

# INTEGRATION OF FINANCIAL MARKETS: PROBLEMS AND OPPORTUNITIES

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## Abstract

*At the present stage of globalization and increased competition it is necessary to solve problems of the integration of financial markets. The goal of the paper consists in investigation of the mechanism of integration of national financial market to the global market and suggests significant challenges in the current environment and the scheme of integrated financial market.*

**Keyword:** *financial market, stock exchange, globalization, CIS, EurAsEC, security markets, the integration of financial markets.*

## 1. INTRODUCTION

The global financial market is undergoing major changes. This is associated with the development of new markets, introduction of new instruments, consolidation, and consolidation of stock exchanges, changes in business principles. One of the main trends of financial institutions development lies in their internationalization.

The reasons for these processes are seen in the sharply increased globalization and consolidation of the financial business in context of increased competition. This article seeks to throw light on this relationship by first discussing the major problems that prevent the integration of financial markets, including the scheme of integrated financial market, as well as suggestions for their solution.

In spite of some economic and political differences, episodically arising between post-soviets countries, integration processes are gaining momentum. It has created Anticrisis Fund of the Eurasian Economic Community. Authorities and economic counterparts of the CIS countries are trying to work out common approaches to overcome the crisis. From this perspective, the crisis has given additional impetus to integration processes. No wonder that in 2009, the official agreement was signed, the Common Customs Tariff and Customs Code. Also, in April 2000 in Moscow, it was established that the International Association of CIS Exchanges (IAE CIS) in order to coordinate efforts to the development of organized financial markets in accordance with international standards.

It is noted that certain infrastructure and legal basis of integration processes in CIS/EurAsEC has already been created. At the same time, the degree of integration of financial and currency markets do not meet the level of interaction between economies, capital flows and the population of the CIS countries. Particular attention is paid to the development of stock markets priorities, to the interaction of CIS Exchanges and to the prospects of the national currencies trading.

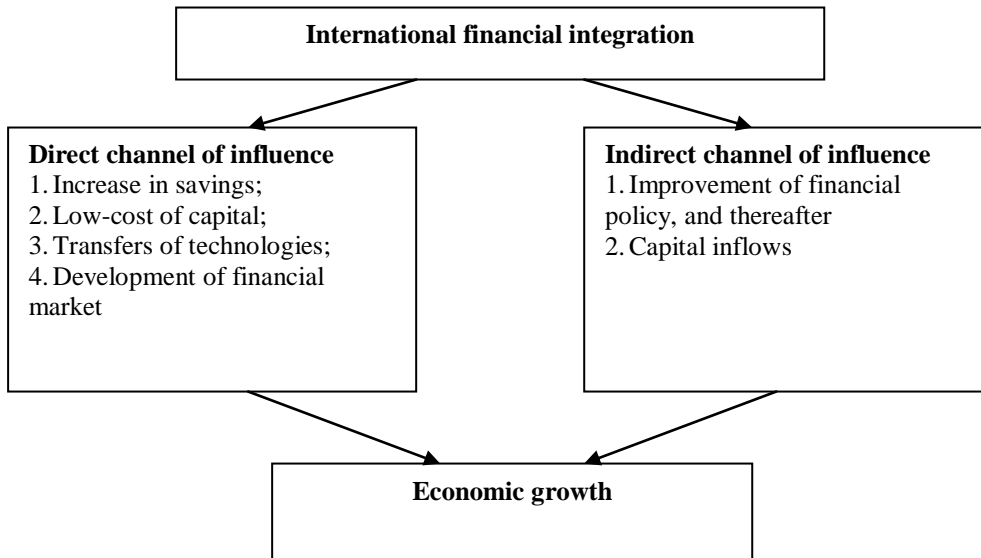
## 2. OPPORTUNITIES OF INTEGRATION IN FINANCIAL MARKETS OF RUSSIA AND KAZAKHSTAN

The intensity of the economic relations between Russia and Kazakhstan opens up possibilities for closer cooperation between national security markets. So, it is important to improve, harmonize and unify the legal conditions of issuance and circulation of securities, the activity of professional participants of the securities markets.

The purpose of the integration of financial markets of the CIS countries:

- growth of the investment potential of the participating countries, increasing liquidity and reducing the risks of stock markets;
- diversification of instruments, reducing the cost of capital;
- the development of transnational ownership.

The integration of financial markets of the CIS countries can be realized through direct channel and indirect channel as shown in Figure 1.



**Fig.1** Channels of influence of financial integration on economic growth

The financial crisis in 2008 significantly affected the dynamics and structure of the Russian and Kazakhstani security markets. Significant outflow of capital, aggravated macroeconomic problems (inflation, growth of industry, a large amount of external borrowing by the private sector, etc.) have led to a protracted decline in the late 2008 stock markets in Russia and Kazakhstan.

Formation of the security markets of Russia and Kazakhstan happened almost simultaneously with the process of market economy formation. Fundamentals of the security markets were laid in the 90s, when under the influence of denationalization and privatization processes were set up joint-stock companies, brokerage firms, stock exchanges.

Almost simultaneously in both states has been developed legislation regulating the security markets, and created the appropriate infrastructure, including stock exchanges, depositories and clearing organizations. Under the influence of various factors, including institutional building, introduction of legislation, carrying out social and economic reforms, the markets of these countries, subsequently, in addition common features, acquired its own characteristics and peculiarities.

Also, decline in the proportion of nonresidents' transactions, the share of private investors, decreased the activity of other categories of investors, including investment funds. Stock markets in Russia and Kazakhstan are leaders in the region, well ahead of absolute figures for other CIS states. In Belarus there are functioning government security markets but there is no substantial progress in the development of the corporate security markets. In Central Asia, organized security markets are underdeveloped, although in recent years demonstrate a positive trend.

Now the level of development of security markets in Russia and Kazakhstan are still characterized by weak investor base. Many legal issues of the market are at discussion stage or elaboration, and therefore security markets participants are less protected than in developed markets. There is no developed derivatives market allowing risks insuring.

In Kazakhstan, the most active agents of the security markets, as well as in Russia, are the banks. They act as issuers of their own stocks, bonds, bills, depositary certificates and other securities, as well as investors, buying securities and carrying with them brokerage operations. Companies working in the retail sector and in the sphere of collective investments do not hide that they are focused on attraction in Kazakhstan free financial resources and further invest this money abroad. This approach does not carry the benefits of Kazakh economy, but creates a competitive environment, increasing the efficiency of the market.

Financial institutions of the CIS countries are increasing their presence in the markets of each other. The most active in foreign expansion in the CIS banks in Russia and Kazakhstan. The largest of them Russian - VTB, Sberbank and Alfa-Bank and Kazakhstan - BTA Bank, Kazkommertsbank and Halyk Bank. Unlike banks and investment companies, mutual presence of the stock market infrastructure institutions is still limited.

Kazakhstan organizations are interested in the Russian financial market, primarily as a mechanism to attract capital. Russian business is considering Kazakhstan's capital market more as a "bridge", which provides access to natural resources of the RK. Accordingly, if a significant part of Kazakhstan organizations interested in the withdrawal of its securities on the Russian market, Russian companies are not willing to provide.

For Kazakhstan's securities market's professional participants' priority sectors for investment are extraction of natural resources, financial institutions, energy and telecommunications. Russian market participants limit the scope of its interest in Kazakhstan, so they demonstrate interest to natural resource extraction and financial institutions.

Having said that, securities of Russian issuers are purchased not on Russian stock exchanges but on international exchanges in the form of GDR and ADR. In current situation Kazakh issuers are not interested in the withdrawal of its securities on the Russian market - most of them listed on the LSE. Immediate circulation of foreign securities on the Russian security markets is severely restricted by high level of requirements established by the law.

Pension funds, which before the crisis were the largest group of domestic investors, by virtue of the rules of investing have reduced their activity in the domestic security markets. Money of private pension funds or asset of executive companies can be considered as a potential source of Russian portfolio investment in securities of Kazakhstan organizations. However, to realize the opportunities provided by Russian law, it is necessary to form the corresponding mutual funds, including securities of Kazakhstani issuers. This is unlikely to happen soon, while the capital market of the RK is recovering from the effects of the global financial crisis or until the securities of the RK issuers will not be withdrawn on the Russian stock market capable of providing them with adequate liquidity.

Accumulative pension funds (APF) are active investors in the Kazakh financial market and foreign countries. However, in the near future we should not expect substantial investments to foreign countries, including in Russian securities. In the current period investing strategy of pension assets was changed in favor of increasing the share of government securities of the RK while simultaneously reducing investment in securities of foreign issuers.

From the three stock exchanges in the context of investment to the economy of another country Russian Stock Exchange (RTS) is most active. Today it only has a subsidiary in Kazakhstan (JSC "Commodity Exchange" ETS ).

Russian security markets are showing interest in cooperation with Kazakh partners and would like to expand the list of tradable instruments on their facilities due to foreign securities.

Although a significant burden to facilitate interaction between members of an organized trade of both countries is entrusted to the stock exchanges, an important role in this process is given to the legislature. For example, both the stock exchanges and capital market professionals need to be an acceptable mechanism of nominal holding for foreign investors, the relevant legislation of both countries, as well as in the developed clearing obligations, including centralized.

An important element of the technology integration process should be recognized development and application of common technologies of electronic documents that would standardize and accelerate information exchange both between stock exchanges and between trading participants.

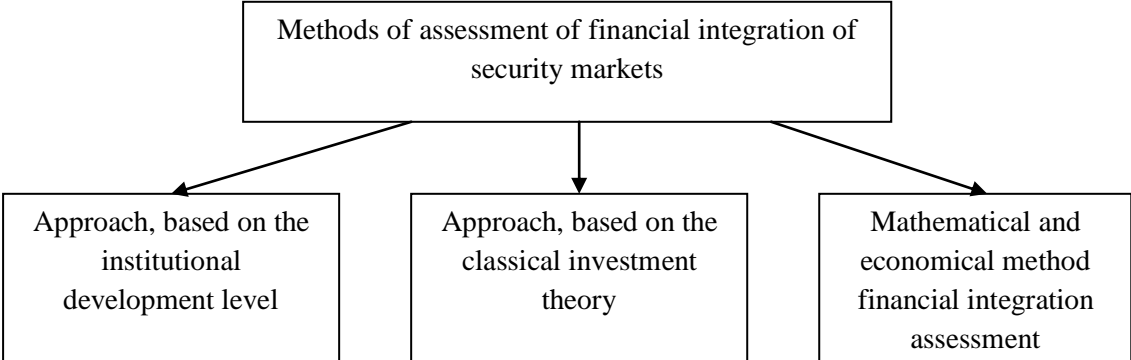
With this project, in fact, project for the Eurasian exchanges of agricultural products, raw materials and food being prepared at the initiative of the EurAsEC Integration Committee with the participation of Russian and Kazakh partners competes. As a base for the project is selected OJSC "Belarusian Universal Commodity Exchange".

Over the past 10 years, both countries had done a lot of organizational work but there is no efficiency integration, and a joint exchange area.

### 3. PROBLEMS OF INTEGRATION OF FINANCIAL MARKET IN THE CIS COUNTRIES

In search for an answer to a question about the causes of low financial integration, which occurs on the background of trade cooperation, inter-connected infrastructure and close historical and cultural relations between the two countries can address to experience of Asian region. It is known, Asian countries are closely linked in trade but the stock markets at the same time hardly interact. Bank of International Cooperation has analyzed the integration of stock markets in Asia. In the study, four hypotheses were put forward regarding the factors that determine the level of interaction: 1) the geographical focus of investments; 2) the impact of trade; 3) the influence of profitability; 4) the impact of liquidity. The results showed that the lack of integration in the Asian markets is largely influenced by low liquidity and lack of development of financial systems in the region, causing investors to allocate funds to other financial centers.

Assessment of the prospects of integration of financial markets of Russia and the RK, seems necessary stage of coordinated economic development of both countries, as well as other countries in the Eurasian Economic Community, which under present conditions is impossible to be imagined without an effective financial policy and strengthen its relationship with the real sector of the economy. (Figure 2)

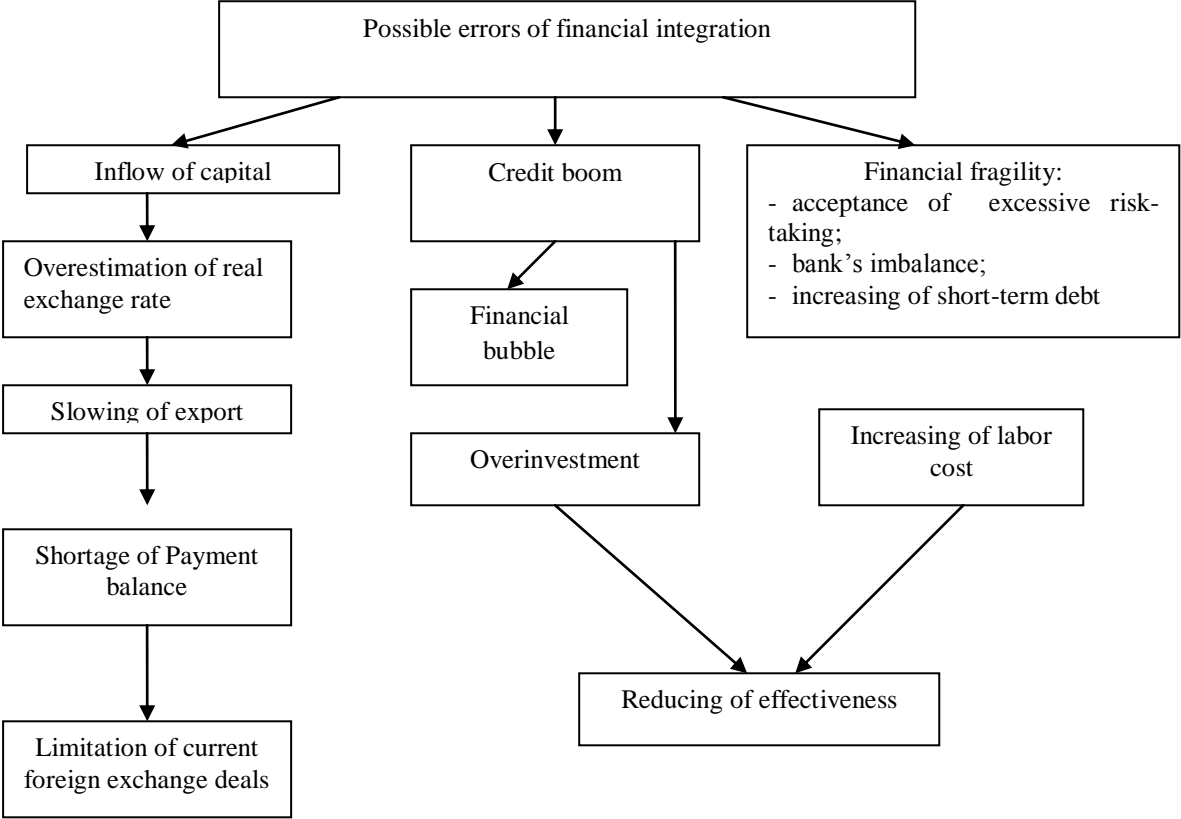


**Fig.2** Methods of assessment of financial integration of security markets

This kind of assessment requires in particular a comparative analysis of the legislative framework and regulatory systems of financial markets in both countries to identify the crucial

differences between them, the elaboration of common approaches to solve common problems. Particular attention should be paid to the development of a consolidated infrastructure of financial markets, including interrelated trading, clearing and settlement systems of securities that generate technological opportunities for the free movement of capital.

Therefore, CIS countries should avoid mistakes of integration of financial markets which is clearly demonstrated by Figure 3.



**Fig.3** Possible errors of financial liberalization

The CIS countries are gradually moving towards financial liberalization and integration into the global system. However, this process is not unidirectional. Temporarily tightening of financial market regulation in order to suspend the withdrawal of capital, stock indices and national currencies stabilization was observed during the crisis. Therefore, the national financial systems of the CIS countries do not meet the prerequisites for a considerable external financial liberalization.

Banking systems of the CIS countries, that are the basis of the financial market, do not fully fulfill the function of the transformation of savings into investments. Although the pre-crisis financial systems of the CIS countries were gaining momentum but could not become a full source of funding for the development of the real economy.

In the majority of a country region's banking sector is the one of the most advanced segments of the financial system because security markets are characterized by low liquidity. The exception just the markets in Russia and Kazakhstan, before the crisis there was a significant growth of the participants' activity.

Foreign institutional investors are reluctant to work in the security markets of the CIS countries, believing that the infrastructure in emerging markets is built mainly by short-term speculative and noninvestment operations.

Technological capabilities and the competition pressure make the stock exchanges go to international financial markets. Compared with Russia, Kazakhstan's security markets characterized by low secondary market liquidity of financial instruments, related mainly to the lack of such tools, underdeveloped market of derivative securities and the limited development of the stock market. Many Kazakh issuers have not yet willing to disclose financial information and prevent the executive company of external shareholders. These problems are inherent in the security markets of CIS countries, which together with the legislative barriers have a negative impact on integration processes in the region.

As noted previously, that integration of currency markets does not correspond to the degree of integration of economies, capital flows and the population of the CIS countries. Today in national currencies of CIS countries the number of calculations is not to amount to much and use dollar and euro as world currency leads to increased costs of foreign trade activities, the deterioration of the mutual settlement of financial transactions, forcing economic entities of the CIS countries to keep additional amount in foreign currencies that connected with currency risk.

During the crisis, the need to abandon this practice has become even more vivid. Connectivity and the similarity of the economies of the CIS countries led to synchronization of economic cycles and comparability of impact of external shocks to their financial systems. So, fluctuations in the national currencies of CIS countries to each other were significantly less than their fluctuations against the U.S. dollar or the euro.

From a comparative analysis of the regulatory framework for counter movement of capital of the Russian Federation (RF) and the Republic of Kazakhstan (RK) in the form of securities market instruments implies that there are no insurmountable legal obstacles. Moreover, certain legal prerequisites for such a movement have already been created. However, the financial instability and the lack of embeddedness of capital markets of Russia and the RK into the global financial market in the form of a joint international financial center (IFC), they remain unclaimed.

So, exactly in these countries of EurAsEC - Russia and Kazakhstan - there are no explicit political and other obstacles to the integration of capital markets.

#### **4. THE CONCLUSIONS**

The processes of globalization and modern trends in the internationalization of the financial infrastructure have a significant influence on the activity of financial institutions in the CIS countries. The existence of modern electronic stock exchanges facilities and the use of Internet technology greatly simplify the process of integration. Creating of alliances increases the liquidity of security markets, and provides cost savings. The experience of the interaction of organized markets of CIS countries shows that their effective development requires serious improvement trade payment infrastructure.

However, some effort on the stock exchanges of technological standardization and harmonization of trade settlement is not enough consistent rules for admission of non-resident participants in the ethnic markets are needed. The successful implementation of integration projects is impossible without the active participation of the central national banks and other financial market regulators of EurAsEC/CIS countries, and without prompt taking appropriate legal standards. Only with the support of all stakeholders – stock exchanges, participants, regulators - creation of a single financial space will lead to desired results; will facilitate cross-border payments in national currencies, the formation of market-based rates, the development of securities markets and the growth of investment activity in the CIS countries.

A prerequisite for such a coordinated development is the gradual mutual penetration of infrastructures and the financial markets of Russia and Kazakhstan. Increased interaction between the two capital markets is especially important in the context of the prospects of the Common Economic Space (CES) as a next step in the deepening of the Customs Union. This is due to the fact that the interaction between capital markets may become one of the bases of regional economic integration in general and the formation of cross-border financial infrastructure. The integration of financial markets will

contribute to more effective use of excess savings in one case and to attract additional investment - in others. By overcoming the boundaries of national markets for issuers of financial instruments costs of attracting investments would be reduced for investors - will increase opportunities for diversification of investment portfolios and the risks of investing will be reduced. In addition, funds attracted through integrated capital markets of Russia and Kazakhstan and then other members of the SES can be used to finance the development of cross-border infrastructure projects in various sectors of the economy.

The main directions of development of financial markets - the participants must become:

- ensure mutual tolerance of professional market participants, including the mutual recognition of national regulators of security markets – CIS licenses to engage in professional and other activities to be traded on exchanges of countries - CIS, and the introduction of remote access of investors to trade on the stock exchanges of those countries;
- ensure the admission of securities to trading on the stock exchanges of states - participants of CIS;
- standardization of clearing technology, risk management, product line;
- creation of integrated depository space (removal of obstacles in national laws and restrictions on opening deposit accounts of foreign nominee);
- recognition of the concept of a foreign nominee in the depository account property rights to foreign securities;
- creation of an integrated information environment of financial markets; harmonization of national legislation.

The results of these processes could be the formation of an integrated trading space in the security markets. Important tasks of the competent authorities on regulation of financial markets of the CIS countries - are:

- orientation of the regulatory activities in the financial market on the recommendations for regulation, control and supervision of the financial market, produced by international associations (G20, the Financial Stability Board, etc.);
- join the national regulators of the securities market to the Multilateral Memorandum of the International Organization of Securities Commissions;
- continued implementation of measures aimed at creating international (regional) financial centers in the states - members of CIS, including in Moscow.

On this basis, organizes its work and the Council of heads of government on regulation of the security markets of the CIS countries, whose main task is to develop a harmonized approach and coordination of joint activities on the formation and development of an effective system of the CIS countries.

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