



## Priorities of stock market development in Kyrgyzstan

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### Tendencies of the world stock market

**The capitalization of the world stock market** in 2005 reached the amount of 43 trillion dollars (in 1990-9.3 trillion dollars and in 2000 – 32.1 trillion dollars). The rate of capitalization is 5-6 times ahead of the GDP growth. Capitalization has been increasing mainly due to developed countries' markets, which constitute more than 90% of the world capitalization total. According to the capitalization rate, the US market is in first place, constituting 40% (50% by the end of the 1990s) of the world market capitalization. The share of the Western European markets is 31% while the Japanese market -11%. Thus, the rest of the countries or developing economies constituted only 8% of the floating world capital at the beginning of the millennia while recently it has reached 15%.

The increase in the capitalization of the world stock market is related to the **structural changes in the financial market** as a whole. The point is that the infrastructure of capital formation in the world economy has favored the securities market - 58% as opposed to bank lending. The picture from country to country varies depending on traditional ways of policy-making. For example, for Germany and Japan where the bank system has been conventionally favored the financial market, the ratio is 75%:25% and 80%:20% correspondingly in favor of bank lending. However, in such countries as the USA, Great Britain and France, where debt security is increasing, this ratio is 59%:41%, 27%:73% and 30%:70% correspondingly in favor of the securities market.

The tendencies of the world stock market are related to **the changes in the structure of players**, which appears as follows. In the 1970s the major market investors were the investment banks, funds and companies. In the 1980s institutional investors were added to this list: pension funds, safety funds and investment companies, mutual funds that attracted the means of individuals. The end of the 1990s brought about the appearance of private investors in the market by changes in the relative profitability of financial instruments and technological opportunities. The decreasing profitability of state securities, the low interest rate of bank deposits increased demand for capital stock as the most profitable. The number of private investors has increased by 4-5 times in Western Europe. In the USA more than 55% of the population participates in the stock market directly or via mutual funds.

The experience of the world economy shows that for developing and transition economies during crisis periods, and under the conditions of stabilization, the state should play an active and constructive role in the process of financial market development, and especially in the securities market. The active role of a state is to promote a favorable climate for investments, to improve legislation and liberalization of the securities market regulations, to develop the market of state and municipal capital stocks, and capital stocks of state-supported enterprises. The contribution to the development of the stock market is possible via the system of administrative support of the main players and the economic stimulation of investors.

### The stock markets of Kyrgyzstan and other transition countries

15 years have passed since the former Soviet countries took the path of independent development. From the first days of independence, each new state faced problems that should have been addressed in the past. The time to establish the transition, and then the market economy was small; former Soviet republics have done a lot within such a short time period to reform their systems. The level of success differs from country to country. Some were lucky to have hydrocarbon resources; some were able to keep the potential but lagged behind in reforms, others went into market economy reforms, but lost their fundamental positions. However generally speaking, all former Soviet Republics are similar in that they started enthusiastically and quickly adopting the basics of a market economy, coming from the same system of planned economy, and it was necessary for them to learn from both each other and developed nations.

Within this context, it is necessary to make a comparative analysis of the achievements of new post-Soviet states in developing one of the most important components of the market system – the stock market or the securities market, where the capital flows into the economy and state enterprises become private. **It is useful to see the realities of the Kyrgyz stock market as being one of equals, taking into account its advantages and disadvantages rather than to hear from skeptics or to imply simply that there is no such thing as a securities market.** Such an analysis will help us to see carefully and define all problems and lags in Kyrgyz stock market development in order to catch up with the leaders.

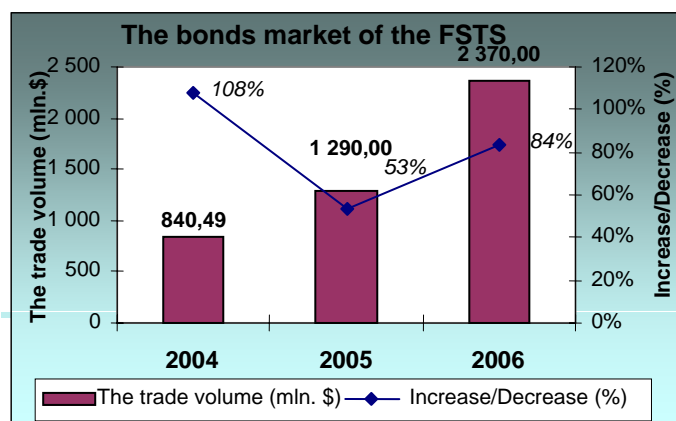
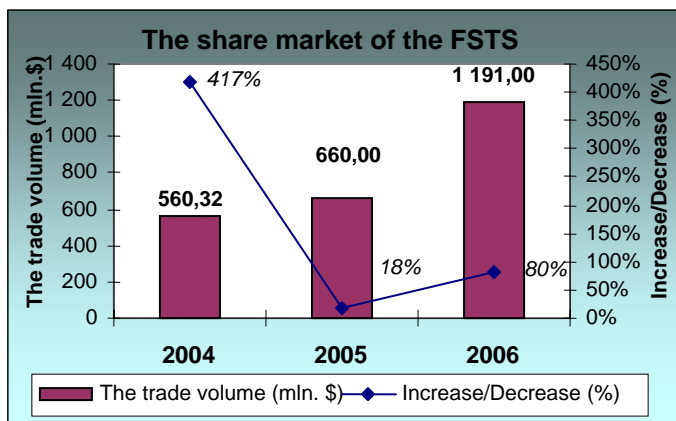
To have a complete comparative analysis, we have chosen the stock markets of Azerbaijan, Georgia, Uzbekistan, Ukraine and Kyrgyzstan, which can be considered to a certain degree as equals. In some countries like Moldova and Tajikistan, the stock markets are just starting to develop. The current state of the Russian and Kazakh stock markets cannot be compared with the others, since they are far ahead in size. Solid activities in the stock market are recently being performed by Ukraine as well.

**Ukraine** is a country of vast territories and large economic potential. The stock market of Ukraine had 801 dealers of securities, 352 registrators, 156 investment funds, 81 keepers, 1 depository, 7 stock exchanges, 2 trading information systems as well as 10 self-regulating organizations (SRO). The overall number of shareholders in Ukraine according to records is 17 million people; that is considerably more than in nearby countries of Eastern Europe. The most rapid development of the stock market in the country has started since the “Orange” revolution.

The largest exchange in Ukraine among seven currently operating, is the exchange established by the Association “The first securities trading” (FSTS) in 1996 as the system for the electronic trade, which became a stock exchange two years ago.

Diagram #1

Diagram #2



The listing of the FTSS integrated 276 securities including corporate bonds -150; shares – 96, investment certificates – 23, municipal bonds – 7. Totally, by January 1, 2007, the FTSS trade estimated 682 securities: shares- 311, corporate bonds – 303, investment certificates – 49 and municipal bonds – 19.

In **Azerbaijan** there are 14 companies that may operate in brokering and dealership. It is interesting to note that 8 of these companies are banks, which gives grounds to think that the development of the stock market is closely related to bank infrastructure. To a certain degree such a close relation is conditioned by the functioning of two trading systems: Baku Stock Exchange (BSE) and Baku Interbank Currency Exchange (BICE).

Diagram #3

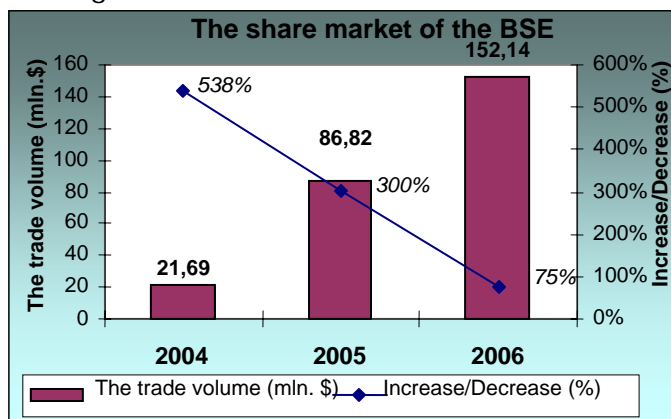
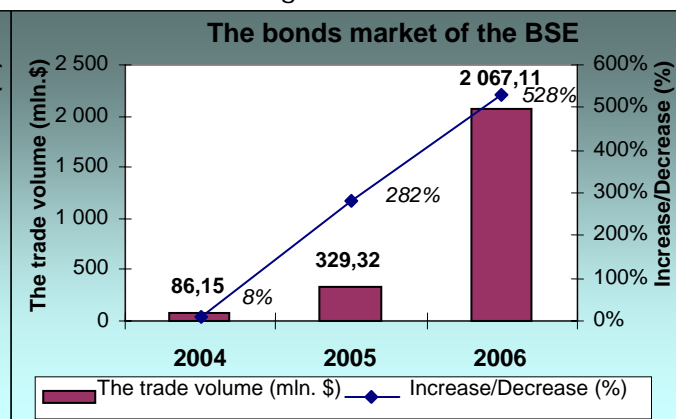


Diagram #4



There are the following financial instruments in the BSM: 1) shares; 2) corporate bonds; 3) state exchequer stock; 4) notes of the Central bank; 5) REPO deals. From the view of the instruments' development level, this exchange can compete with any other in the CIS. Seemingly, the close cooperation of exchange management with state structures brings positive results. In the near future, the issuing and circulation of municipal securities is planned.

In the stock market of **Uzbekistan**, there are 71 broker companies that work in every part of the country, even though most of them are concentrated in the capital (the same as in our country). The geographical location of the broker companies is as follows: Tashkent – 44, Andijan – 4, Fergana – 4, Namangan – 4, Kashkadarya – 3, Surhandarya – 3, Khorezm – 3, Bukhara – 2, Navoi – 2, Karakalpakiya – 1, Samarkand – 1. The total number of depositaries of the second range which operate in the country has reached 36; the growth rate is 20% in the recent 2 years.

The main manager of the exchanges in the country is the Republican Stock Exchange "Toshkent" (TRSE) which was established in March 1991 on the basis of the Universal Commodity and Stock exchange "Toshkent" in the form of an Open-type Joint Stock Company.

Diagram #5

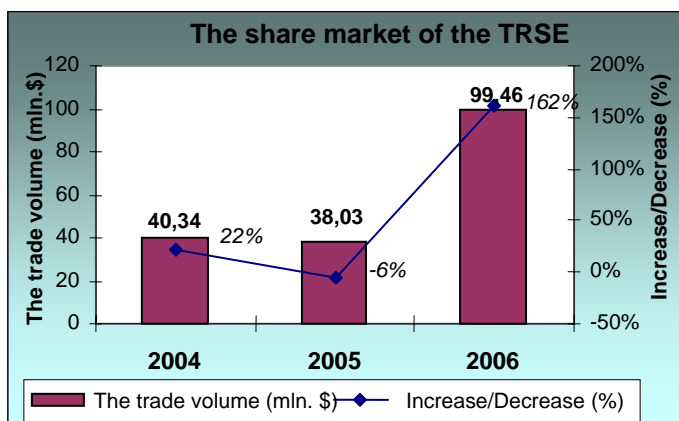
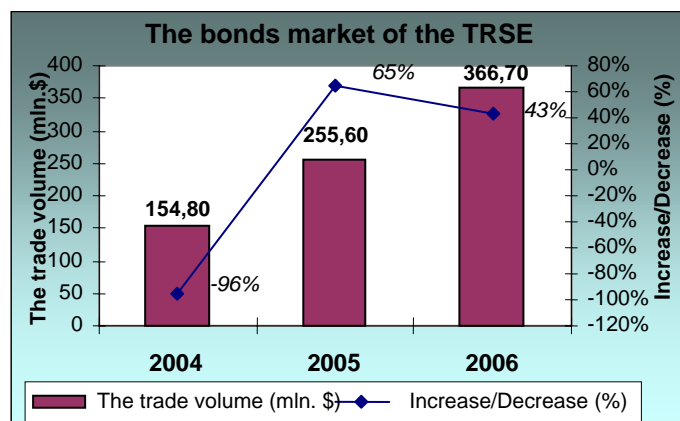


Diagram #6



There are such financial instruments in the TRSE like the shares and corporate bonds. The amount of growth in 2006 mainly was triggered by the realization of the state program on decentralization and privatization, and the foreign investment attraction.

**Georgia**, where the systems of the Georgian stock exchange (GSE) and the Tbilisi Interbank Currency Exchange (TICE) function, has recently succeeded in developing the stock market.

The TICE is the place for currency exchange; it is the main player of the financial market of Georgia, which participates in important economic processes in the country. For example, the official rate of the national currency in relation to foreign currencies starting from August 6, 1993 is being fixed in this exchange. The perspectives of the exchange are in two directions: the interest and currency future markets; precious metals, interbank loan market, bills' market and the commodity future market.

As in our country, there are two financial instruments that circulate in the GSE – shares and corporate bonds. The market of corporate securities in Georgia shows a considerable volume of exchanges. "The Rose Revolution" in 2003 forced the government to take decisive steps in the economic sphere.

Diagram #7

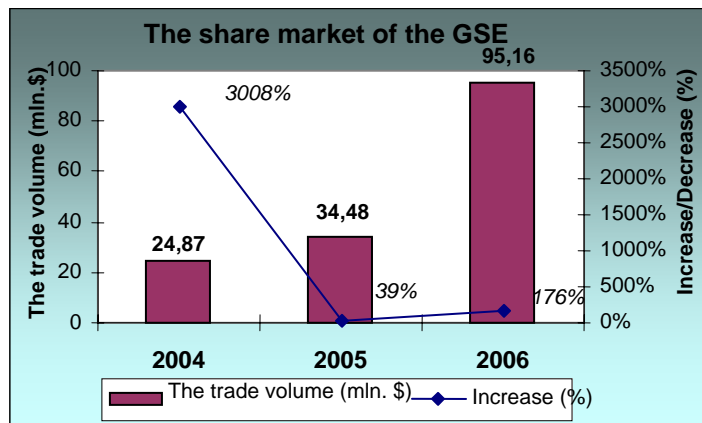
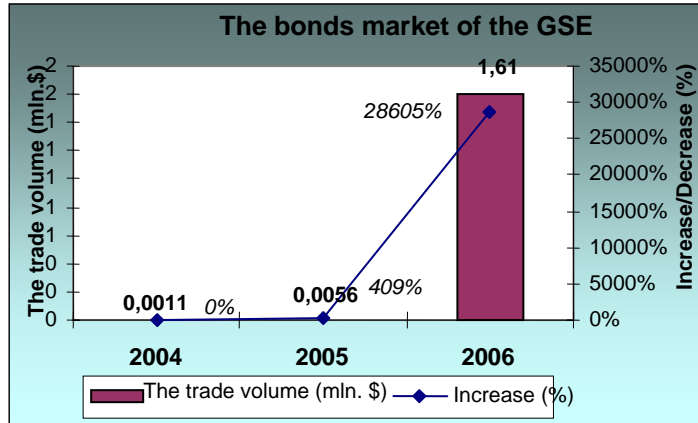


Diagram #8

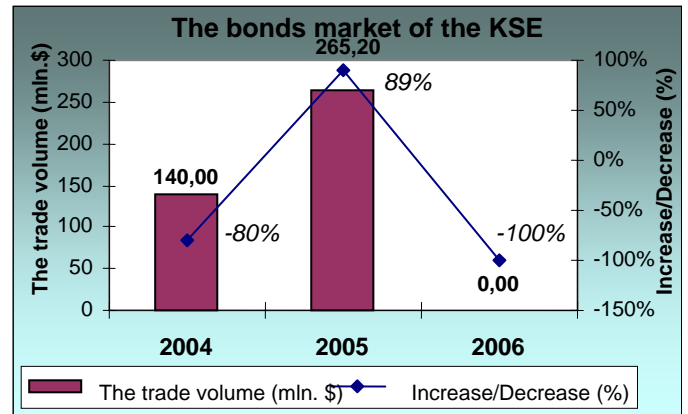
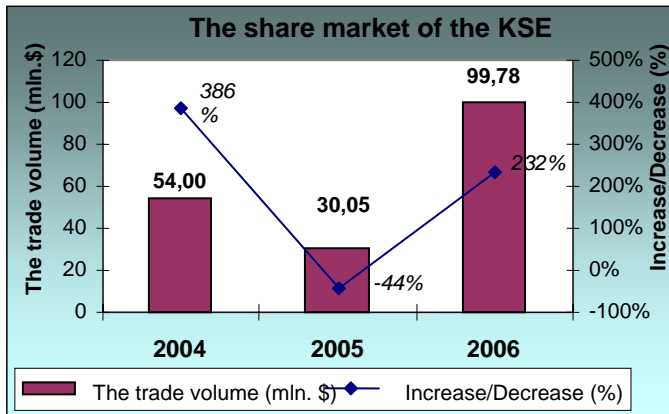


The major managers of the exchanges in Kyrgyzstan are the Kyrgyz Stock Exchange, the Exchange Trading System (ETS) and the Central Asian Stock Exchange (CASE). All three exchanges circulate 2 financial instruments: 1) shares, and 2) corporate bonds. The exchanges for currency or state securities are not present. The possible reason is the absence of state will to hand over this issue to "market" mechanisms of exchanges; as we all know the trading place for state securities and currency trade is the trading system of the Central Bank. The market of corporate securities, in its turn, is nowadays represented by shares only, because of the sound story of Renton Group bonds, the investors have lost their trust in this instrument for attracting investments. Also, to develop the market of corporate bonds there is the state barrier – each bond issuer has to pay a considerable amount to register the bonds' offering circular while investors must pay taxes of 10% of income.

According to the results of 2006, the most share of trading in the stock market at 94.66% belongs to the Kyrgyz stock exchange, established in the form of the Joint Stock Company in 1995. Within 8 months of this year, its share estimates at 90.4%, and the trade volume is 3,137 million soms. The share of the CASE is 7.4% and the share of the ETS – 2.2%. Thus, the developments of the KSE mainly characterize the overall condition of the market of securities in the country.

Diagram #9

Diagram #10



### Problem zones and priorities of the domestic stock market development

Based on the above comparative analysis, we can see, **first**, that the stock market in Kyrgyzstan has been developed and can be fairly compared with other similar foreign markets. **Second**, we could see a significant difference in state policies of neighboring countries and of Kyrgyzstan on defining the place and role of the stock market in economic development. And ultimately, **the third** is that the comparative picture allows us to estimate correctly our successes and problem zones in order to choose proper directions for development.

The list of problem zones can be started by stating **the fact that there are no operations with state securities in the Kyrgyz stock market, yet in other countries it is a major part of trade volume.** Until now, State Exchequer Bills (SEB) circulation and its secondary operations are performed at interbank, organized and regulated by the Central Bank of the Kyrgyz Republic. In this regard, the pilot-project that has been launched since September to transfer trading from SEB to the trading space of the KSE gives some hopes for further market liberalization. We hope that as a result the state will be able to attract more financial means for internal investment towards state securities. This, in its turn, will create preconditions for transfer of short and mid-term state securities into long-term ones. The latter may become an alternative way to pay the foreign debt of the country by means of transferring foreign debt into internal debt. Such a scheme successfully functions in many developed countries.

**The Kyrgyz government did practically nothing in order to effectively use capital formation by local enterprises via the issuing and placing of corporate bonds,** while these securities have been circulating well in Kazakhstan, Russia, Ukraine and Azerbaijan. To increase interest in bonds as the effective means of real economy capitalization, the authorities must take principle measures. The stimulus for development can be given by reducing registration fees to the country's treasury from the amount of bonds' issuing, and by exempting investors from taxes in the initial stages. Tax exemption from the income of bonds-holding will interest many banks in receiving an effective instrument of crediting other banks and real sector enterprises by purchasing circulating bonds. Moreover, the population will be interested in purchasing bonds, if its income is tax-free, while the interest rate will be higher on bank deposits.

**The serious problem in the stock market development in Kyrgyzstan is the absence of municipal bonds issuing.** In the beginning of this year, the issue of municipal bonds was discussed in government. According to the former head of the State Agency on Financial Supervision and Reporting, the Bishkek Mayor office and other regions were interested in issuing their municipal bonds. But the real steps in this direction have not been taken yet. By issuing bonds, local governments could attract the money of portfolio

investors to solve issues of regional development, while a portfolio stock investor could receive one more attractive and liquid financial instrument to increase income.

The multiple efforts of the government in the past to expand the issuing and circulation of such financial instruments for investors as house and savings certificates, and municipal bonds, were not successful because they were limited and not grounded in reality. The government decrees unfortunately did not involve the elimination of legislation lags and were not accompanied by the creation of necessary steps for their implementation. Moreover, the current mutual dependence of the local and republic's budgets and their consolidation did not allow local authorities to issue the bonds without permission of the Ministry of Finance.

Today, one can say that even though there is a necessary infrastructure and legislation, the potential of the securities market as a component of the financial market has not been activated. The potential and the role of the stock market as one of the priorities for economic development in Kyrgyzstan is not completely realized, or is simply being suppressed in the process of state management.

Until today, commercial banks have not been involved in operations with corporate bonds. Such an absence of interest among commercial banks towards this issue sometimes depends on these banks and on economic policy that does not allow for increasing the financial space of Kyrgyzstan to the desirable scale.

In reality **the markets of the state and corporate securities operate in different spaces**, which does not make a harmonious development of the non-bank financial sector, and does not involve commercial banks in the corporate securities sector.

It is necessary to increase regulations for the issuing and corporate management of public companies and to decrease such requirements for non-public companies. The improvement of the system of state and non-state supervision to check the protection of the rights and interests of all players in the securities market must constitute the basis **for the completion of a new version of the Law of the Kyrgyz Republic on the "Securities Market"**.

The securities market in Kyrgyzstan must develop according to the best world practice with the purpose of its complete involvement in all spheres of investment, and establishing financial revenue to attract the money of the population to solve the urgent tasks of socio-economic development. **Kyrgyzstan must have a united stock market**, since such concentration of trading will allow for an improvement of investment attractiveness due to strengthening the potential of this institute, and more successful advancement of securities issuers of Kyrgyzstan in the international capital markets. The efforts of state authorities to regulate the securities market must concentrate on finding ways to integrate current trade managers.

To solve this issue, the system of the securities market must be led by the united Central Depository, which will play the role of stock-taking and accounting. The Central Depository must be integrated into the payment system of Kyrgyzstan to include accounting for all deals including state securities. Such a development process will require the proper measures not only of the government, but of the Central bank of the Kyrgyz Republic as well.

It is necessary to take a number of measures that provide for the expansion of institutional investors by including pension funds and investment **funds as well as safety companies**, creating an atmosphere where commercial banks start participating in the securities market.

It is obvious that we need a well thought-out strategy for securities market development. The purpose of such a strategy, in our view, is to turn the securities market into one of the main mechanisms for the realization of investment programs, and at the same time, **to create conditions to effectively attract private funds and money from private business for the expansion of the task to capitalize the economy, and to provide opportunities to realize the interests of different categories of investors.**

To achieve this purpose, the government must take additional measures to solve these three key tasks:

- to decrease investment risks by providing proper protection of rightful interests of investors;
- to form a portfolio investor by means of developing the forms of collective savings and provision of the principles of investment;
- to conduct reforms in legislation and state management, directed at the creation of conditions for regulating the financial market and its institutes.

**It is essential to think seriously about stimulating foreign capital and local funds attraction via securities.** With regard to this issue, it is important to provide for a long awaited tax exemption from bonds income and restoration of preferences to exempt from income tax investments to state securities. Such a measure will not impact the state budget much, but will allow for making the securities market more attractive and increasing investment revenue into the economy, that ultimately will increase tax-paying and preferential systems of issuing registration. The listing must become the national rating for successful companies in Kyrgyzstan.

It is important to quickly start the project "national blue markers." The idea is as follows. **A minimum of 5% of shares of the most strategic elements of our economy must circulate in the public stock market of the country.** I mean such companies as "Kyrgyztelecom", TNC "Dastan," "Manas International airport", etc. We must create a situation where any foreign and domestic investor has the opportunity to purchase shares of Kyrgyz strategic companies at the stock market. Today, we are in the situation where a number of portfolio and strategic investors are willing to buy our "blue markers," but they cannot make it since the offer rate is limited. This is because most such companies have not finalized the process of privatization, and brokers are not able to meet the demand of domestic and foreign investors towards their securities.

The topic of stock market development discussed here is indeed one of the most important ideas for our country. Until there is state policy where the leading principle is to provide the priority establishment and development of conditions for proper economic activities of portfolio and institutional investors (pension funds, safety companies, and individual investors), there will be no serious success in the development of the stock market. Therefore, **the management of Kyrgyzstan must express not only the political will, but readiness to cooperate with businesses and to have common action according to the agreed program.**

**Nurbek Elebaev, the managing director of the Financial-Consulting Company "Niet-Araket", chairman of the Council of Directors of the Kyrgyz Stock Exchange. Presentation at the round-table of the Institute for Public Policy "Perspectives of the financial market in Kyrgyzstan", September 14, 2007.**