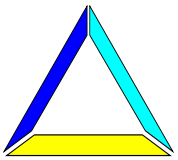
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Capital Markets in Ukraine: Proposals to Increase Supply and Demand

Executive Summary

Capital markets in Ukraine remain vastly underdeveloped. While some observers make the lack of liquid assets responsible for the current situation, others identify a shortage of funds as the main culprit. In our view, the only way to develop capital markets is to tackle both the demand and the supply side of capital. On the demand side, we recommend the usage of stock exchanges (including PFTS) in future privatisations of state companies. Furthermore, we suggest floating 10% to 25% of the shares of "strategic" companies, i.e. those state companies considered to be too important to be privatised. On the supply side of capital, we propose the swift implementation of the second pillar of the new pension system. Besides, the already existing third pillar should be popularised. Last not least, the system of currency regulations should be improved, in order to attract foreign financial investment.

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1 Introduction

The purpose of this paper is to draw attention on the significance of well-functioning capital markets for the economic prospects of Ukraine and to provide policy recommendations on how to further develop capital markets. This issue is important from both an economic and a social point of view. Despite most economic preconditions for active capital markets being in place, the markets remain vastly underdeveloped. The problems that hinder the development of the capital markets are rooted in both demand and supply sides of the markets. That is why, the only way to facilitate the progress of the markets is to approach these both sides simultaneously.

The paper is structured as follows. The economic and social functions of capital markets are discussed in Part 2, where we also compare capital markets and banks. In Part 3 the current situation on the capital markets is described and the main problems of them are identified. We focus on the problems of both demand and supply of the capital markets. Then in Part 4 we present our ideas on how to improve the situation of the capital markets in Ukraine and give concrete recommendations for this purpose. Part 5 provides conclusions.

2 The economic and social importance of capital markets

Capital markets are important for the economic development of every country. They provide long-term funds for the private and the public sector.[1] More specifically, capital markets fulfil important economic and social functions, and we briefly describe those functions below.

2.1 Economic functions of capital markets

The major economic functions of capital markets are to facilitate investment and economic growth, to promote the development of the financial industry and to enhance corporate governance.

Investment and economic growth: Financial markets in general and capital markets in particular perform the essential economic function of channelling funds from people who lack productive investment opportunities to people who have such opportunities. By doing so, financial markets contribute to higher production and efficiency in the overall economy.

Financial industry: Capital markets facilitate development of the financial industry by determining prices of assets traded through the interaction of buyers and sellers. Also, capital markets provide liquidity and the ability to convert a financial asset into cash. Besides, capital markets reduce the cost of financial transactions by bringing sellers and buyers of financial assets together and hence explicit search costs are eliminated. Information costs, which are incurred in assessing the investment merits of a financial asset, are also reduced because a specialized institution emerges to produce information more efficiently.

Corporate governance: Stock exchanges, stock brokerage houses and investment banking firms provide economic benefits and facilitate corporate governance. Stock markets also serve as thermometer for corporate performance enabling the management of listed companies to get early signals from the stock price behaviour and judge the performance and take corrective action. In general, the stock market votes on corporate performance.

A proper functioning financial system is vitally linked to economic growth. Countries with large banking sectors and active stock markets tend to grow faster than countries with underdeveloped financial sectors.

[1] The capital markets (that include stock market and the bond market) can be defined as the markets for securities, where companies and the government can raise long-term funds. The capital markets can be contrasted with other financial markets such as the money market, which deals in short term liquid assets, and derivatives markets, which deals in derivative contracts.

2.2 Social functions of capital markets

Capital markets also fulfil important social functions. First, they provide investment opportunities for households – both directly (personal purchase of stocks, bonds) and indirectly (through asset management companies and non-state pension funds). In this respect capital markets facilitate development of non-state institutions that are an important complement to the state pension system. Secondly, capital markets are a "democratic" way for participation of population in profits of enterprises. This makes an important contribution towards a more fair income distribution in the society.

2.3 Capital markets and banks

Developed capital markets are often viewed as competitors to commercial banks as they both compete for savings and investment opportunities. However, in modern financial markets there is usually a complementary relationship between capital markets and banks as they choose different segments of financial market and focus on different types of clients. For example, small young high-risk companies obtain financing from banks while mature large companies turn to capital markets. Another example of complementary relationship is mortgage lending when banks rely on capital markets to issues mortgage loans through securitisation.

In advanced countries both financial sectors - capital markets and banks - are well developed, which is illustrated by Table 1. Developed countries tend to have relatively large capital markets and banking sectors.

Table 1
Size of banking sector and stock market in selected countries, 2003

Country	Domestic credit provided by banking sector, (% of GDP)	Stocks traded, total value, (% of GDP)	Market capitalization of listed companies, (% of GDP)
Germany	142.93	47.74	44.90
Japan	157.33	52.85	70.70
United Kingdom	150.35	119.83	134.41
United States	261.77	142.00	130.30
Bulgaria	29.79	0.99	8.84
Croatia	65.46	0.82	21.27
Czech Republic	49.45	9.81	19.69
Estonia	54.78	6.21	41.73
Hungary	58.29	10.03	20.22
Kazakhstan	13.74	1.39	8.15
Latvia	45.48	1.31	10.30
Lithuania	23.69	1.09	19.27
Moldova	29.85	1.78	25.84
Poland	37.00	4.06	17.73
Romania	15.88	0.78	9.81
Russian Federation	27.57	18.72	53.32
Slovak Republic	44.69	2.04	8.55
Turkey	53.90	41.44	28.45
Ukraine	**32.75**	**0.21**	**8.69**

Source: World Development indicators 2005.

Note: Stocks traded refers to the total value of shares traded during the period. Market capitalization is the share price times the number of shares outstanding. Domestic credit provided by the banking sector includes all credit to various sectors on a gross basis, with the exception of credit to the central government, which is net.

3 Current situation and problems concerning capital markets in Ukraine

3.1 Current situation

During the last years capital markets in Ukraine have been growing quite rapidly. From 2003 to 2004 capitalization of the regulated Ukraine's stock market almost tripled reaching UAH 98.1 bn[2] or 18.1% of GDP comparing to 8.7% in 2003. In 2005 the market continued to grow further. Market capitalization doubled comparing to 2004 and reached approximately 35% of GDP (see Table 2). Trading activities were also growing. Annual volume of trades in the First Trading Securities System (PFTS), the largest trading platform in Ukraine, reached UAH 14 bn in 2005, which is two times higher comparing to 2004. This is, however, very low level of trades comparing to the market capitalization, which means basically that free floating of shares is currently very limited in Ukraine. For instance, 12% of market capitalization of the PFTS is the share of the capitalization of "Kryvorizhstal" plant, only up to 2% of shares of which is traded on the market.

Table 2
Key indicators of Ukraine's capital markets

	2001	2002	2003	2004	2005
Market capitalization, USD m	1,520	3,120	4,302	11,778	28,878*
Market capitalization, % of GDP	3.9	7.4	8.7	18.1**	35.3***
Volume of trades*, USD m	1,186	1,176	603	1,320	2,440
including trades in stocks, USD m	215.3	126.8	102.6	204.2	483.9

Source: World Development Indicators2005, PFTS reports.
Note: * in the PFTS;
** estimation based on the PFTS capitalization data;
*** estimation based on IER's GDP forecast for 2005.

Even though the value of trades grew substantially during last years, the ratio of the value of trades to GDP remains at a low level as compared to the developed countries and to other transition countries. In 2003 in Ukraine the total value of trades in stocks was 0.2% of GDP, which is lower than in Latvia (1.3%) and Poland (4%), considerably lower than in Czech Republic (9%) and Hungary (10%) and much lower than in Germany (47%) and in the United Kingdom (142%) (see Table 1).

The main trading platform in Ukraine that deals with almost 76% of total secondary trading in securities is an over the counter based trading and information system – the PFTS. In the structure of trading in securities in the PFTS the biggest share is occupied by the trading in corporate bonds (45%), in government bonds (26%) and in shares (23%). The rest is trades in municipal bonds (5%) and investments certificates (1%). The PFTS, however, is not recognized by Ukrainian legislation as a stock exchange. One of the consequences of this is that the PFTS is not used for primary auctions of the State Property Fund of Ukraine to privatise state owned enterprises. Legally recognized stock exchanges[3], the share of trades settled on which does not exceed 16% of total volume of trades, are mostly used for that purpose. In Ukraine substantial part of shares trading, about 80%, is settled outside of the regulated market. However, a substantial part of such trades is the trades in so-called "junk shares"[4] and they are frequently used for illegal financial schemes. That is why the problem of a big unofficial market does not have to be overrated. Much more important is the fact that an estimated 80%-90% of trades in securities are made outside Ukraine.[5]

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2 According to State Commission on Securities and Capital Markets (later on Securities Commission).

3 There are 7 such stock exchanges in Ukraine.

4 Junk shares are shares of non-existing or bankrupt company, which are due to lack of proper performing registry system, are still in circulation. Such shares have no value and used in shadow financial schemes.

5 Seeger M. C. (Financial Markets International, Inc), Patton C.H. (Independent), 'Background for Financial Markets Development in Ukraine', January 1, 2000.

As compared to the banking system, capital markets in Ukraine are much less developed. As of November 1, 2005 UAH 64.5 bn[6] were attracted from households as deposits to the banking system. This is much higher comparing to what is accumulated in capital markets in the mutual investments funds, which attracted only around UAH 200-300 m from households.

3.2 Problems concerning capital markets in Ukraine

Most economic preconditions for an active capital market in Ukraine are in place. On the one hand, a rapidly growing industry in the country demands and will demand more capital. For instance, public utilities enterprises need about UAH 32 bn of investments as estimated by the government. On the other hand, a large population of around 47 m people can in principle generate enough private savings to ensure sufficient supply of capital. Thus, in spite of good enough economic preconditions for development of capital markets, their development are still limited by impediments in both the demand and the supply side of the market.

On the demand side, free floating of shares is very limited. Less than 10% of shares are put into free floating according to the PFTS. Besides, public offerings of securities are not a popular way of raising capital in Ukraine. Out of 11,754 open joint stock companies registered in Ukraine, the stocks of only 673 companies were listed at the end of 2004.

On the supply side, capital markets happened to be comparatively less attractive for domestic investors as compared to bank deposits. This is partially a result of the government policy, since the deposit interests are not taxed in contrast to capital earnings, which are taxed as ordinary personal income.[7] Supply of capital by domestic investors is also very much limited due to a delay in implementation of the pension reform. For instance, according to an estimation the accumulated by non-state pension funds capital would exceed UAH 47 bn by 2017.[8] Moreover, some negative experience, which resulted into the lack of trust to mutual investment funds or private pension funds, is also among the impediments for the development of capital markets in Ukraine. For foreign investors, Ukrainian markets are not very attractive due to a range of very restrictive regulations, which are in place in Ukraine.

4 Policy recommendations

As it is described earlier, problems of capital market development in Ukraine are rooted in both the demand and supply sides. From the demand side, the purpose should be to attract more assets into organized capital markets. From the supply side, the task is to pump more financial resources into the markets.

It is essential for a fast progress of capital markets to properly protect the rights of investors and shareholders. At the moment, rights of portfolio investors are poorly protected and only the riskiest investors are on the market in Ukraine. Technically it is fairly simple to increase the protection of investors and shareholders. The draft Law On Joint Stock Companies (JSC), which has been already passed by the Verkhovna Rada in the first reading, has to be adopted. According to selected market participants, the main point of disagreement that hampers the adoption of the law is the reluctance of some parliamentarians to abolish the institution of a Closed Joint Stock Company (CJSC), as it is foreseen by the draft Law on JSC. In such a situation, if it is politically necessary, the draft law should be passed without abolishing of CJSC. This would already be a huge improvement compared to the current situation.

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6 Source: National Bank of Ukraine.

7 Personal income tax is 13%.

8 Material of the 16th science conference "Assets management: strategies and risks", Yalta, June 10-13, 2004, Presentation of USAID/PADCO expert Greg MacTaggart "Save and increase. Cumulative pension funds in Ukraine", (http://www.pension.kiev.ua/FILES/Go%20Forth%20And%20MultiplyUkr.zip).

4.1 Demand for capital: How to pump more assets into the market?

First, in order to enhance liquidity of the markets, free float of shares has to be increased. For this purpose, we suggest to improve the privatisation procedure in Ukraine. We propose to use a different procedure for some privatisation cases. Traditionally privatisation in Ukraine is done through tender, where "industrial investor"[9] has a priority to acquire the major shareholding. As a result, only an insignificant part of shares (up to 10 %) is free floating. If significant share of a company is sold to portfolio investors through the stock exchange, this will result in higher supply of assets to the market as well as in higher liquidity in the market. Thus, we recommend privatising companies in three steps. In the first step, before privatisation, not less that 10% of shares are to be sold to portfolio investors on the stock market (including the PFTS). Selling shares on the market will not only facilitate the development of the stock markets, but also will provide a market assessment of the real value of an enterprise. In the second step a maximum of 51% of shares is to be sold to an industrial investor on a competitive tender. And the third step consists in selling the rest of the shares to investors through stock exchange (including the PFTS). This will raise supply of assets to the markets and improve their liquidity. For instance, in 2006 it is planed to receive UAH 2.1 bn from privatisation of the state assets. Assuming that all privatisation is done using the proposed scheme, i.e. 49% of this sum will be received from the sale of shares in the capital markets, than it can be expected that volume of trades could increase by approximately UAH 1 bn. Besides, such privatisation schemes will lead to a lower concentration of property and of economic power of some owners. Plus, this will allow better corporate governance of companies and better control of their management. Non-efficient companies with poor corporate governance will face a competitive pressure and, as a result, average performance of the economy will improve.

Our second proposal is to increase the free float in shares of so-called strategic enterprises[10]. Currently, the state keeps almost all shares of strategic companies in its portfolio, e.g. shares of Naftogaz, Turboatom, Ukrnafta etc. The government should in our view consider selling 10%-25% of shares of such enterprises on the stock market. Such step will improve liquidity on the market. In addition, since changes in share prices formed on the market will reflect successes or failures of the management activities, it is a good way to improve and assess management of the companies. Besides, floating of shares on the market will indicate a real value of the companies, which force them to behave in a more transparent way.

Third, unfair treatment of capital markets earnings and bank deposits has led to lower attractiveness of the former as a mean of investment. Capital markets gains and banks deposit earnings should be treated equally. For this, we recommend in the short term prospective *not to tax* both capital markets earnings and bank deposits earnings.[11]

4.2 Supply of capital: How to pump more money into the market?

Simultaneously with expanding the number and volume of securities, it is equally important to assure adequate demand for those securities, i.e. the supply of funds. Additional supply of funds can come from domestic as well as external sources.

4.2.1 Domestic capital

The most promising domestic source of additional funds for the capital markets is the potential savings accumulated by pension funds. Ukraine has set a legislative framework in

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[9] Industrial investor is a domestic or foreign investor that is interested in securing a share of the privatized enterprise on the particular market and has been producing the similar the enterprise's main products for not less that three years, Besides, industrial investor guaranteed not to change the main activities of the enterprise for the predefined period of time, takes the particular investments and social obligation.

[10] Strategic companies are those, which have high importance for the national security and which by law cannot be sold to private owner and must remain in hands of the state.

[11] For details see policy paper by IER/GAG, S27 "Should the interest income be taxed in Ukraine?", March 2003, (http://www.ier.kiev.ua/English/papers/s27_en.pdf).

2003 for a pension reform, which consists in a gradual shift from a purely pay-as-you-go system to a three-pillar system. The framework envisages the introduction of a second pillar (a compulsory state accumulation pension system) and a third pillar (the voluntary non-state system of pension savings).[12] The successful implementation of the pension reform promises to create significant supply of "long money", which may be invested into bonds and shares. However, the second pillar of the pension system has not been introduced yet, while non-state pension funds are rather young and accumulated only around UAH 45 m by the end of 2005.[13]

Another source of "long money" is life insurance, which is a larger source of capital at the moment. For the first 9 months of 2005, the insurance premiums of life-insurance companies equalled to UAH 226.4 m, from which 80.8% are accumulated according to contracts of long-term accumulative insurance, while 9.8% were received according to the contracts of pension insurance. By the end of the third quarter of 2005 the reserves of life-insurance companies equalled to near UAH 300 m. In 2005, shares and bonds accounted for 22% of all reserves.

Swift implementation of second pillar

As opposed to the current pay-as-you-go system, the second pillar envisages that the special Accumulation Pension Fund (APF) accumulates contributions paid by current employees and invests them into assets. For this, the contribution paid by the employee will be transferred to the APF, while the contribution paid by the employer will go to the Pension Fund (first pillar). At the moment, employers pay around 94% of the total pension contribution. With the introduction of the second pillar of the pension system, this proportion is to be changed. In 2003 during the approval of new pension legislation, a proposal to set the contribution by employees to APF at the rate of 7% of wage was under discussion.

Therefore, the introduction of the second pillar will insure future pensioners against possible negative demographic trends, and increase the total amount of pension benefits through investing money of the APF. Thus, it will create additional sources of financing for investment in the national economy. Asset managers, chosen through open tenders, will manage the funds of this pillar. This provision will improve the efficiency of asset management by ensuring the competitiveness between private companies for management of pension assets of the second pillar.

The introduction of the second pillar is expected in the future[14], when certain economic prerequisites, an effective system for state supervision and the necessary infrastructure are in place. One of the most striking is the requirement for non-deficit Pension Fund's budget, which is now plagued with large structural deficits. Therefore, one option in this situation is to wait till the moment when the Pension Fund balances its budget. However, this approach poses a risk of indefinite delay in the introduction of the second pillar.

Therefore, we put forward the following policy recommendations:

- Disproportional increases in pension benefits such as the ones in 2004 and 2005 should be avoided in the future.
- The legislation necessary for the introduction of the second pillar should be approved in 2006.
- We suggest introducing the second pillar in 2008 (which is similar to the terms defined by the Cabinet of Ministers), but with a contribution of 1% of wages. Then the contribution should be gradually increased each year to the full contribution level (e.g., every year the rate should increase, for example, by 1 percentage point of wage up to 7% of wage). Such recommendation is supported by our calculations provided in Box 1.

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12 The law "On non-state pension provision", July 9, 2003, # 1057-IV.

13 Interfax-Ukraine information agency (Kyiv, Ukraine), January 30, 2006.

14 According to the Strategy of Pension System Development approved by the Cabinet of Ministers (December 15, 2005, # 525-p) it is expected that this pillar will be introduced in 2008-2009.

If the Pension Fund lacked the contributions of 7% of wages, it would face an additional deficit in 2006 of more than UAH 10 bn, which cannot be financed.[15]

Box 1
Second pillar of the pension system and supply of capital

Level of contribution	UAH bn	% GDP
7% contribution	10.0	2.0
1% contribution	1.4	0.3

Source: the Ministry of Finance, own calculations.

Here we estimate the effect of the introduction of the second pillar on the supply side of capital markets. We conduct our estimations taking into account a 7% contribution rate discussed in 2003 by the government and a 1% rate suggested by us. The calculations are based on 2006 figures.

The introduction of the second pillar with the initial 1% of wages would have enabled to accumulate UAH 1.4 bn at the APF in 2006. All of those funds could go to capital markets (government and corporate bonds, and equity shares), thus boosting the market capitalization by nearly 1%.[16] The resulting additional demand for stocks will be at most UAH 0.56 bn (taking into account that the APF can invest to the equity shares not more than 40% of their assets), and the additional demand for corporate bonds will be at most UAH 0.28 bn.

A crucial thing in these recommendations is to start the process, no matter how small the initial steps are. The process must get started to ensure the success of the pension reform!

Popularisation of pension reform - Disseminate information on third pillar

The third pillar of the pension system – the voluntary non-state pension system – started in January 2004. There are three ways how individuals can save voluntarily for the old age: through non-state pension funds (NPF), life insurance companies and banks. The NPF may be in the form of open-end, corporate and occupational pension funds. The state, in particular, the State Commission for Regulation of Financial Markets, supervises the non-state pension system, primarily through licensing NPF.

Currently, employers are eligible for certain tax exemptions and individuals are eligible for tax credit while paying contributions to the NPF. This creates incentives for employers to provide their employees with the additional benefit of higher pensions in the future and for individuals to become more responsible for their future. The pension contributions received by the NPF, life insurance companies and banks are not subject to tax.

So far the importance of the third pillar for the capital markets has not been large. One of the major problems with the third pillar is the low level of awareness in the population. The results of a recent research[17] show that citizens are not aware about a variety of possibilities of influencing the size of pension (in particular, a pension account in a financial institution — this factor was mentioned by 32.3% of respondents).

Thus, it is important to disseminate information on third pillar of the pension reform. We recommend making the information on the new pension system more accessible, especially for trade unions and labour representatives. Also, a possibility to initiate cooperation with employers to introduce pension schemes at the company level may be considered.

[15] The Pension Fund already faces a high deficit (UAH 7.2 bn planned for 2006).

[16] Here we use 2005 figure for Ukrainian capital markets capitalization from Table 2 as an estimate of capitalization in 2006.

[17] Results of the public survey of attitudes as for pension reform conducted by the GfK-USM company in July-August 2005 and commissioned by the USAID/PADCO project "Ukraine: Pension Reform Implementation". http://www.pension.kiev.ua/FILES/ENG/PublicOpinion2005-e.pdf

4.2.2 Foreign capital

Tapping resources of foreign investors can be another important way to pump money into the Ukrainian capital market. Currently, investment into Ukrainian stock and bonds markets remains not very attractive for international investors because of two major reasons. First, buyers of (non-cash) foreign currency have to pay a contribution to the Pension Fund of 1.3%. This "currency tax" reduces significantly the attractiveness of Ukrainian assets for foreign investors. For this and other important reasons[18], we recommend abolishing this tax as soon as possible.

Second, repatriation of capital and profits is complicated with the fact that foreign investors should obtain permission to buy foreign currency. Acquiring such permission requires submission of some documents and takes a significant amount of time (normally 1 month), which altogether is rather expensive in terms of work and time. Consequently, we recommend substantially simplifying the procedure for buying foreign currency and repatriating capital.

5 Conclusions

The financial sector is very important for the economic development of Ukraine. That is why a significant part of attention of the government should be paid to the present shape of the Ukrainian financial sector and its components. There was an impressive progress of the Ukrainian banking industry, whereas the achievements on the capital markets still leave a large room for further improvement. Thus, economic policy should focus on capital markets. We believe that the only way to approach the task of developing capital markets is to look at both sides, supply *and* demand, simultaneously; all attempts to look at only one side will fail.

Kyiv, February 2006

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[18] For further arguments against this currency tax see the policy paper V2 "Managing capital flows: Ensuring long-term benefits while controlling for short-term risks" by the IER and GAG.