

STRUCTURAL ADJUSTMENT ON THE ROMANIAN STOCK MARKET PURSUING EUROPEAN INTEGRATION

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Abstract: The paper reviews the stages of the Romanian stock market's establishment and development, and later of structural change in pursuit of a level harmonisation with European legislation and institutions that would allow its integration into a mature market. While not perfect, the structural adjustments were successfully finalized when Romania entered the EU, providing compatibility between the Romanian and European institutions.

Keywords: financial integration, capital market, structural adjustment, regulation, institutions

1. Stages of structural adjustments on the Romanian stock market

Romania's EU integration involved a complex process of both establishing structures essential to any functioning market economy, and overhauling those left from the communist era. This would ensure the Romanian laws and institutions' compliance with European regulations and compatibility with EU structures. Financial services hold an important place in this context, and a transparent and liquid stock market, able to connect with the European stock market, is of the absolute essence.

In our country the stock market's foundations were laid after 1989 over certain communist left-overs. On the one hand, there was a stable national currency and an important balance of payments surplus, and on the other a super-centralized financial system, within which the banks and goods and personal insurances were state monopolies.

The events of December 1989 opened the way for the establishment of a free market and functioning economy, a development process that started from scratch, given that Romania had lacked a stock market for the last 50 years, and had no experience in the field.

In the early 90s Romania faced many stock market dilemmas, over the techniques, sizing and stages of the funding process, modern portfolio management strategies, the establishing and upholding of general market principles and regulations, and also the trading techniques, crediting, guarantees, clearing and settlement of operations, and financial instruments.

The Romanian stock market's establishment and development took place during the harmonization of Romanian market institutions and legal framework with the European regulations and institutions managing the EU's financial services market. After expressing its desire to join the EU in the 90's, our country initiated a wide and complex process of alignment with European regulations and restructuring of market institutions in accordance with EU rigors.

The principal events in the stock market's evolution, marking both introduced regulations and the founding of the main market institutions, can define the following stages in the establishment and development of the Romanian stock market while pursuing EU integration:

- **1990 – 2002 - laying down a legal framework for the stock market and founding fundamental stock market institutions.** This first stage was a process of forming organizations, drafting and introducing regulations, and forming and surveying specific stock market behavior (educating operators and the general public about concepts long forgotten or never known, still an ongoing process).
- 2002 – 2004 – the first harmonization of Romanian stock market laws with European legislation. The second stage begun while the EU accession negotiations were prepared and organized, and the regulatory and institutional stock market reform was launched.
- **2004 – 2006 – institutional consolidation and stock market restructuring** pursuing Romania's EU integration. The third stage opened with the passing of the **Consolidated stock market law** in 2004. It finalized the Romanian stock market structural adjustments for

integration into the European Union, and the NSC declared it finished when the Romanian stock market legislation was considered completely harmonized with current European regulations. This harmonization process defined two distinct sub-stages:

- 2004 – 2005 – the introduction of the consolidated stock market law and the secondary legislation for its implementation; architectural changes.
- 2006 – the alignment of Romanian legislation to the latest European regulations introduced after the Financial Services Action Plan was finalized.

2. The founding of the Romanian stock market and first harmonization with European regulations

The first stage in the Romanian stock market's existence was its actual establishment, in a economy that had no free securities market in the previous 50 years. The lack of market experience available at first-hand to its participants, initially the law maker's lack of professional training and certification, made for the establishment and development of market institutions and operator categories without continuity and un-coordinated or even non-existent regulations.

We can assert that the lack of a coherent stock market legal framework enabled some participants to enter the market and operate for years at the edge of the law, gravely damaging, through fraud and lack of ethics, a sector of the economy extremely important to funding the real economy, but very sensitive to information.

Nonetheless, we must admit that, even given these defects, politic willpower on the one hand and investor interest on the other enabled within 10 years the esestablishing of all necessary institutions for a functioning stock market.

The implementation of specific stock market mechanisms and the trading of the first financial instruments on the Romanian market – shares and bonds – did not happen effortlessly.

The small number of issuers on the Bucharest Stock Exchange has been to this date an obstacle for increasing capitalization and market turnover, and it has been kept low by Romanian entities' lack of interest for listing on the exchange.

The other stock market segment – the RASDAQ Electronic Exchange – has also been established in a fashion particular for the Romanian economy, which entered an ample privatization process, creating overnight millions of „shareholders” who were unaware of or not interested in the stock market mechanisms. Its introduction on the market – also forced - has made for a tough, years long, struggle to surpass a ridiculously low trade volume and impose a market discipline for investor information and market transparency. Due to these issues, the main tier contained for a long time thousands of inactive companies, whose shares were never traded.

In this climate, there were few financial instruments offered on the Romanian market: not many firms considered an IPO, the first corporate shares issues were failures, municipal bonds didn't enter the market until 2001, and derivatives have only begun being traded in 1997-1998.

The second stage in the Romanian stock market's evolution was directly related to the intention in the '90s to become a full EU member, as soon as possible. This required Romania to enter a pre-accession process that would align its regulations and institutions with the European standards.

This process was more difficult for the stock market, than for the sectors of the economy with an actual history. The difficulties were due partly to having to conform its legislation and institutions to a mature market, with tens of years of trading, and partly to the European financial services market's own ongoing integration process, involving regulatory changes which took place in parallel with Romania's integration. This required successive legislative harmonizations for the Romanian stock market, in order to keep the pace with European regulations.

The legislative harmonization included with the 2002 regulations package brought important changes concerning market participants and operations, and as mentioned above, had no pretention to perfection, but represented a step forward for the stock market in the pre-accession process.

At the end of the secong stage, exchange institutions on the market began putting forward the idea of consolidating th Romanian stock market. The BSE and RASDAQ set as their main goal for the next period advancing the Romanian stock market to the first positions among the Central and Eastern Europe stock

exchanges. One direction toward this was identifying optimal solutions for stock market consolidation, either by a RASDAQ takeover by the BSE, as the BSE proposed, or by a merger, as proposed by the NASD. On 22nd May 2003, the RASDAQ Electronic Exchange and the Bucharest Stock Exchange made an official announcement of their intention to merge into a single, well capitalized and liquid stock exchange, with a trading system, clearing, settlement and modern register, and regulations compatible with the ones of European exchanges.

The institutions on the Romanian stock market had evolved, by the end of the stock market's second stage, to a position superior to that of their inception, with well defined structures, oriented toward qualitative goals targeting transparency and integrity, the elimination of dishonest practices like market manipulation and insider trading, and dedicated to increasing competitiveness on the market. Among this stage's missed accomplishments we find the failure to implement the universal bank concept, due to credit institutions' inability to operate directly on the capital market, and the absence from the market of institutions imposed by the European directives, like the investors' compensation fund, even though they were included in the legislation.

3. The completion of Romania's stock market structural adjustments targeting European integration

The final stage of the capital market's structural adjustment process pursuing compliance with the European standards for the financial services market took place between 2004 and 2006, beginning with the introduction of the consolidated legislation for the capital market in 2004. We must point out that this last, finalizing stage of harmonization with European legislation and building institutional structures compatible with the European ones, happened simultaneously with the definitization, at the EU level, of the legislative framework intended to accelerate the financial integration process initiated after the Maastricht Treaty, and continued by the Financial Services Action Plan.

The review of the stock market evolution between 1990-2003 and the analysis of the stages it went through during this period leads to the conclusion that in 2004 the Romanian capital market hadn't made significant progress toward alignment to European standards, and shows that the interval leading to the integration moment should have marked major changes that would have built a Romanian stock market capable to take up the challenge of integration into the mature European financial services market.

The regulatory process on the Romanian capital market and the new market architecture achieved by restructuring some institutions and introducing new ones in accordance with Law 297/2004 demonstrates that some important progress has been made in this last stage, toward alignment to the European standards, but some unresolved issues remained, leaving the Romanian financial services market's potential only partially exploited.

Firstly, we consider that only at this stage was the concept of a market conforming with European regulation correctly defined and implemented on the Romanian capital market, and thus in January 2007 there were two regulated market operators: the Bucharest Stock Exchange and the Sibiu Monetary-Financial and Commodities Exchange. Secondly, the consolidated legislation for the capital market introduced the „unique European passport” concept, by regulating the authorization conditions for financial intermediaries able to provide financial services within the EU, based on the capital market authority's authorization, and the regulation of activity on the Romanian market of intermediaries authorized in other EU member states.

Thirdly, in this stage the concept of universal bank was successfully implemented, by regulating the access of credit institutions to financial intermediation activities. This was a subject of criticism from the European Commission, as the first attempt at regulation in 2002 was a failure. After 2004, at least 10 Romanian credit institutions solicited NSC's authorization for financial services intermediation. Fourthly, we think that an important step was taken toward a capital market that guarantees investor protection, through the introduction of the Investor Compensation Fund. This institution was regulated since 2002, but it only came to reality in 2005. Although it became operational on the market the maximum compensation per investor is much lower than the 20000 Euros imposed by European regulations, and Romania asked since 2002 for a gradual increase of this ceiling.

Another positive effect of the consolidated legislation for the capital market was its unification effect on post-trading services institutions, through the establishment of a unique such institution – the Central Depository, thus aligning the Romanian market to European standards.

In our opinion the consolidated legislation for the capital market has the merit, even with all the critiques by market participants, of defining on the Romanian market concepts such as market manipulation, insider trading, and transparency, long since consecrated on the European financial markets, but new or little known to Romanian market participants.

We also consider that the implementation of the latest regulations meant to bring the Romanian legislation up to the European standards had qualitative effects for the structure of capital market institutions, and also on educating market participants on financial instruments and the opportunities of the capital market's segments. We remark the growing preoccupation for imposing stronger quality criteria for listing on a regulated market – the BSE, the beginning of diversification of financial instruments offered to the investors by the exchange (preemptive rights trading, international issuers), imposing performance criteria that led to cleansing companies traded on RASDAQ, which finished the technical support phase for trading shares of companies participating in the mass privatization program.

Educating market participants and awareness of the advantages of derivatives trading has determined a remarkable evolution for the only derivatives exchange in Romania, recording 200-300% growth in traded volume for futures and options, from 2004 until EU accession.

Considering all these aspects, we can affirm that this last stage in the Romanian capital market's structural adjustment process towards EU integration was successfully finalized, and on 1st January 2007 Romania had a market segment able to join the other European capital markets in the complex process of financial integration still taking place in all the EU.

4. Conclusions

Going through these stages was a difficult process, both because the Romanian capital market was rebuilt from the ground up, since in 1989 it didn't exist even in an incipient form, and because of the authorities' lack of experience in creating and implementing a coherent legislation for capital markets. The market participants were thus in the position of participating to trading activities with unknown mechanisms, and using poor understood financial instruments. These difficulties were amplified by the need to harmonize fragmented legislation, created after anglo-saxon models, with European regulations undergoing themselves redefinitions and restructuring.

The process of harmonization of Romanian regulations with the European ones had its failures too. We find that the European regulations were transposed in Romanian legislation with excessive verbosity, with ambiguous and vague provisions, and references to a future secondary regulation which would cover for specific issues. One cause for this was NSC's wish to declare the Romanian legislation completely harmonized with the European one, while not paying sufficient attention to signals from market participants. Thus, the entire EU regulations were transposed, not taking into consideration the Romanian market's different stage of development, shorter history and fewer experience.

The result was not perfect, but it led to a capital market that even still under development, can compete with similar European structures, and benefit from the advantages of integration into a mature market.

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