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Impact of the Financial Crisis on the Macedonian Securities Market

Abstract

The origin of the crisis is coming from the summer 2007 when the loss of confidence of investor in USA to securitized mortgages, created liquidity crisis to the trading of these securities. The liquidity crisis deepened with other assets backed securities (especially swaps on credit derivatives) which created defaults in many issues of ABS and financial institutions involved in trading with these securities.

The world's stock markets are becoming very volatile, reacting on any news on macro or micro level, with unusual increase/decrease of the stock prices/indexes. Expectations on the future economic outlook are not positive still, so the markets cannot recover very soon.

Macedonian securities market although still very small and illiquid reacted also accordingly. The MBI index tumbled almost 60% over the last 6 months. Macedonian institutional investors industry (investment funds, pension funds, insurance companies) is underdeveloped. The main investors on the Macedonian stock exchange used to be several investment funds form Slovenia, Croatia, and Austria. After the first negative signals, they immediately started with withdrawing their investments on MSE. Some of them completely left the market; some are still present on the market. They are not investing new funds and are implementing passive, hold approach portfolio strategy. There are no new comers on the stock markets, local investment funds are very passive regarding creating new portfolios and investing on the stock market, new local investment funds are still lacking. The liquidity of the stock market was ruined.

The main threats to the securities market are coming from deepening the crisis in the real sector of the national economy, especially export oriented companies, which if are not able to recover soon, will cause a foreign exchange crisis in the country and possible devaluation of denar. This situation will ruin further the liquidity on the stock market. Only positive signals from EU on starting membership negotiations or NATO membership next year, can create positive expectations and possible entry of foreign institutional investors on the local securities market. These expectations can boost the market earlier, create higher liquidity and increase the stock prices.

Keywords: *process, securities, market, liquidity, stock prices.*

Introduction

This paper is prepared to be presented on the 4th UACS Conference - *Europe in crisis: Threats and Opportunities*. It has two main objectives: to explain scope and cause of the financial crisis 2008-2009 and to make prudent judgments of the impact of the global financial crisis to the Macedonian securities market.

The paper is consisted of 3 main parts: The scope and the cause of the 2008-2009 financial crisis; The impact of the financial crisis to the stock markets in the world; Macedonian securities market-threats and opportunities?

The first part gives a brief overview of the scope and main reasons for development of the latest financial crisis in general. The second part briefly showed impact of the financial crisis to the main securities markets in the world. And the last part explains the impact of the financial crisis to the Macedonian securities industry.

The main source of data came from official sites of different Stock Exchanges, publications of international financial organization and periodicals.

The scope and cause of the 2008-2009 financial crisis

The origin of the crisis is coming from the summer 2007 when the loss of confidence of investors in USA to securitized mortgages created liquidity crisis to the trading of these securities. The liquidity crisis deepened with other assets backed securities (especially swaps on credit derivatives), which created defaults in many issues of asset backed securities (ABS) and financial institutions involved in trading with these securities. An estimated $8.7 trillion of assets worldwide are funded by securitization. More than half of the credit cards and student loans originated in America in 2007 were securitized. Many European banks used securitization to fund the expansion of their loan books in the boom (The Economist, 22 April 2009).

The US financial market was suddenly on the brink of default as five major US investment banks could not function without new fresh money (A.Torbat, 2008).

Lehman Brothers had to file for bankruptcy, two were rescued by the depositors' money, and the other two were converted to commercial banks so that could borrow money from the US Federal Reserve Bank and could open deposit accounts filed for bankruptcy. Merrill Lynch had to be sold to Bank of America, Washington Mutual had to be seized by FDIC and its deposits were sold to J. P. Morgan Chase, and Wachovia had been sold to the Citigroup. Everything happened so fast in a few weeks in September, constituting the largest financial failure in the US since the great depression 1929.

First signs of failure came in early March 2008, with financial backing of the government; Bear Stearns was sold to J. P. Morgan Chase. Furthermore the US government seized several major financial institutions in September 2008. Two financial institutions involved in home mortgage lending Fannie Mae and Freddie Mac, and the largest insurer company in the world, American Insurance Group (AIG), were also bailed out by the US government.

The UK had the same problem after depositors ran on Northern Rock in September 2007 and the troubled mortgage lender HBOS agreed to be acquired by Lloyds TSB and Bradford and Bingley a mid-sized mortgage lender, was taken over by the British government in September 2008.

Other European banks suffered less, but the government financial support was welcome. Major Icelandic banks were nationalized, FORTIS (Belgium-Dutch financial group) was bought by French bank BNP Paribas, Hypo Real Estate was rescued by German Government, Danish Roskilde bank was bail out by Central Bank, Dexia was bailed out by French, Belgian and Luxembourg Governments, 6 major Irish banks were bailed out by the Irish government.

Large amounts of money had been poured into bailing out US financial institutions. In 2008 around $29 billion for bailout the takeover of the investment bank Bear Stearns, $85 billion to bail out AIG, and $200 billion for Fannie and Freddie plus guaranteeing their $5 trillion debts in September. Other investment banks were forced to to merge with commercial banks, a rescue strategy that put more risk on the shoulder of commercial banks and in turn on their depositors' money (the takeover of Merrill Lynch by Bank of America). Early estimates for bailing out of $1 trillion in the latest IMF report went up to 4$ trillion, which makes the largest world crisis in the history.

Although America's housing collapse is often showed as the main cause of the crisis, the financial system was vulnerable because of highly-leveraged financial contracts and operations, a lack of regulation and supervision of OTC trading with ABS and generally a "hypertrophy of the financial sector" so called *financialization* This term is frequently used in recent discussions of a form of capitalism which developed over several decades leading up to the 2007-2009 financial crisis and in which financial leverage tended to override capital (equity) and financial markets tended to dominate over the traditional industrial economy. This becomes main characteristics of Anglo/American capitalism.

One simple definition of *financialization* is the increasing dominance of the finance industry in the sum total of economic activity, of financial controllers in the management of corporations, of financial assets among total assets, of marketable securities and particularly equities among financial assets, of the stock market as a market for corporate control in determining corporate strategies, and of fluctuations in the stock market as a determinant of business cycles (K.Phillips, 2006). More popularly, *financialization* means the expanded role of financial motives, financial markets, financial intermediaries and financial institutions in the operation of domestic and international economies.

The lack of liquidity caused slowing down of the banking credit activity to the real sector, which caused decline of GDP around the world this year. The world economy is in red!!. Latest estimates of IMF are predicting 2009 US GDP decline of 2.4%, Germany (-5.6%), UK (-4.1%), Italy (-4.4%) , France and Switzerland (-3%), Russia (- 6%), Japan (-6.2%). It is the deepest post WW II recession. Their estimates of GDP growth for 2010 are stagnation.

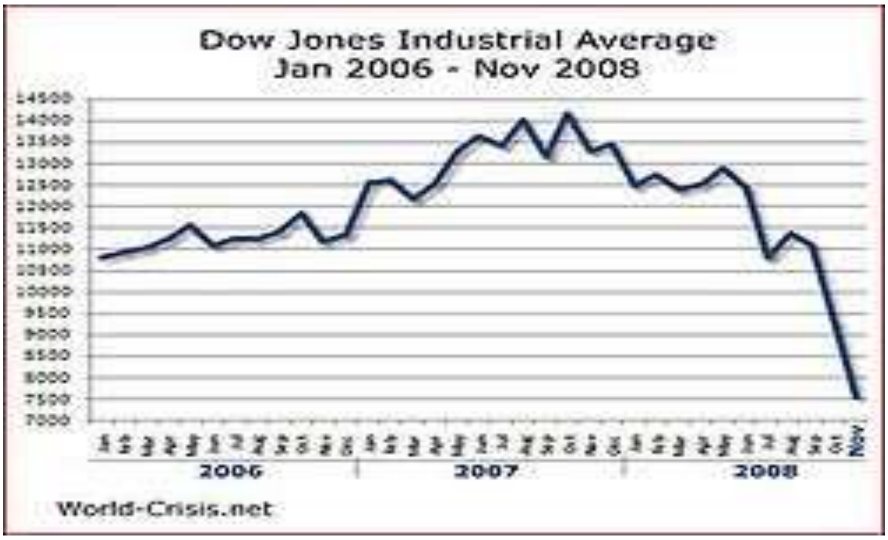
Main international multilateral organization agreed that at the heart of the crisis is the continuing overhang of losses in the financial sector, which the IMF now estimates at $4tn, four times higher than it projected just one year ago. It warns that the current outlook is "exceptionally uncertain, with risks still weighting on the downside." Among the risks they are stressing the rising household and corporate debt cause further falls in asset prices and losses by financial institutions. And expectations are that the recovery will be slower than in the past. There will be a smaller financial sector, with financing harder to come by than in the past, especially for developing countries, which will limit their growth.

The impact of the financial crisis to the stock markets in the world

The decline in the real estate prices caused weakness in the US financial market in August 2007, when the FED started to reduce the discount rate. Defaults on subprime loan payments led to decline of mortgage back securities and that caused stocks of financial institutions that had issued and purchased such securities to fall. That was followed by sharp decline of home building stocks and also junk bonds. Finally there was a domino effect on the entire US and the other countries' stock markets.

The impact of the financial crisis to the stock markets around the world was astonishing and devastating. The market capitalization of listed stocks of NYSE lost in one day over 1.2 trillions $, biggest lost ever in the history of the exchange (September 29,2008) .

Dow Jones Industrial Average Jan 2006 - Nov 2008



All around the world stock markets react accordingly, losing a vast of market capitalization of listed stocks and declining major SE Indexes . The NYSE Euronext Global index of best 100 European companies in September 2008 tumbled down 20%. Since April 2007 the value of best100 European companies lowered 2 times.

Global Index of best 100 European co. FTSEEUROFIRST 100

www.euronext.com

The world's stock markets are becoming very volatile, reacting on any news on macro or micro level, with abnormal increase/decrease of the stock prices/indexes. Expectations on the future economic outlook are not positive still, so the markets cannot recover very soon.

Standard & Poor's points out that all the major bourses are at least 50% below their peaks. Most of them are 60% down. It has been no use buying smaller stocks, or value stocks (those that look cheap in terms of earnings, assets or dividends); all have fallen by a similar amount. Diversification has been a washout: stock markets have been almost perfectly correlated with each other.

Is the worst over for the world economy? This is mainly a balance-sheet recession precipitated by a financial crisis. And it is a downturn that it is unusually synchronized around the globe. As an analysis in the IMF's new *World Economic Outlook* stressed, each of these characteristics points to a deep recession and a weak recovery. The report pointed out that in the aftermath of a financial bust, private investment tends to fall even after the downturn reaches its trough, whereas private consumption grows more slowly than in other recoveries. Recoveries from globally synchronized recessions take 50% longer than other recoveries.

The fundamentals in terms of corporate profits, house prices and bank lending have not yet bottomed. Valuations showed that the cyclically adjusted price-earnings ratio of the American market is 14.5, compared with previous bear-market lows in single digits. The dividend yield on the S&P 500 index is just 3.2%, and payouts are likely to be cut for 2009. So, April/May recoveries on the major stock markets are not sign of the end of the crisis!!!

Lot of discussions occurred in the recent months around the globe about the future steps in recovering the financial system. The main conclusion is that the international financial system has to be reformed in order to avoid systemic financial and subsequent economic crisis in the future. The focus should be put on strengthening the regulatory framework to prevent development of practices and products that pose an inherent risk to system stability, improvement of the transparency of financial markets and tightening the supervision of the financial market.

World's securities regulators have taken a step towards harmonising global short selling rules in the wake of the sudden changes and restrictions that many countries introduced last year following the collapse of Lehman Brothers. Many countries including the US, the UK, France, Germany and Australia restricted or banned short selling as markets tumbled in October and November 2008 as they feared the practice was exacerbating the decline in prices and artificially boosting volatility. The International Organisation of Securities Commissions (IOSCO), which is a forum for regulators in more than 100 countries, proposed common principles to help create a more consistent international approach to short selling, including a reporting regime to give markets timely information.

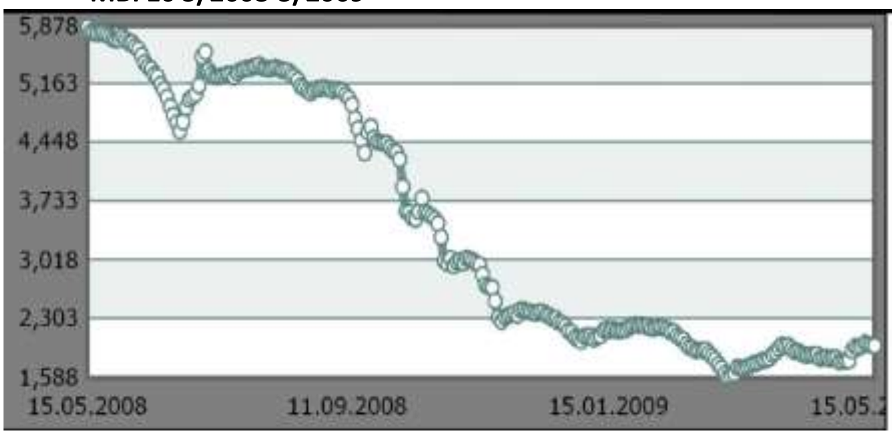
Macedonian securities market –threats and opportunities

The impact of the financial crisis to Macedonia was expressed trough collapsing exports and the drying up of capital inflows.

By far the biggest market for Macedonian goods is the Eurozone, now in recession. Meanwhile, the global credit crunch has sapped capital inflows to the SEE region as a whole .On the other hand the banking sector in Macedonia is away from heavily exposed banks in SEE region, but became very cautious in lending policy, which shrink the loans to the real economy. Owing to limited fiscal and monetary policy options, the government might need a call for help from IMF again.

Macedonian securities market although still very small and illiquid, reacted accordingly to the financial crisis, like other stock markets with sharp decline of SE index and value of trading. The MBI index tumbled almost 60% over the last 6 months. Early May recovery of the index still gives more than 2.7 times lower level of the MBI index compared to 2008 .

MBI 10 5/2008-5/2009



www.mse.com.mk

MSE index went down from the beginning of this year less comparing to the others regional exchanges. For the first 4 months of 2009 MBI 10 is lower around 4% , Belgrade Stock Exchange index is down 6%, Zagreb Stock Exchange is down 4%, Sarajevo Stock Exchange index is down 20%, Bulgarian stock Exchange Index is lower 5%). May's rally of MBI 10 due to dividend payments is not the sign of recovery of the Macedonian securities market.

What are the prospects of the Macedonian securities market, what are the threats, are there any opportunities?

Local institutional investors industry in Macedonia (investment funds, pension funds , insurance companies), is underdeveloped.

There are only 9 open investment funds in Macedonia, with total NAV of the industry around 2 million euro, which put Macedonian investment fund industry on the bottom of the list among SEE countries. There are no new funds on the horizon, so expectations that local institutional investors, especially investment funds, can create liquidity on the stock market, are not realistic.

Two pension funds from the second pension pillar have a strong potential in terms of cash inflows (monthly cash inflows is estimated to 1.5-2 millions euro). But, due to conservative investment strategies, these funds invest mainly in bank deposits, T-bills and government securities (mainly in bonds for denationalization). With roughly 5% of their portfolio investing in stocks their impact on the prices of the stock market is marginal.

Existing ten insurance companies in Macedonia are not active investors on the stock market and are not considered as important institutional investor yet. They are mainly depositing cash in banks and buying T-bills. The least developed part of insurance business in Macedonia is life insurance, which is based on long term sources of financing and those companies doing life insurance are supposed to be more active on the stock market. But, there are only 2 small life insurance companies, with very small potential for investments on the securities markets.

Foreign investment funds are not active investors on the stock market anymore (like used to be during the bull market in 2007). According to Central Securities Depositary figures, around 31% of outstanding shares in Macedonia belongs to foreign investors. In terms of active trading on the stock market, Macedonian Stock Exchange figures shows that as buyers foreign investors represent around 6% of trading in April 2009 (down from 36% in April 2008) and as sellers foreign investors represent around 15% of trading in April 2009 (down from 53% in April 2008). So, in this stage of development of the stock market, local investors are creating liquidity. That's why liquidity is very low, tumbling to the level of 2005.

According to data published by MSE (monthly bulletins, different issues) the average daily volume of trading (without block trades) in the first 4 months of 2009 is around 220,000 € , much lower compared to the first 4 months of 2008 average daily volume of 600,000 € and 1.9 millions € in 2007 accordingly. Number of daily trades went down too, from 675 trades in 2007, 197 trades in 2008, to 125 trades in 2009. The market capitalization went down 2.7 times, from 4.3 billions € in January 2008 to 1.6 billions in April 2009.

With velocity (value/market cap) around 1.1% , the market shows very low liquidity, but also high potential for growth. There is very low depth of the market. Selling orders dominate in trading and there are few buying orders, which is characteristics of a thin market. There are more stocks losers than stocks gainers, which shows low breath of the market. The average price spread of stocks representing index MBI 10 is around 4%, which shows also low liquidity of the market.

The stock prices are low and cheap. With average (not weighted) P/E for stocks representing MBI 10 of around 11 and average P/BV around 0.72 prices are backed at the level of 2005. With earnings yield (1/p/e) of around 9%, investing in stocks creates higher return compared to T-bills interest rate e.g. risk free rate and are becoming more attractive investment opportunities.

With such underdeveloped local institutional investors industry, main investors on the Macedonian Stock Exchange are local investors. Several investment funds from Slovenia, Croatia, Austria, used to be active in the bull market during 2007, but with the first signs of the crisis immediately started with withdrawing their investments on MSE. Some of them completely left the market, some are still present on the market. They are not investing new funds to MSE and are implementing passive, hold approach portfolio strategy. There are no new comers on the stock market, local investment funds are very passive regarding creating new portfolios and investing on the stock market, new local investment funds are still lacking. The liquidity of the stock market is ruined.

Expectations are that the global financial crisis will end some times during the 2010 and the full recovery of the stock markets in developed economies will take additional 1-2 years. Securities markets in small countries will recover later, especially those with underdeveloped local investment fund industry, like Macedonian case.

Expectations on the future economic outlook in Macedonian are not positive still, so securities market cannot recover very soon. Expectations for 2009 are that the economy will decline around 1%, and this information's are included in the current stock prices. So fundamentals cannot be the main factors for boosting the market.

Also, there are no sings that this year new local investment funds will be established and will enter Macedonian securities market. Small local private investors are very few which cannot create higher liquidity on the market.

New foreign investment funds (mainly from Slovenia, Croatia, Bulgaria) will enter Macedonian securities market after recovery of their local stock markets and accumulation of profit from investing on the local markets. Excess of these funds later can be invested abroad (maybe in Macedonia), but not this or next year.

The main threats to the securities market are coming from deepening the crisis in the real sector of the national economy, especially export oriented companies, which if are not able to recover soon, will cause a foreign exchange crisis in the country and possible devaluation of denar. This situation will ruin further the liquidity on the stock market.

Opportunities for earning money on the stock market exist. In terms of valuations of stock prices, there is a potential for growth (now is right time to buy, many professionals are saying). Many stocks are undervalued, market capitalization of many companies are backed on 2005 level. But there are no to many investors in this stage of the stock market, which can boost the market.

Only positive signals from EU on starting membership negotiations or NATO membership next year, can create positive expectations and possible entry of foreign institutional investors on the local securities market. These expectations can boost the market earlier, create higher liquidity and increase the stock prices.

The future of Macedonian securities market is in a more active approach in globalization and integration of stock markets. It is the main opportunities for survival and development of all small and illiquid securities markets, including Macedonian securities market.Maybe it is not right time to look for strategic investor for MSE, but that process has to continue without any delays or postponements. The approach first to get closer on the regional level and later to enter into the process of consolidation of regional stock exchanges, showed lot of inefficiencies so far and wasting lot of time.

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