THE PECULIARITIES OF CAPITAL MARKET IN THE REPUBLIC OF MOLDOVA AND MAIN DIRECTIONS OF ITS DEVELOPMENT BASED ON EUROPEAN UNION EXPERIENCE

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Abstract
The transformation of the economic structure of society, including changes in the field of financial relations, requires improving the research methods and developing of new methodological approaches that are adequate to market transformations. The below article presents a study of the national capital market through the modern integrated analysis method used to assess the evolution of the capital markets of the EU countries, both by national regulators and European and international institutions. The study aims at improving the existing methods of analyzing the financial market of the Republic Moldova and reveals the complex interconnection of ongoing institutional transformations, understanding the logic, main trends principles, basic elements of evolution and development prospects.
Keywords: *financial market, banking sector, capital market, methods of analysis.*

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1. Introduction

Theories of financial markets development are one of the most dynamic and promising areas of scientific knowledge, and their structural and institutional transformations in the context of financial globalization are advancing as one of the priority areas of economic science. A study of the institutional features of a market economy allows us to identify the relationship between institutional transformations and economic growth, to understand the logic, the main trend, principles and basic elements of economic development. The solution to this problem creates opportunities, based on institutional dynamics and its management, to forecast and regulate economic development. The capital market is allocated a special place in the economy and carries out important functions within the production system, acting as the field in which financial sources of economic growth are formed. Insufficient development of the capital market lowers its role as one of the most important sources of stable long-term financing of the market economy, subsequently increasing the risks for a pressured banking sector. Evidence increasingly suggests that while both banks and capital market are important for the financing of economic growth, non-bank financial intermediation provides a relatively more powerful contribution to innovation and productivity enhancing activities in modern sophisticated economies. Importantly, complementarities between banks and capital market increase as the economy develops [1]. Increased competition between intermediaries improves the efficiency and pricing of these intermediaries, resulting in a decrease in the cost of finance for borrowers and an increase in returns to savers. This ensures that potential borrowers with productive investment opportunities have access to the funding they need, and that the financial risk is matched to the risk preferences of a diverse set of investors [1].

The development of two main sectors of the financial market - banking and non-banking cannot be carried out and analyzed autonomously, as the development problems of one inevitably impose an additional burden on the other. That is why in recent years, the analysis of capital markets conducted by both European market regulators and international institutions includes a comprehensive study of the main indicators of the entire financial market, including the banking sector, non-bank financial intermediaries, market infrastructure, the features of its institutional development, analysis of demand for investment alternatives in the capital market, an offer of financial instruments , as well as other indicators needed for investigation the risks and development prospects of all participants in the financial market.

2. The aim of the research is based on the improved methods of studying financial markets, perfected in accordance with European practice that are used in assessing the evolution of capital markets of developed and developing countries of the European Union, both by national regulators and European and international institutions, to analyze dynamics of the national capital market and to identify the peculiarities of the evolution of capital market in the Republic of Moldova and main directions of its development.

3. Applied methods

The investigation presented in this article was carried out based on the following research methods: documentary method, analogy and grouping, quantitative and qualitative data method, graphical method, method of synthesis and comparative analysis method, complex financial analysis. Analysis is grounded on data released by the Centre for European Policy Studies (CEPS), European Bank for Reconstruction and Development (EBRD), European Capital Markets Institute (ECMI), *European Central Bank* (*ECB*), World Bank, Organization for Economic Co-operation and Development (OECD), National Bank of Moldova (NBM), National Commission for Financial Markets (NCFM) etc.

4. Results and discussions

During 2017-2018 the Republic of Moldova marked a robust economic expansion. Thus, in 2018 gross domestic product (GDP) registered 4% growth, largely determined by the increased of investment activity. The economic growth was also considerably influenced by the increase in the final household consumption by 3.8%, following the growth of the disposable income of the population. During 2018, the annual inflation rate accounted an average of 3.0%, decreasing from 7.3% in December 2017 to 0.9% in December 2018. But from the beginning 2019 the annual inflation rate is constantly growing [10].

In the Republic of Moldova, as in most developing European countries, *the banking sector* is the primary source of financing the economy. Namely the banking sector accumulates the main capital inflows into the financial sector (table 1).

Table 1

Analysis of the saving inflows evolution in financial market in the Republic of Moldova

	Annual deposit growth		Gross insurance premiums Government securities		Securities offering (allocated volume)				Net inflows of pension funds		Net inflows of investment funds	
					Equities							
	mln. MDL	mln. EUR	mln. MDL	mln. EUR	mln. MDL	mln. EUR	mln. MDL	mln. EUR	mln. MDL	mln. EUR	mln. MDL	mln. EUR
2012	39772,2	2486,3	1089,3	68,1	6987,3	436,8	1106,0	69,1	-	-	-	-
2013	51889,9	2887,6	1198,9	66,7	7692,1	428,1	950,1	52,9	-	-	-	-
2014	65462,5	3446,0	1203,6	63,4	8541,1	449,6	1249,6	65,8	-	-	-	-
2015	50201,5	2337,4	1228,5	57,2	9254,9	430,9	221,1	10,3	-	-	-	-
2016	54838,5	2625,2	1380,1	66,1	11250,4	538,6	442,0	21,2	-	-	-	-
2017	59896,9	2934,7	1441,9	70,6	10292,5	504,3	462,9	22,7	-	-	-	-
2018	63462,5	3251,0	1518,1	77,8	10046,2	514,6	585,9	30,0	-	-	-	-

Source: *developed by author based on https://www.cnpf.md/ro, https://www.bnm.md/*

License revocation from the largest commercial banks: Banca de Economii S.A., “Banca Socială” S.A. and “UNIBANK” S.A., had a significant negative impact on the volume of accumulated assets in the banking system of the Republic of Moldova, however, starting from 2016, the total assets of Moldovan banks begun to grow again (table 2).

Table 2

Assets of financial institutions in Republic of Moldova, 2012-2018 (MDL million)

	2012	2013	2014	2015	2016	2017	2018
Commercial banks	58304,4	76184,0	93877,3	68790,2	72830,4	79464,8	83076,6
Microfinance organizations	1892,9	2509,4	3318,9	3677,5	4705,2	5435,6	7819,3
Savings and credit associations	334,5	403,9	483,9	518,6	633,2	804,3	933,8
Insurance companies	2375,1	2425,2	2592,9	2934,5	3210,7	3292,2	3481,9
Investment funds	0	0	0	0	0	0	0
Non-government pension funds	0	0	0	0	0	0	0
Total	62906,9	81522,5	100273,0	75920,8	81379,5	88996,9	95311,6

Source: *developed by author based on https://www.cnpf.md/ro, https://www.bnm.md/*

The National Bank of Moldova measures to improve the regulatory and supervisory standards in the banking sector (BASEL III etc.), aimed at minimizing credit risk, market risk, operational risk of the financial market, initiated additional requirements for bank lending, which complicated the bank lending for both individuals and legal entities. This resulted in a significant increase of loan portfolios of microfinance organizations and savings and credit associations, which subsequently resulted in a significant increase of their assets (table 2). In general, in the absence of functioning non-government pension funds, investment funds and a relatively low share of insurance companies in the financial market of the Republic of Moldova, credit institutions dominate the market in terms of accumulated assets (figure 1), their share is significantly higher than even those EU countries, whose capital markets are still in their development stage.

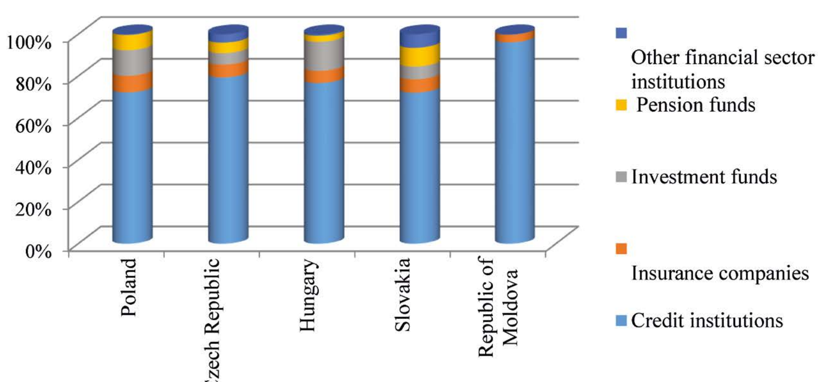

Figure 1. Structure of financial systems in selected European countries, at the end of 2017, by value of assets, %
Source: *developed by author based on* [7]

However, it should be noted that, despite all efforts made to develop the national banking system, to increase its stability and efficiency in accordance with modern international norms and standards and EU practice, the main indicators of the development of the banking sector of the Republic of Moldova still significantly lag behind those of the EU countries (table 3).

Table 3

Financial sector development levels, 2016-2018, %

	Assets/GDP			Loans/GDP			Deposits/ GDP			Stock market capitalization/ GDP			Stocks traded value/ GDP		
	2016	2017	2018	2016	2017	2018	2016	2017	2018	2016	2017	2018	2016	2017	2018
Poland	91,7	89,4	85,6	51,2	49,4	52,7	54,9	53,4	61,8	29,4	38,3	27,4	9,7	12,9	9,4
Czech Republic	124,9	138,7	137,3	63,4	62,9	63,1	76,4	62,9	65,3	12,6	14,1	10,9	5,1	4,1	7,8
Hungary	97,3	95,3	97,1	33,2	32,1	32,9	39,4	40,1	43,6	17,7	22,3	18,3	6,1	7,3	6,3
Euro area	288,3	271,9	292,5	90,4	88,8	87,0	84,6	84,8	na	63,9	77,8	54,8	na	na	na
Republic of Moldova	54	44,4	43,6	25,8	18,7	18,6	40,6	33,5	33,3	2,61	2,69	3,39	0,21	0,05	1,04

Source: *developed by author* based on [12, 13, 17]

The main factors in the Republic of Moldova that negatively impact the strengthening of the activities of commercial banks as the main source of financing the economy are:

- a still-present insufficient transparency of the membership of shareholders and final beneficiaries, shareholders' non-compliance with established requirements, violations in the process of acquiring and owning shares in several banks;

- the rate of non-performing loans is one of the highest in Europe. In 2018 the rate of non-performing loans in Moldova's banking system was 12.5% [10], while the same indicator in Hungary in 2018 amounted to 2.6% , in the Czech Republic - 3.2%, in Romania - 5.0%, in Poland - 6.83% [15]. The high rate of non-performing loans negatively affects assets quality and often results in increasing bank margins and risk premiums to recover lost profits;

- low supply of financial lending instruments with a long maturity, accompanied with the lack of an adequate proposal to attract long-term financial resources from the population and other stakeholders in the economy;

- high annual average of the weighted interest rate on new loans granted in national currency to businesses, which in 2018 constituted 9.31%. In Poland, the same indicator in 2018 amounted to 3.41% [11], in the Czech Republic - 3.5% [2], in Romania - 5.7% [8];

- high growth rates of consumer loans (1.3 times) amid a 1.5% decrease in the volume of loans issued to economic agents [10];

- aggressive competition in the lending segment and migration of borrowers' demand towards less regulated non-bank loans, the high risks of which, as a rule, are offset by high interest rates on loans. In 2012-2018 only, the volume of loans issued by microfinance organizations and savings and credit associations grew more than 4 times, their share in GDP at the end of 2018 reached 3.94% [12].

The *capital market* of the Republic of Moldova, as already noted, contributes insignificantly to attracting investment capital, the main indicators of its development are much lower than in the countries of the EU, as evidenced by the low level of its capitalization, whose share in GDP is 4 times lower than in Eastern Europe and 13 times lower than in the Eurozone (table 3, figure 2), and the share of exchange transactions in GDP is almost an order of magnitude lower than in European countries with developing economies (table 3).

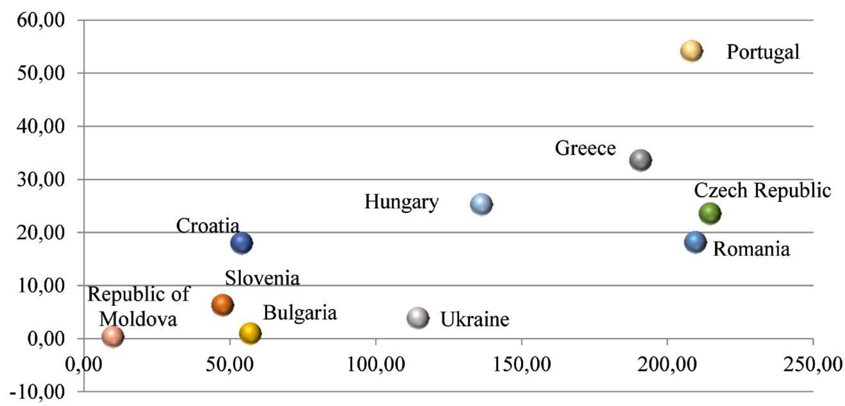

Figure 2. Interrelation between capitalization (x-axis) and GDP (y-axis), 2018, billion EUR

Source: *developed by author based on* [12, 13]

In the absence of corporate bonds, the market of debt financial instruments in the Republic of Moldova is represented only by government securities, its share in the GDP is about 4%, which is significantly lower than in other European countries (figure 3). There is no derivative market in the Republic of Moldova.

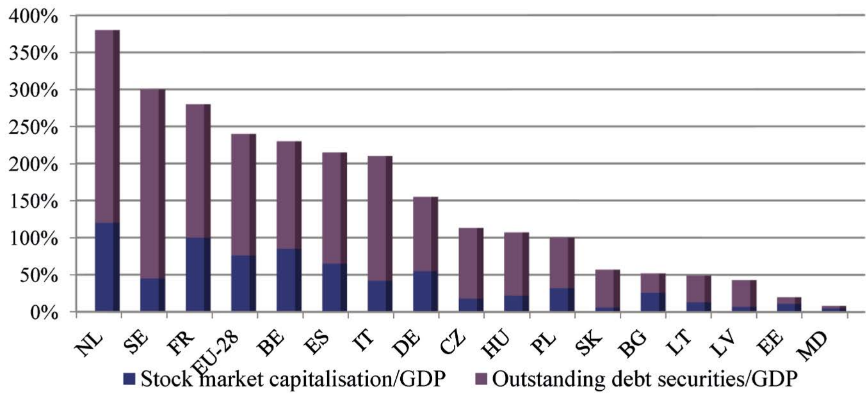

Figure 3. Stock market capitalization and outstanding debt securities, end-2017, % GDP

Source: *developed by author* based on [1, 10]

The capital market infrastructure in the Republic of Moldova is not sufficiently developed, the process of organizing trade and post-trading services requires software and technological improvement, many market participants aren't using modern digital and information technologies efficiently enough. A significant step in the development of the market was the creation of the Central Securities Depository in 2018, its business model being based on international standards and practice in settlement systems. A positive factor was also an increase in the transparency of the exchange market, which was promoted to a certain extent by Stock Exchange of Moldova.

The development of the industry is negatively impacted by a narrow range of potential investors forming *demand* in the capital market of the Republic of Moldova (there are no non-state pension funds, investment funds, etc.) and their low activity, as well as a low level of *supply* due to the lack of interest of potential issuers in attracting investment funds in the capital market.

All the above allows us to highlight the following main peculiarities of the national capital market that affect its development:

- insufficient development of financial infrastructure;
- a narrow range of financial instruments;
- low level of financial intermediation;
- low proportion of private investors;

- the dominant position of the banking sector as a source of real economy financing;

- insufficient transparency of the market and its participants;

- low level of population' financial literacy;

- lack of an integrated approach to the development of financial market sectors.

The study of the practice of the EU countries resulted in identifying the following recommended measures aimed at modernizing the capital market of the Republic of Moldova:

- Carrying out a comprehensive analysis of the evolution of the national capital market, for which, in addition to the main macroeconomic indicators, explore the current financial sector environment, and understanding how capital market fits into the overall context of the national financial sector and economy. It seems useful to carry out a comparative analysis with the main indicators of the development of the financial markets of developing EU countries, which will allow us to determine the development targets for the short and long term. For analysis, recommendations are to use the experience of the EU, where as part of the Action Plan, the Structural Reform Support Service (SRSS) is implemented, whose main task in the context of the EU Capital Market Union (CMU) plan is to develop the capital markets of developing EU countries and apply the analysis methodology used SRSS during evaluation of the capital markets to identify existing problems and market features at the initial stage of the program [3]. To identify obstacles and challenges it will be of good use to apply the experience of Estonia, where the corresponding list was compiled through a process of interviewing market players and stakeholders´ workshop results, the results of which were lists of gaps and barriers, ranked by their importance from high to medium.

- Encouraging the activity of investment funds, non-government pension funds, other institutional investors on the capital market. In the EU countries the share of non-bank financial intermediation has been growing, with implications for financial stability. The non-banks increase diversification of funding sources for the real economy, which is now less dependent on banks than it used to be before the financial crisis. Non-banks' holdings of euro area government bonds are more than twice as much as banks' holdings and amounted to 30% of the total outstanding

sovereign debt. The expansion of the non-bank financial sector has been accompanied by increased risk-taking. Non-banks' in current condition of low investment returns on relatively safe assets, actively diversify their investment portfolios using alternative funds, infrastructure, private equity and v*enture capital* funds, loans and real estate holdings thus stimulating *innovative development* of the national *economies* [4].

- *Making the market more attractive for retail investors*. The participation of retail investors in the capital market in Republic of Moldova is very low. In EU countries, the level and the form of savings of domestic households are of great importance for financial system and are carefully monitored and stimulated. In EU household financial assets since 2003 increased by 70.1% and amount 35000 bln. EUR. The share of currency and deposits comprises 30%, insurance and pensions schemes – 38%, mutual funds – 8%, debt securities – 2%, equity investment, with the exceptions of Estonia, Bulgaria and Slovakia where households invest 51.4%, 44.7%, and 0.9% of their assets into shares and equity, is very close to the EU-28 average of 24% [1]. In the Republic of Moldova, analysis of households financial assets is not carried out, therefore, before developing measures to stimulate households investments in the capital market, it is necessary to collect and study statistical information on their structure and dynamics. To attract retail investors to the capital market, will be resultative to apply the EU experience, where the guaranteed amount of compensation is regularly increased, which results that, even in countries with an undeveloped capital market, its size is more than 20,000 EUR, whereas in many countries it reaches 50,000 EUR, and to set in the Republic Moldova, the guaranteed amount of compensation paid from the Investor Compensation Fund in the amount of 100000 lei, with the prospect of its further increase. Other recommended action to incentivize investor interest may be the adoption of the Individual Savings Account (ISAs), to some degree this concept could be considered as part of the changes to the pension system development, what successfully was implemented in many EU developing countries [6];

- *Making the market more attractive for issuers. Promoting small and medium enterprises (SMEs) access to the market*. In the Republic of Moldova, as in EU countries, SMEs account for about 98% of the total number of companies. In the EU, special attention is paid to the development of SMEs, to the diversification and cheapening of their funding sources, including by providing access to public markets through the so-called 'SME Growth Markets', which is one of the key element of the CMU agenda, and which are the reason for adjusting the regulatory requirements regarding access and circulation of securities at Stock Exchanges, companies' reporting and other [14]. Hungary is a good case of successful state support for SME equity financing activities, this support has focused on: (1) *support for venture capital finance* (private equity). Government supports venture capital funds through different programmes and schemes that are focusing on different SME areas, including pre-seed, seed, start-up, later stage, introduction of new digital technologies, etc., as well as financing specific areas such as manufacturing, industry and cross-border trade. Capital funds are provided mainly by means of co-investment; (2) *support carried through the Budapest Stock Exchange*, which has for 2016-2020 the Strategy of encouraging SME financing using the capital markets through the National Stock Exchange Development Fund, in order to counteract the slowdown in financing through banks [3].

- *Expanding the range of proposed investment alternatives and to increase market liquidity.* The creation of *supply* of securities on the capital market and an increase in its liquidity could be facilitated by a "people's IPO", whose mechanism implies a public privatization of state enterprises with the offer of shares to retail investors. This mechanism was widely used during the period of privatization in European transitive countries. "People's IPOs" were conducted in different economic conditions in many other countries, including the UK, Germany, France, etc. Its use was particularly successful in Poland, where were privatized more than 210 large companies and several hundred small ones, which greatly contributed to the creation in Poland of the most developed capital market in Eastern and Central Europe. The Poland still holds a leading role in Central Europe due to the efforts of the local government, which set clear goals for national capital market participants, including Warsaw Stock Exchange and has been active in introducing bonds on the exchange and has strongly advocated pension fund investments in companies listed on the Warsaw Stock Exchange [3]. Applying the Czech Republic's experience, where to make it more attractive for banks to hold bonds as a greater percentage of their assets the national regulator allowed using of specific bonds as eligible collateral for bank

/ Czech National Bank refinancing transactions and using short-term government securities as collateral for member operations on the Stock Exchange, could help the development of a fixed income market in the Republic of Moldova [6].

- *Increasing the level of financial literacy of the population.* Quite a few projects are being currently implemented in the Republic of Moldova, which are aimed at increasing the population' financial literacy. These projects are supported by different international organizations, NBM, NCFM, Ministry of Finance, commercial banks and other financial institutions. Most of them are aimed at improving youth education, some of them - to *enhance financial knowledge of representatives of small business, remitters etc. However, despite several encouraging results, it will be useful to develop in the Republic of Moldova a National Strategy for financial education, with a target audience that covers "the general public" or "consumers in general", considering the international experience, including those of the EU countries.*

5. Conclusions

Capital market can be regarded as model of a "complex system", consisting of a multifaceted set of institutions. At the same time, the capital market is one of the most important components of the financial market, therefore, to assess its role in the economy and development prospects, a clear understanding of the specifics of its evolution in the context of the dynamics of the entire financial sector is necessary: its savings destination flows, financial sector asset composition, shareholders' equity of the market participants, interest rate environment etc. This is especially relevant for the Republic of Moldova, which operates on a universal banking concept in condition when banking sector and capital market are significantly intertwined. One of the main peculiarities of financial system in the Republic of Moldova is that it is highly bank-centric, which is proved by the volumes and share of assets and capital flows redistributed by banks in the form of loans and deposits in GDP. At the same time, the level of development of the national banking sector still lags the EU countries. Under the current conditions, the development of the national capital market and its role as a source of financing for economic growth should increase, but such peculiarities as: insufficient development of financial infrastructure, a narrow range of financial instruments, low level of financial intermediation, low share of retail investors, insufficient transparency market, low level of population' financial literacy, lack of an integrated approach to the development of financial market sectors, etc. impede the market's implementation of its functions. A study of the practice of the EU countries allowed to formulate the following recommended areas for modernization of the capital market of the Republic of Moldova: carrying out a comprehensive analysis of the evolution of the national capital market, encouraging the activity of investment funds, non-government pension funds, other institutional investors on the capital market, making the market more attractive for retail investors, making the market more attractive for issuers, promoting SME access to the market, expand the range of investment options offered, increasing market liquidity, increasing the level of financial literacy of the population.

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