savings, making short-term loans and granting long-term loans. In a country that does not have a developed banking system, the profitable but more risky investment projects will not be carried out successfully due to lack of available capital. The development of the banking system should lead to a better allocation of capital and to an equilibrated balance between the short and long term private sector investments.

Third, financial intermediaries play an important role in reducing the cost of collecting and processing information on future investment projects, as well as on exerting control over firms. Many firms manage to obtain the necessary amount for financing their activity from a large mass of foreign investors who, individually, cannot monitor the use of funds by firm managers. On behalf of individual investors banks play the role of "delegated monitoring activity" and firm management

[2] Milan Kuber, Management consulting, ANCOR Publishing House, Bucharest 1992 and many other American authors Hans F. Olsen, Daniel Kessler, Kenneth Kuttner, Andrew Lo, Robert Merton, Vance Roley or David Laibson and Romanian authors: Valerica Olteanu, Beatrice Vlad (The behaviour of financial products consumers, online marketing magazine, volume 1 no. 4), Camelia Burja, T. Hada, M. Stoian, I. Stanciu, N.C. Ene, V. Valcu and others

[3] Demirgüç-Kunt, Asli and Maksimovic, Vojislav. "Law, Finance, and Firm Growth", Journal of Finance, December 1998, 53(6), pp.2107-2137.

behaviour monitor. The banks' ability to carry out this function stimulates foreign investors to invest, which improves the allocation of funds for investment projects. A developed banking system will lead to increased investment and a better allocation of capital.

Banking innovations provided the possibility to offer customized financial products that address specific needs of each firm. These represent the investors' main source of external financing who have limited access to financial markets, such as small or newly constituted firms. According to economist Robert C. Merton,[4] "financial markets tend to be efficient institutional alternatives to intermediaries when the financial products are standardized, being able serve a large number of investors, and they are facilitating the contracting parties in order to be comfortable in assessing their prices." Studies have shown that, in industrialized countries, small firms depend more on bank financing than large firms. Moreover, the reduction of the volume of loans granted by banks (due to the new monetary policy) has a large impact on the investments of the firms that are dependent on the banking financing.

Banks are important for the discovery of new financial products due to the customized packages offered to customers. Some of these new products are transferred on the capital markets; banks and financial markets are complementary institutions. Therefore, banks play an important role in the process of financial innovation for both the real economy – by financing innovative investment projects - and for the financial sector - by creating new financial instruments.

Those who criticize the bank-based financial systems describe a number of disadvantages and weak points of such a system in terms of growth in investment and economic performance. First, banks are interested in active participation in innovative investment projects from which they can earn a lot reducing the effort of firms to carry out innovative activities. Second, banks may be inclined towards greater caution. Indeed, evidence shows that in Japan firms closely connected to a bank are using fewer technological innovations and have lower profit rates than the others, fact which suggests that banks profit from their relationship with the client-firms. Third, critics of the bank-based economies state that the existence of some close relations between firms and banks prevent the competition on the credit market and reduce banks' ability to boost corporate governance. Some studies show that banks tend to support firms that face problems, but where they and / or other banks from the system have shares, while their relations with the other firms promotes the interests of creditors. If a close connection between firms and banks can facilitate access to capital, this does not necessarily reduce the cost of capital, nor increase the volume of investments for the firms where they hold shares.

The implications of the financial sector on enterprises

Several recent studies have shown that industrial sectors, namely those firms that depend heavily on external financing, grow faster in countries with developed financial sectors. Therefore it is natural to expect for industrial specialization and trade to be influenced by the financial sector. Indeed, a well-developed financial intermediation sector and some developed financial markets have a positive impact on the external trade financing.

Financial systems endowed with strong, well-structured and regulated institutions will specialize in production of goods that use intensively the services provided by these institutions. Economists believe that the financial markets and intermediaries are all factors that influence the production of goods and services. In order to support comparisons between countries, the condition imposed to a production factor is to be movable in international trade. Although it is not obvious that this condition is met, it is considered that between the development of the domestic financial sector and the internationalization of production factors is a negative relationship. Recent studies have shown that financial services are immovable geographically speaking, even in the USA.

[4] Robert Merton, Nobel Prize laureate in economics in 1997 (together with Myron S. Scholes)

The financial sector

The financial sector is seen as a production factor. A country endowed with strong financial institutions will specialize in sectors that widely use services provided by these institutions. On the other hand, countries with developed financial markets are external financing exporters.

Why the financial sector is seen as an immovable production factor building in terms of international trade? Currently the answer to this question is given by the fact that the inclusion of international production factors can lead to incorrect results. If capital markets are integrated, the level of domestic financial development would not be important for local investment opportunities. Financial services are not movable in terms of trading, even within a country.

The information asymmetry on the financial markets and the conflict of interests between creditors and debtors have led to intermediaries specialised in evaluating and monitoring investment projects, information dissemination, which reduces the negative effects of market imperfections. If we were to compare two countries with relatively equal interest rates, of which one has a more developed financial sector, the difference would occur in terms of allocation of financial capital. The level of uncertainty of investment projects and the share of investments in intangible assets are just two of the factors that make financial intermediation even more important. Financial intermediaries have other roles as well besides collecting money to finance investments in physical capital.

Many economists consider the financial sector as a type of human or organizational capital, specialised in overcoming market imperfections related to the financing of the economic growth. The level of financial development represents a determinant factor of the level of development of firms, industry and overall economy. In this type of study a causality problem emerges: a developed financial sector may be the result of high demand for financial services, suggesting a causal reversed relationship, meaning that the industry structure affects the demand for financial services and, therefore, the financial development as well.

Current debates determined by the economic crisis are focusing on bank-based financial systems versus capital market-based financial systems.

An economy based on the banking system may be superior to one based on the financial market due to long-term relationships established between banks and firms, which may increase the investors' incentives to acquire information about the firm and exercise corporate control. Capital markets aggregate information about firms, as well as internal market and they make these data publicly available, an action which a bank cannot do. Moreover, corporate control may be facilitated by stock markets through compensation schemes that are linked to stock market performance. Banks invest less in risky projects, being biased against risk; which can be explained by observations made upon economies based on financial markets where riskier industries attract more external funding. Another explanation might be capital markets expand the possibilities for risk diversification, thereby making high-risk projects more attractive for the individual investor.

The efficiency of financial markets has been brought into theoretical debates starting with 1970, Eugene Fama's studies, which have been followed by a synthesis in 1991, and Jensen's in 1978, Grossman's and Stiglitz's studies in 1980, etc., thus being formulated the hypothesis on whether financial markets have their own "intelligence". In this regard, three major trends can be identified among those trying to analyze the behaviour of financial markets: a) random walk theory according to which all the fluctuation of financial markets is random, b) "fundamentalist" school theory according to which any fluctuation is the result of an intelligible whole, within which assessments can be made c) technical and cartographic analysis which we can call diagnosis and whose supporters take an intermediate position and, rejecting the examination of the explanatory factors of the assessment of financial assets' course, believe that any asset has no other possible value than the price set by the market.

Capital market

Most studies highlight a positive correlation between the activity of capital markets and investment market. In which way do the capital markets effectively affect investments?

Capital market provides information about the expected profitability of investments. As a result, a functioning capital market may increase the volume of investments because it identifies the most profitable projects (with an estimated probability of achieving them and a higher risk) which otherwise would have been considered too risky. Capital market also affects the quality of investments, as well as capital allocation because it identifies the most profitable economic activities.

On the other hand, capital market affects investment decisions by its effects on cost of capital. Along with the development of capital market and as it becomes more liquid, the investment risks decrease which leads a reduction of financing costs. This statement is supported also by studies on the liberalization of capital markets, which is followed by an increase in market capitalization, a reduction in capital cost and an increase in volume of investments.

Third, capital market influences positively investments by exerting pressure on corporate managers, threatened by hostile takeovers and mergers. Capital market affects corporate governance because it allows the connection between firm performance and managers' compensation.

Critics of financial markets-based financial systems support a number of factors that limit their ability to increase the volume and quality of investments. Investment decisions are based on the fact that the market estimation on firm's profitability is a better indicator than that calculated by the firm's managers. This difference emerges due to asymmetric information or speculative operations. Which of the following predictions is better: the prediction made by the market or the one made by the firm's management? Opinions vary in this case. On one hand, some economists suggest that investment decisions should be based primarily on market evaluation. The reason is the fact that foreign investors are willing to accept lower rates of return, while managers try to equalize the rate of return with the marginal product of capital. Although mergers and acquisitions occur on the capital market, critics show that this does not necessarily mean a higher efficiency. Financial markets do not eliminate the information asymmetry and those inside the firms have more information than the outsiders. From the U.S. experience results the fact that large firms do survive not due to increasing profitability, but due to the fact that that the size of the firm increases even more through mergers and acquisitions. Moreover, takeovers do not necessarily lead to a quantitative increase in investment; there is only a transfer of "property" from old owners to new owners. Massive takeovers that took place in the 80s on the U.S. capital market did not resulted in increased net investments or market efficiency, but, in turn, they damaged the corporate sector to a great extent.

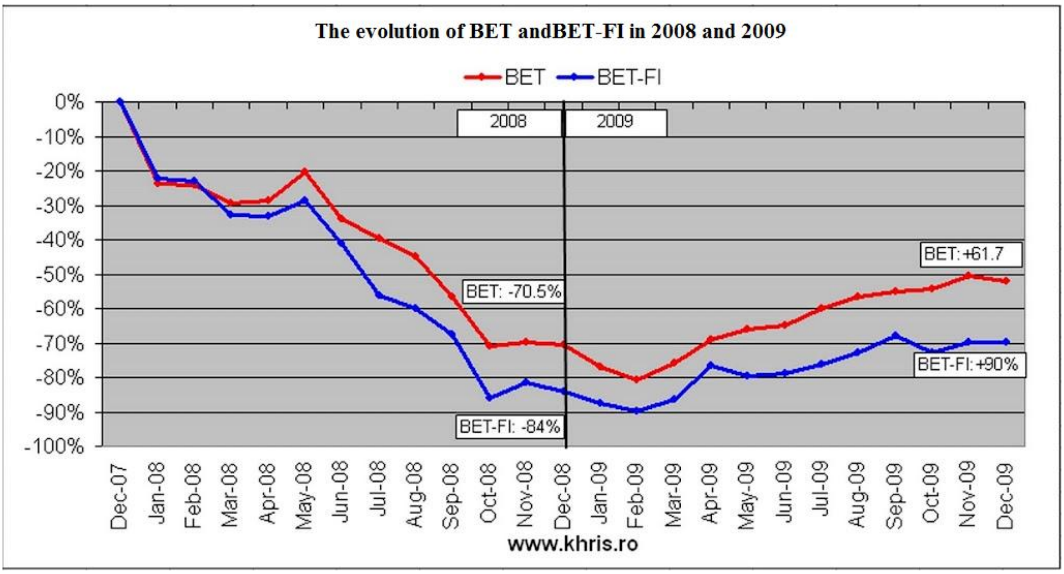
Also based on the observations made on the U.S. capital market, it was demonstrated that hostile takeovers create value only for the new owners, by redistributing the property to the disadvantage of staff and suppliers. Experts point out that hostile takeovers determine a preference of managers to make investments with short-term results at the expense of long-term investments, with negative consequences for the economic performance.

The underlying cause of the financial crisis was the abundant liquidity created by the world's main central banks (FED - U.S. Central Bank, BOJ - Central Bank of Japan) and by the desire of the countries that export oil and gas to limit the currency appreciation. Also, there was a over saturation with savings generated by the increasing integration into the global economy of some countries (China, Southeast Asia in general), with high rates of accumulation, but also by the global redistribution of wealth and income towards the supply exporters (oil, gas, etc.). The abundant liquidity and the over saturation with savings created available resources for investments, including sophisticated financial instruments, more difficult to understand for some investors. The consequences of the abundant liquidity were the very low interest rates and their low volatility. Together, these consequences have led to the increased appetite for assets with large gains. In addition, the low market volatility has created the tendency to underestimate the risk and a real lack of vigilance from the investors. The risk margins have also been very low and non-discriminatory. Together, the low interest rates, the appetite for high income assets, the low vigilance to risk and the low margins hampered the warnings of prices on the financial markets and led to an incomplete understanding of the involved risks. Under these circumstances a series of microeconomic reasons has also functioned as aggravating: excessive securitization, cracks in the business model of the rating agencies, privately rational outsourcing but socially ineffective and, finally, an increased international competition for deregulations. The consequence of the excessive securitization was that once the crisis was triggered by the emergence of failure to pay rates on loans for houses, the financial market became non-transparent. Establishment of investors' lack of confidence has placed rapidly the bonds issued by the special purpose vehicles (SPV) in the risky category (quality of assets financed was not clear any longer) and refinances became impossible. Due to discrepancy between maturities on assets and liabilities, these SPV have started relying on financing from sponsoring banks. In the end, the liquidity demand combined with the loss of confidence in banks, resulted in the rush after cash and the effective interest rate started to increase.

In the USA and some states in Europe, governments and central banks responded by improving liquidity; granting governmental warranties for loans; recapitalization of financial institutions; warranty of the newest issuance by insured banks; prevention of erratic collapse of major interconnected enterprises; purchase of stocks in banks; coordinated reductions of interest rates. Although such type of measures have been implemented, after 17 months from starting the turbulences, the market remained non-transparent, and hence the financial crisis increased and facilitated its entry in the real sector of economy, first in the USA, then in other developed countries. What are the main challenges from now on? How to invest effectively in conditions of recession?

The evolution of stock market

After the poor results in 2008, not too many analysts hoped that in 2009 we'd witness a comeback of the decreasing quotations trend on the BSE, trend started in mid 2007 and continued until early 2009, at which the BET index was 82% lower than the maximum, and BET-FI fell by 92% - in other words, who invested 100 lei in the SIFs in July 2007, in February 2009 had only 8 lei. Moreover, the capitalization of stock markets worldwide decreased from \$ 63,000 billion in October 2007 to \$ 28.7,000 in February 2009, which means a decrease of 54.4%. Thus, the DJIA value was 53% lower than the peak in October 2007, London's index FTSE 100 had fallen by 47%, while the German DAX by 55%. If we think that in order to compensate for a decrease of 84%, an increase of over 500% is needed, meaning 6 times. However, who bought in early 2009 won in 10 months the equivalent bank interest for at least 5-6 years. The evolution of BSE for BET and BET-FI indices, from 2008 - 2009 had the following configuration:

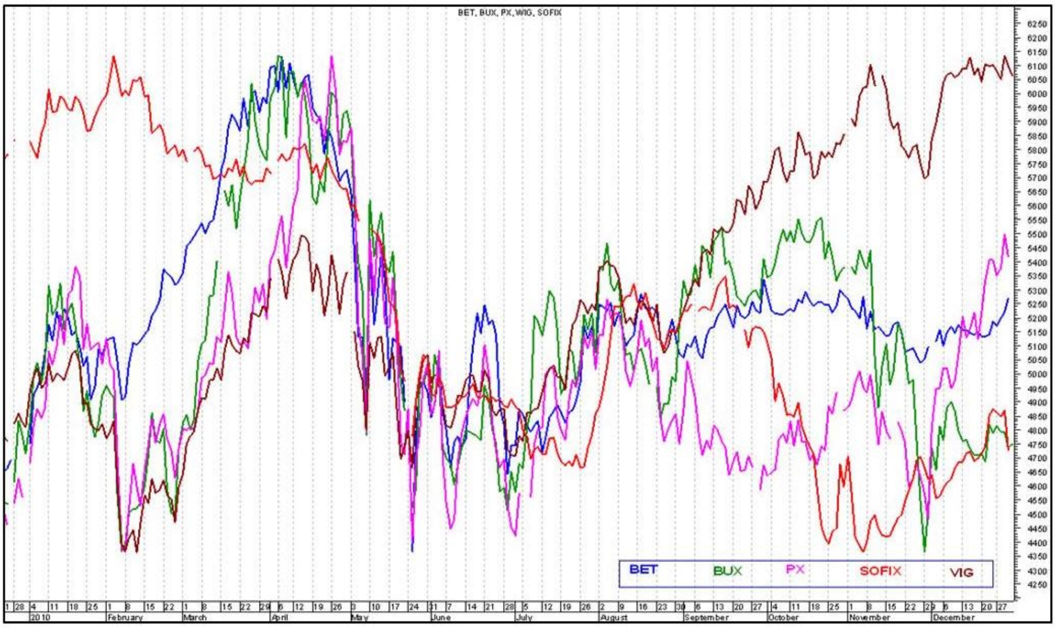


Unfortunately, the evolution of Bucharest Stock Exchange is largely dependent on the development of the other markets, especially the U.S., and the evolution of the developed economies during crisis can also shake the Bucharest Stock Exchange, regardless the evolution of the Romanian economy.

2010 was a weaker year for the stock quote although most indices ended the year with positive values. For share indices, 2010 recorded more modest values than the previous year. The performance of stock indices on BSE, as well as international stock market indices was affected by the fact that some European Union countries have faced and are still facing the sovereign debt crisis, while developed economies have continued to increase after the financial crisis. The contradictory performances recorded on the stock markets of the emerging countries are remarkable: poorer performances on some stock markets in emerging countries (Brazil, China), but an increase on Russian stock market. But some stock markets in Central and Eastern Europe (Czech Republic, Austria, Poland and Romania) had better performance, except the Sofia Stock Exchange which registered a downward trend.

Comparing the evolution of the stock indices in Central and Eastern Europe in 2010, one can see that the Polish WIG index increased by 18.8%, in Austria the ATX index was 16.4%, then the BET index was 12.3%, the Czech index PX was 9.6% and Hungary's BUX index which increased by only 0.5%. SOFIX index in Bulgaria decreased by -15.2% was the discordant note.

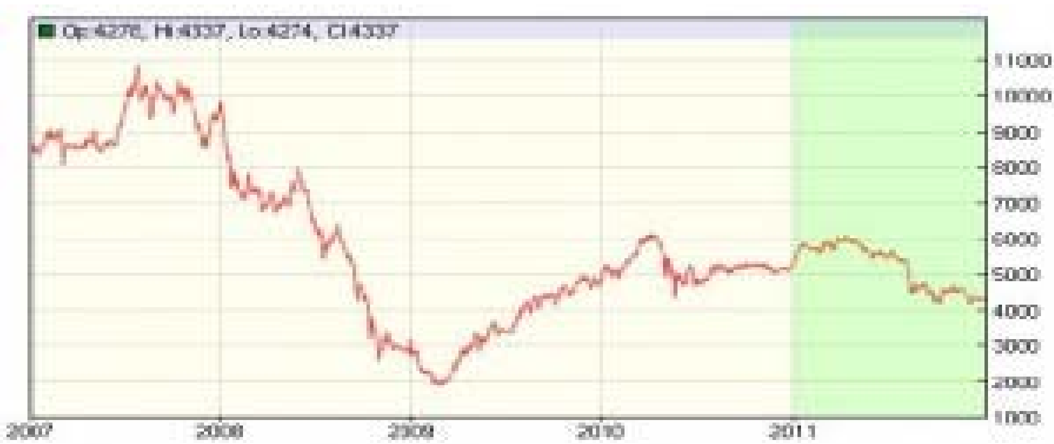
The evolution of the main stock indices in Central and Eastern Europe in 2010



Source: Puls Capital

The evolution of the stock indices experienced distinct periods in 2010. The first part of 2010, precisely the first 3 months, led to further increases recorded since March 2009. But sovereign debt crisis in Europe and panic felt on large international financial markets have shaken the stock market in Bucharest which was already small, with no large companies listed. Thus the situation has changed radically in the second quarter of 2010, when stock indices showed significant corrective movements according to stock market indices of developed markets. In the third quarter, stock indices began to resume their increases, while the fourth quarter brought new withdrawals and reluctant developments of these indices.

Romanian capital market recorded a dropping year in 2011. The evolution of the main index of Bucharest Stock Exchange (BET) from 2007 to 2011 is presented below:



Source: Puls Capital

Contrary to pessimistic analysis carried out by Razvan Pasol, president of Intercapital Invest brokerage company, Romania, the Bucharest Stock Exchange (BSE), ranked 59 in the world in 2011 in the world's major stock markets based on the variation of the main indices.

Due to the global economic crisis only 12 markets ended with positive results in 2011, while the other 77 markets brought negative results to investors. Venezuela Stock Exchange ranked first with a benefit of 78% on the main index. Caracas market is strongly influenced by the decisions of the political regime in this country and the nationalization of several major companies, as well as the shutting down of more than 40 brokerage firms represent the most recent measures that have negatively influenced trading on this market. Stock exchange from Mongolia, Panama and Jamaica are ranked next, each with double-digit returns for their main indices. The New York Stock Exchange makes the USA the only developed market in the world to finish the year with increased results.

Increasing the threshold for holding SIFs and subsequent recovery helped Romanian index BET-FI to get on the first part of the ranking. But taking into account the evolution of BET, the main index of the Bucharest Stock Exchange, Romania descends into the lower half of the above mentioned ranking.

The penultimate place is occupied by Greece, the most affected country by the sovereign debt crisis in 2011. In 2011 Athens Stock Exchange fell by nearly 61%. Only Cyprus Stock Exchange recorded values lower than Greece, with an average loss of 72%.

Conclusions

Before the current crisis, some insights about the aggregate efficiency of the financial system and legal environment have widened the debates on the merits of various structures of the financial system. Some economists argued that financial markets and banking system are complementary rather than substitutes and that the efficiency of the financial sector as a whole, is more important. They believed that the legal system represents the key for the financial system to function (especially, protection of creditors and minority shareholders against expropriation by majority shareholders and management team). Currently Romania is facing one of the highest rates of expansion of money supply in the world, which could predict a large increase in the Bucharest Stock Exchange. In this regard, a recent study made by the analysts of the Austrian financial group Erste Group and released on December 21, 2011[5] shows that in periods marked by intense financial and economic turmoil as the one that we are currently going through – and which will probably continue, if not get worse, and in 2012 – the analysis of the underlying factors is no longer able to offer the players on the stock exchange the right signals needed to accurately explain the market developments and to make correct investment decisions. According to analysis conducted by the Austrian financial group, it is believed that accelerating the growth rhythm of the money supply and credit lead to the appreciation of stock quotes listed, while the opposite phenomenon puts negative pressure on stock prices. Accelerating the growth rhythm of the money supply[6] and the volume of credit in economy is likely to signal investors that a boom period on the stock market is about to happen. Monetary indicators that are most useful to observe in order to anticipate the trends of the capital markets are money supply in a narrow sense (M1), which comprises currency in circulation and current deposits in banks, intermediate money (M2), composed of narrow money M1 plus deposits with agreed maturity up to two years. Along with monetary aggregates, the evolution of credit both the nongovernmental, corporate and public, as well as the government credit may be taken into account. Thus, "investors must rely on the appreciation of stock quotes and to overexpose themselves on cyclical sectors and

[5] The study includes the U.S.A., the Euro area, Japan, the four BRIC countries, 6 countries in Central and Eastern Europe and Turkey

[6] Gerald Walek, Henning Esskucken and Stephan Lingnau. - Austrian vision, Bursa newspaper January 9, 2012

financial companies shares as long as the credit is easily accessible and rapidly growing. As soon as lending conditions tighten and growth rate of loans decreases, investors should sell these shares gradually and to focus on more defensive sectors," says the Erste Group study. In conclusion the two markets overlap in a unique way so that none of them can develop without the contribution of the other. Only if the stock could exploit the advantage provided by the listing of the Fondul Proprietatea which is currently exploited too little, although there is great interest from investors.

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