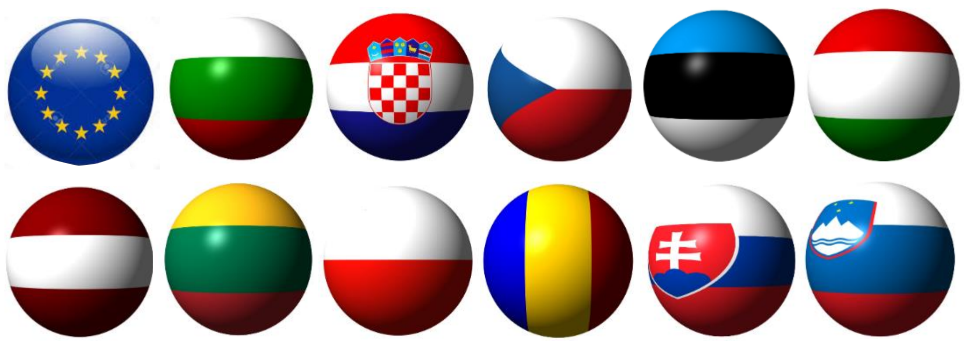
THE BENEFITS OF CAPITAL MARKETS TO HIGH POTENTIAL EU ECONOMIES



ANALYSIS OF THE GROWTH OPPORTUNITY FOR CAPITAL MARKETS IN CENTRAL AND EASTERN EUROPE

November 2016

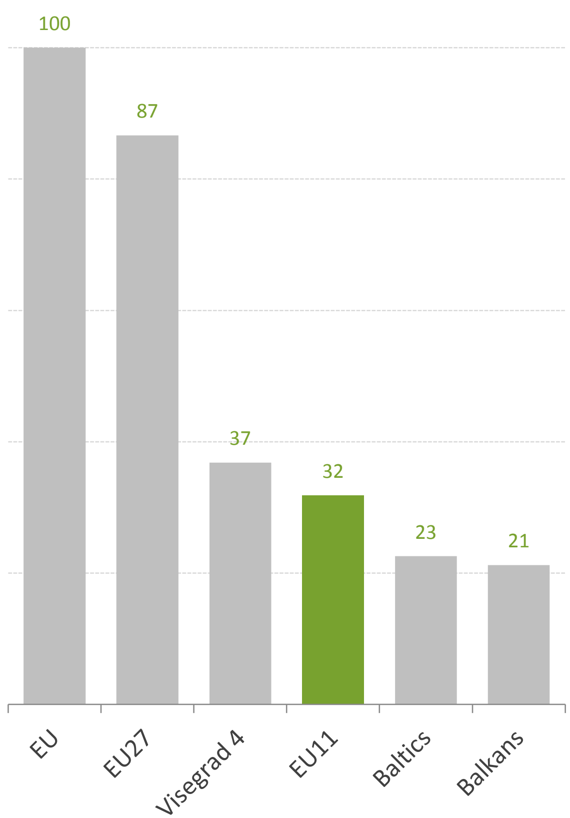
1) SUMMARY

1. The impact of the financial crisis on growth
2. The relationship between growth and depth of capital markets
3. The reliance on bank lending
4. The range in depth of capital markets in the EU11
5. The change in the depth of capital markets over the past decade
6. The size of the opportunity
7. How do we get there?

2) CONTEXT

Fig.1 Relative depth of capital markets in the EU

(23 sectors, relative to GDP, 100 = EU in 3 years to 2015)



The report analyses the depth of capital markets relative to GDP across 23 different metrics in 11 EU member states:

The Visegrad 4:	Czech Republic, Hungary, Poland, and Slovakia
The Balkans:	Bulgaria, Croatia, Romania and Slovenia
The Baltics:	Estonia, Latvia, Lithuania

We refer to these countries as the EU11 or HPEs.

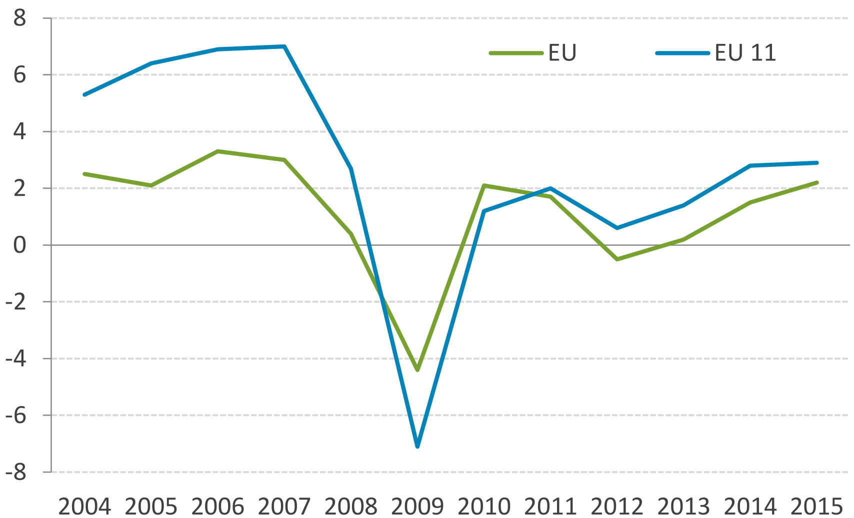
Between them, they account for 20% of the EU's population, 8% of its GDP, but just 2.5% of capital markets activity.

The EU11 economies have made sustained progress over the past 25 years. Today, their capital markets are around one third as developed as in the EU.

3) THE IMPACT OF THE FINANCIAL CRISIS ON ECONOMIC GROWTH

Fig.2 Economic growth in the EU before and after the crisis

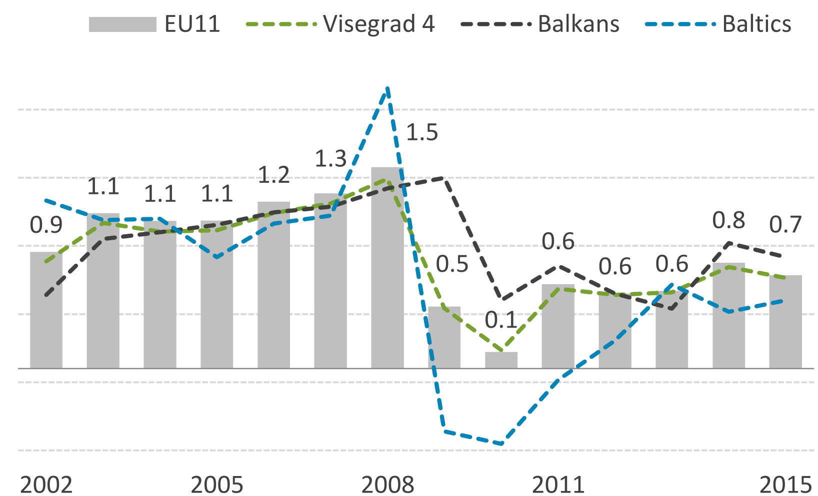
Annual GDP growth in the EU and EU11 economies 2004 to 2015 %



Source: Eurostat

Fig.3 The slowdown in convergence since the crisis

The annual convergence rate in GDP per capita in the EU11 vs rest of EU (percentage points)



Source: Eurostat

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4) THE RELATIONSHIP BETWEEN GROWTH AND CAPITAL MARKETS

Fig.4 The impact of the crisis vs reliance on bank lending

Change in GDP growth pre- and post-crisis relative to reliance on bank lending

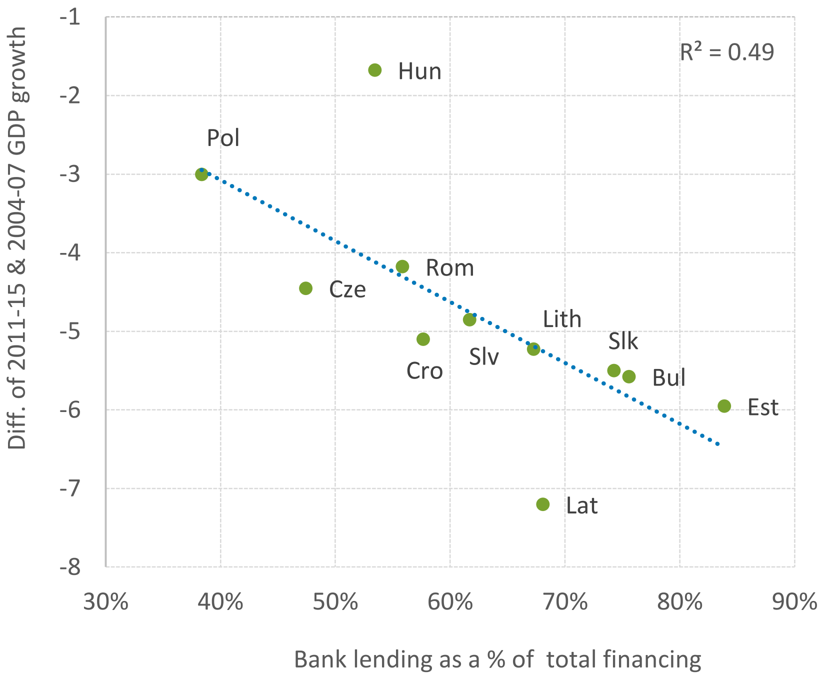
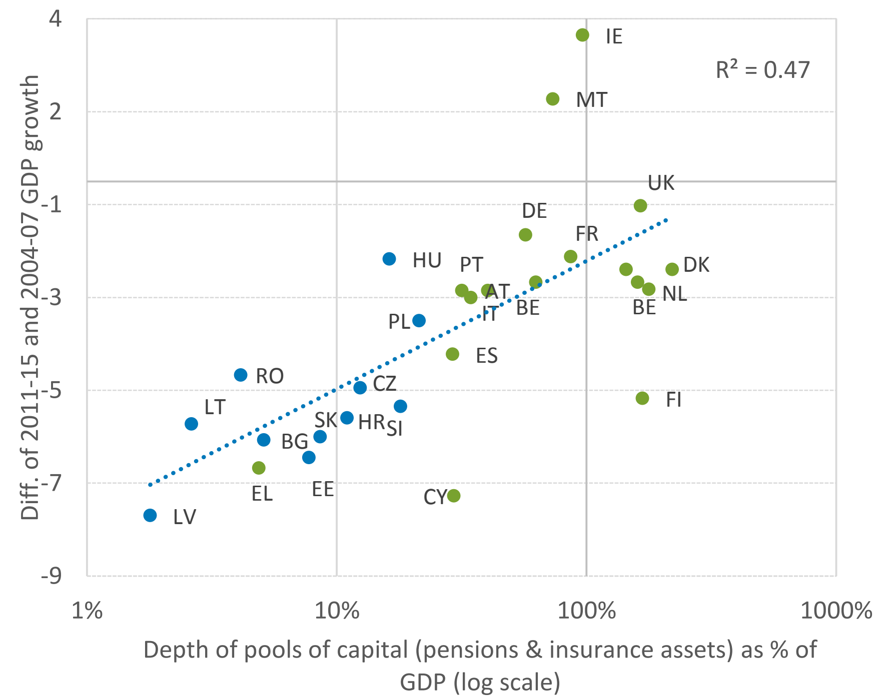


Fig.5 The impact of the crisis vs depth of pools of capital

Value of pensions & insurance assets as % of GDP vs change in GDP growth rates since crisis



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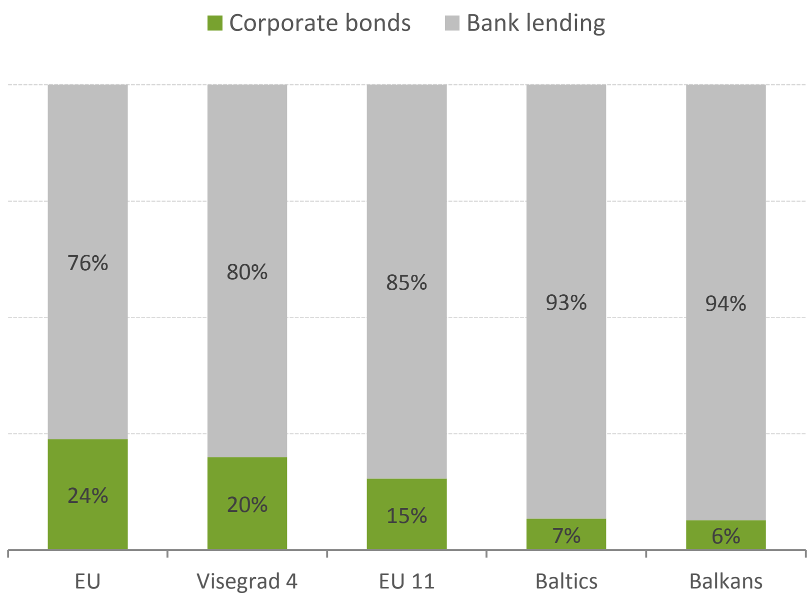
5) THE RELIANCE ON BANK LENDING

Fig.6 The reliance of companies in the EU11 on bank lending

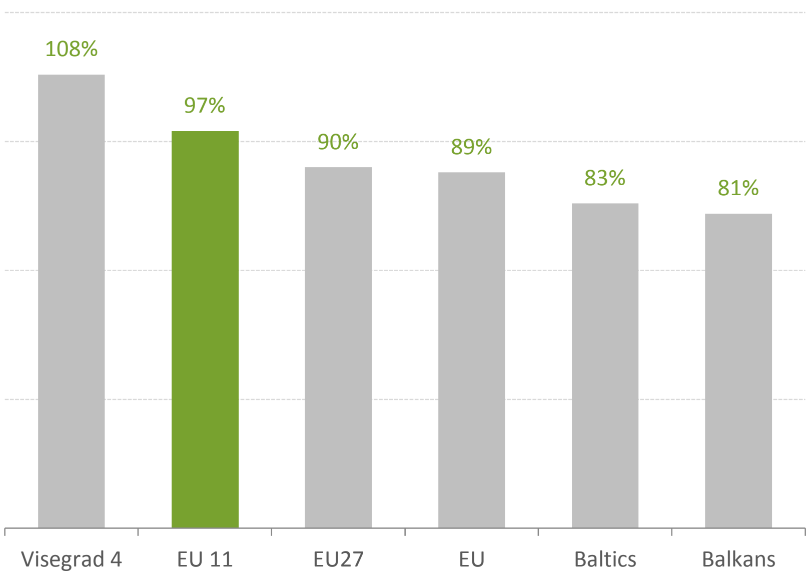
The value of bank lending and corporate bonds as a % of corporate debt, 3 years to 2015



Source: ECB, IMF

Fig.7 The decline in the value of outstanding bank lending

Value of outstanding bank lending to non-financial corporations in 2015 as a % of 2008 value (calculated in €bn)

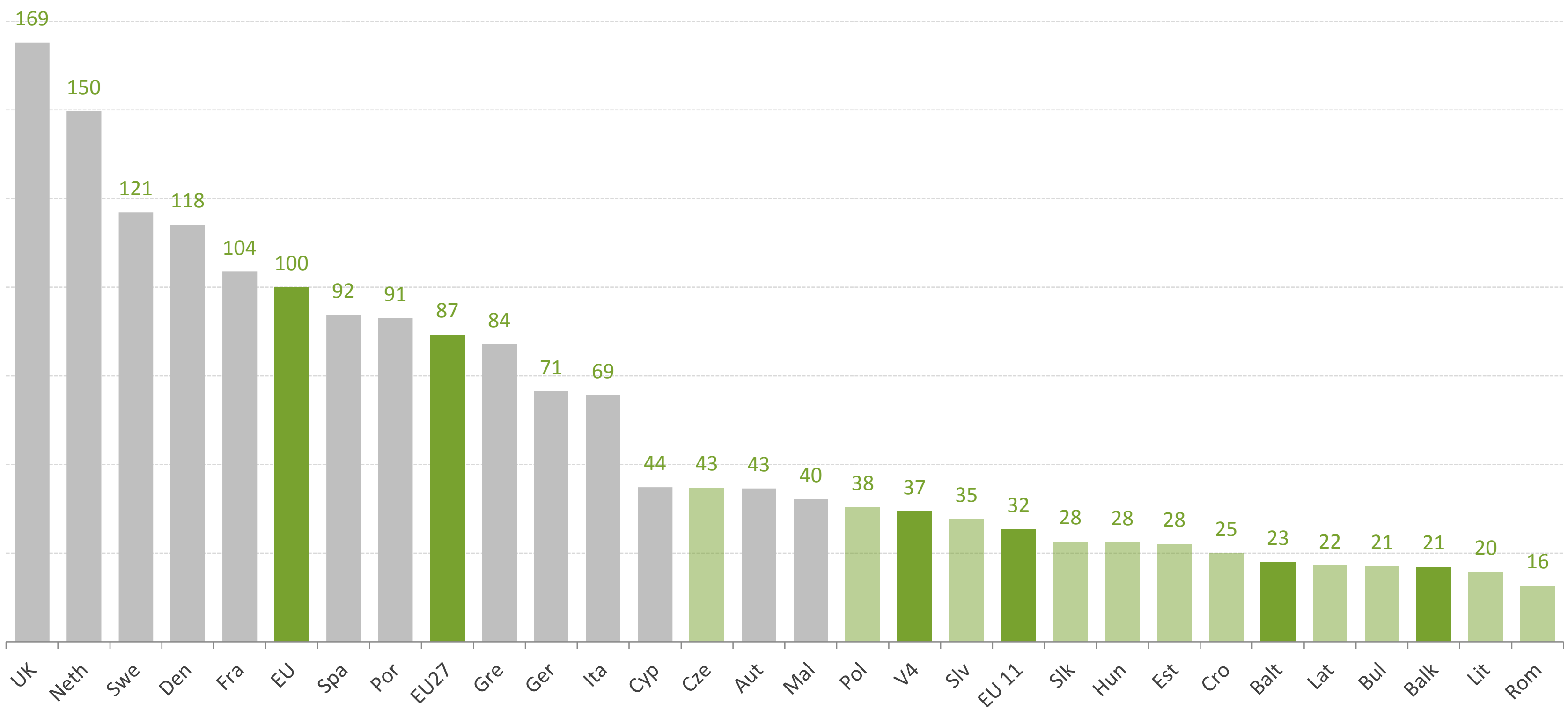


Source: ECB

6) THE RANGE IN DEPTH OF CAPITAL MARKETS IN THE EU11

Fig.8 The range in depth of capital markets in the EU

The relative depth of capital markets in different countries across 23 different sectors over the past three years, relative to GDP
Rebased to EU = 100



Source: New Financial

7) A DECADE OF CHANGE IN CAPITAL MARKETS IN THE EU11

Fig.9 A decade of change in EU11 capital markets

The change in depth in capital markets in the EU11 on a three year rolling basis 2006-2015
Rebased to EU = 100 in the three years to 2015

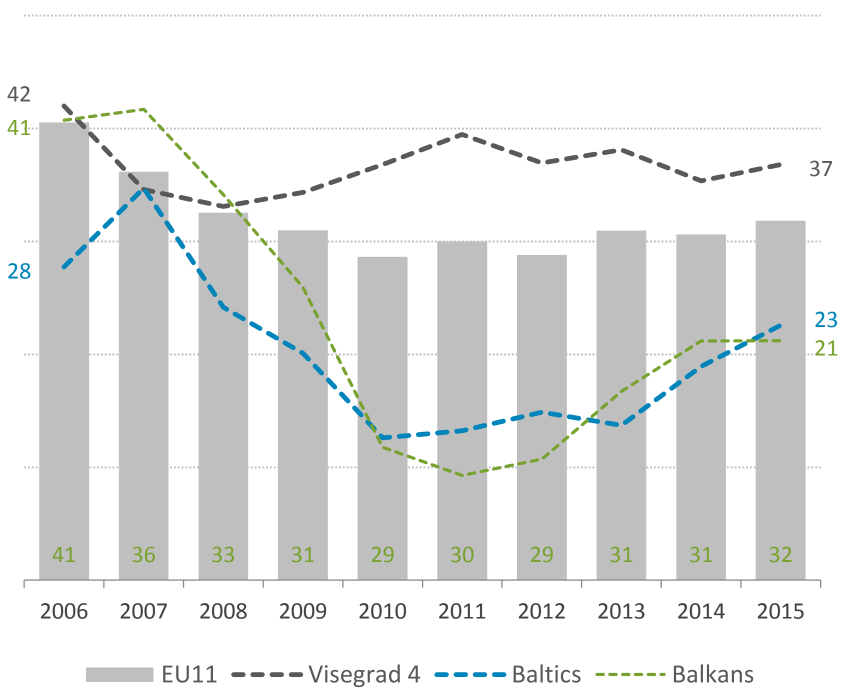
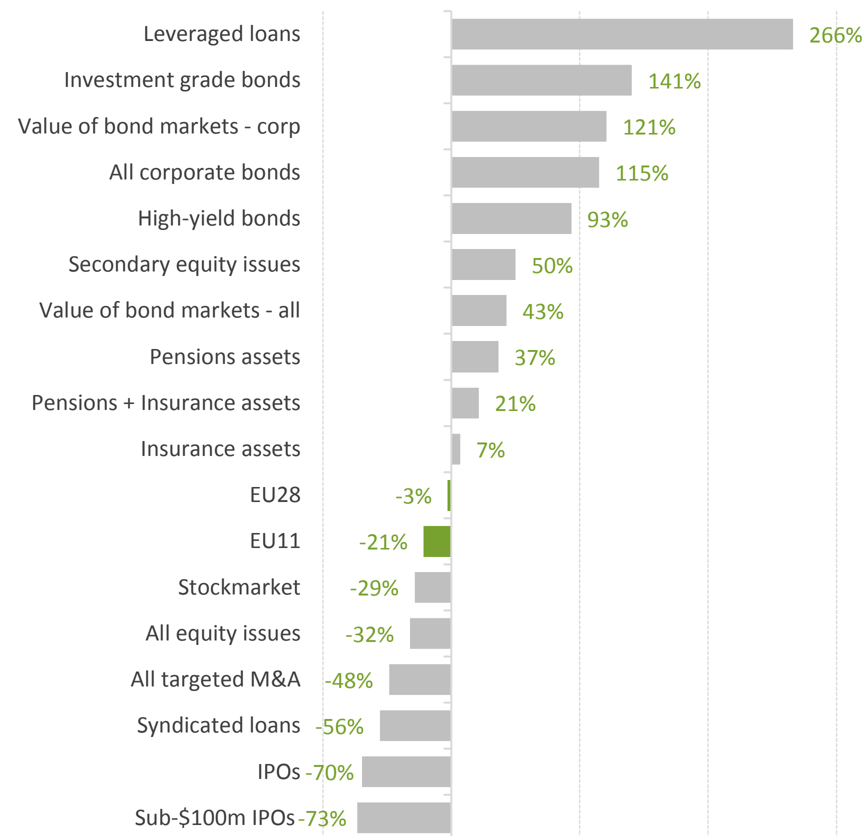


Fig.10 Growth in EU11 capital markets by sector over a decade

Change in the depth of EU11 capital markets by sector relative to GDP between 2006 and 2015



8) GROWTH OPPORTUNITY FOR CAPITAL MARKETS IN THE EU11

Fig.11 Potential growth in pools of capital as a % of GDP

Potential growth in pensions and insurance assets if each country were as developed as the 'best in class' in the EU11 (% of GDP and €bn)

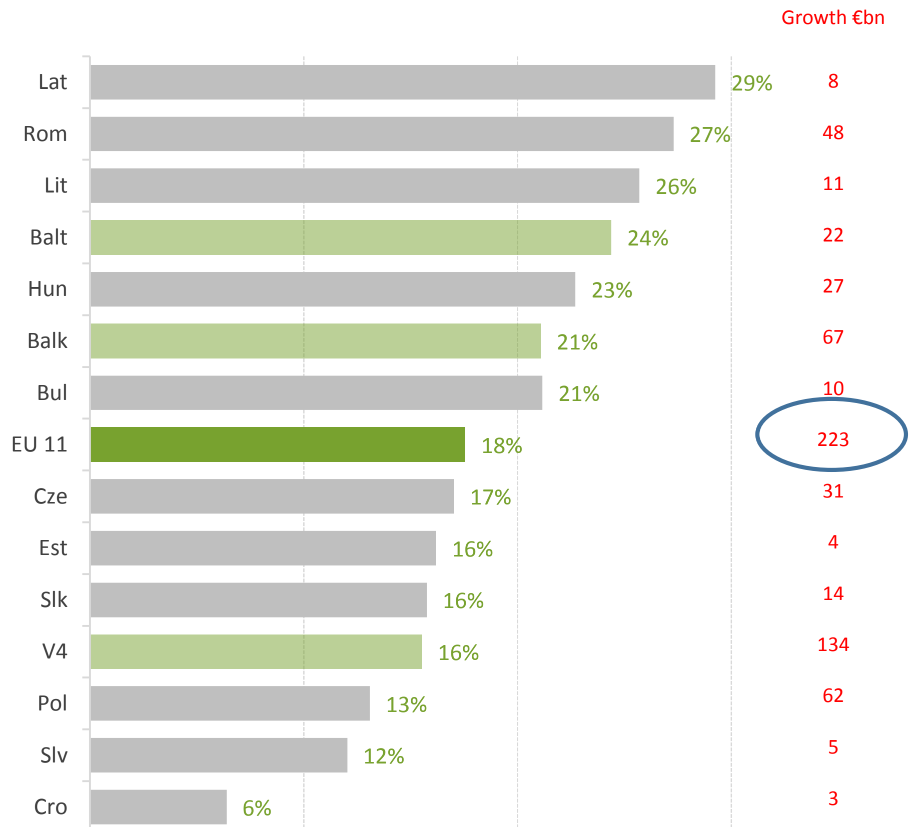
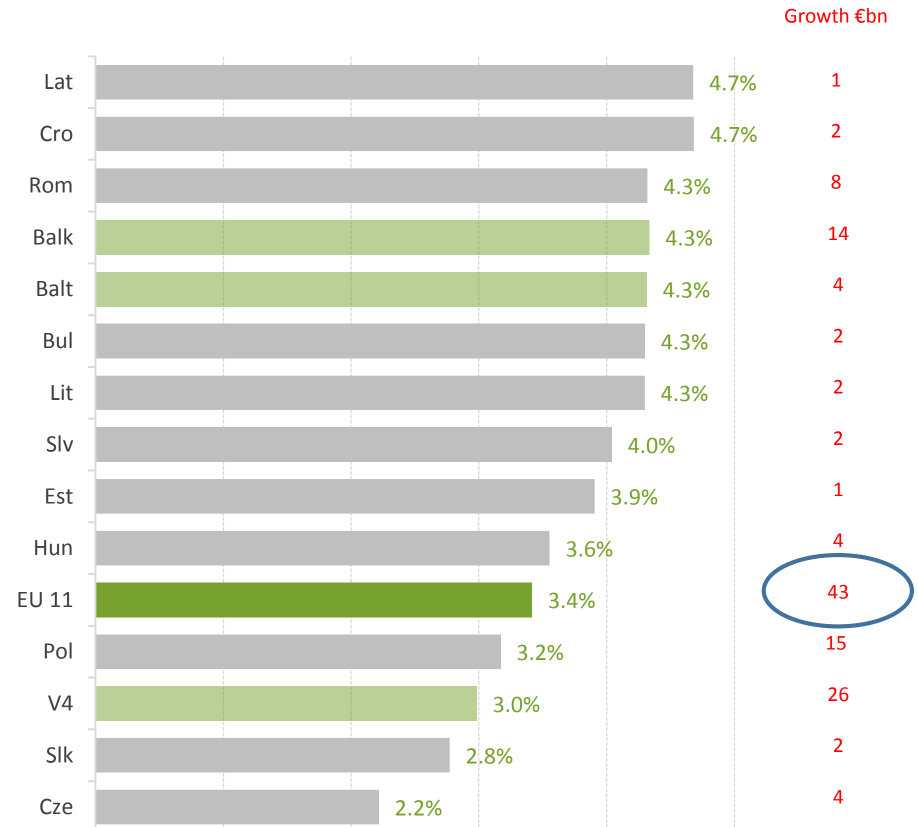


Fig.12 Potential growth in capital markets activity as a % of GDP

Potential growth in annual capital markets funding if each country were as developed as the 'best in class' in the EU11 (% of GDP and €bn)



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9) HOW DO WE GET THERE?

1. What are the main obstacles to deeper capital markets in the EU11?
2. What initiatives are already underway?
3. How to EU11 markets fit into Capital Markets Union?
4. What can the EU / Commission do to help develop capital markets?
5. What can national governments do to help develop capital markets?
6. What can market participants do to help develop capital markets?

10) OBSTACLES

1. A long-term game: It is little more than 25 years since the fall of the Berlin Wall. Many of the EU11 countries have made commendable progress in a short time. It took the UK 30 years to build a pool of pensions assets from 20% of GDP to 100% of GDP.

2. A question of scale: Capital markets benefit from economies of scale and, apart from Poland, EU11 countries have relatively small populations. Smaller markets face higher costs from the fragmentation of market infrastructure, regulatory and legal systems.

3. Chicken or egg? difficulty of developing capital markets from a low base. Policymakers and market participants also need to build up a local base of issuers and investors.

4. A low appetite: Appetite for capital markets is low among issuers and investors. Bank financing is at historically cheap levels. Potential market participants are not as comfortable with capital markets as in much of western Europe.

5. The political perspective: Flourishing capital markets rely on trust and certainty in the legal and regulatory regime. In some cases, political intervention in capital markets has been widely described as undermining this trust

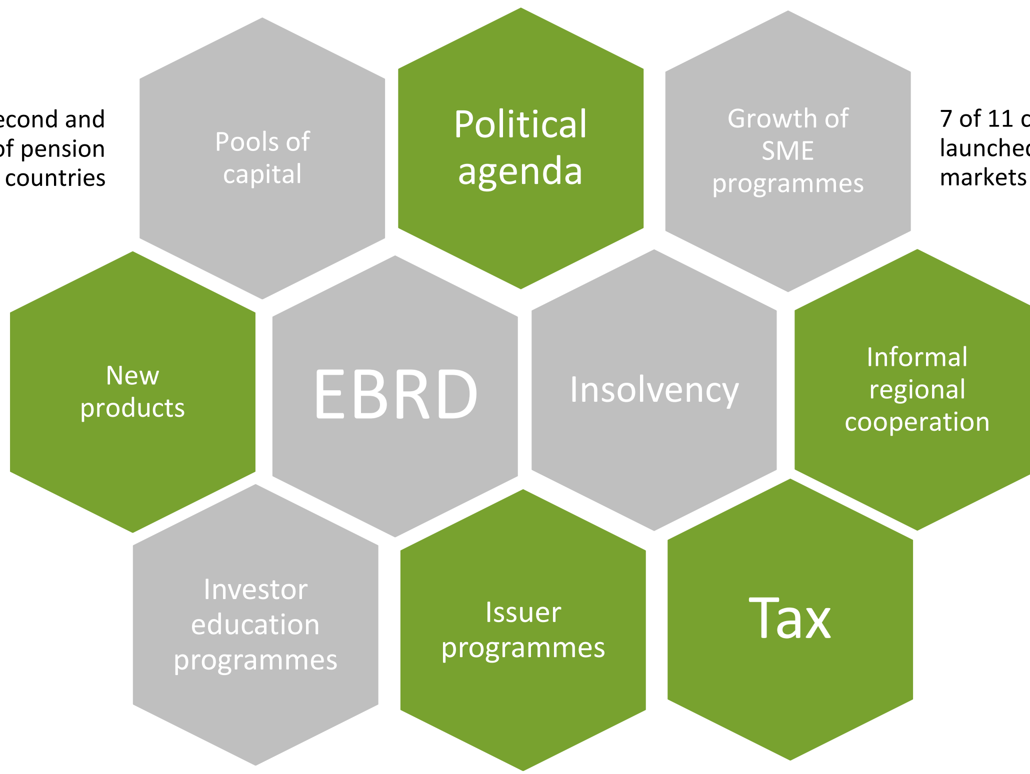
11) INITIATIVES UNDERWAY

Governments (e.g. PL and RO) launching programmes to encourage a wider growth of markets.

Expansion of second and third pillar of pension systems in most countries

7 of 11 countries have launched dedicated stock markets for SMEs

Covered bonds and crowdfunding



Share best practice and common policy positions between governments, trade associations and infrastructure

12) CMU AND THE EU (FEEDBACK FROM INTERVIEWS)

1. Relevance: Support for CMU was virtually unanimous among the market participants and policymakers we interviewed. Danger that it is of limited relevance for some countries where markets are the least developed.

2. Voice at the table: Perception that EU11 countries had a limited voice at the table in setting the direction of EU policy. EU11 countries also need to make their own voices heard (limited response to consultations). New appointment of VP Dombrovskis.

3. Show me the money: In many cases, the main relationship between the EU and EU11 countries was financial – EIF and regional development funds have played a significant role in kick-starting capital markets. Danger that market participants can become too dependent on money from the EU.

4. Regulatory burden: Recent regulatory reforms putting too much of a burden on smaller local market participants. The EU should develop a more proportionate regulatory regime for less developed capital markets (but risk of creating distortions).

5. Big levers: main levers that would have the most impact – tax incentives for investing and building a deeper pool of pension assets – are beyond the Commission's remit. Positive views on debt-equity bias.

13) POLICY PROPOSALS

1. Ease investment regimes of institutional investors: invest in a wider variety of assets. Maximise returns and unlock capital.

2. Encourage diversification of financing at pre-IPO: Angel investing, VC, PE, private placements, crowdfunding.

3. Continue developing market infrastructure: consider regional collaboration.

4. Strengthen business environment to encourage entrepreneurship. Stability of legal framework and continue improving insolvency frameworks.

5. Simplify tax systems: simplification of capital gains tax and withholding tax.

6. Financial literacy: personal finance and the benefits of diversifying away from bank deposits

7. Accompany issuers along the path towards accessing capital markets: programmes to improve accounting standards, transparency, governance.

8. Availability of enough staff resources at Ministries of Finance and Supervisors to develop and implement regulation and supervision

9. Encourage SOEs to access markets: via bond issues or IPO

10. Institutional support from European institutions: technical assistance to develop reforms tailored to local environment