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CWRD Discussion Paper No. 1

# CAPITAL MARKETS IN CENTRAL ASIA

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August 2008

## Abstract

*The views expressed in this paper are those of the author and do not necessarily reflect the views or policies of the Asian Development Bank. Over the last 15 years, most countries in the Central Asian region have made progress with capital market development. The emphasis of this paper is on achievements made so far. The focus is on Azerbaijan, Kazakhstan, the Kyrgyz Republic and Uzbekistan. The paper provides an overview over the size of equity and bond markets in absolute terms and relative to other parts of their financial systems and other markets in Asia. It presents disaggregated data to assess the role of capital markets in resource mobilization and finds that, in 2007, the amount of capital raised through securities issues was equivalent to four to five percent of gross domestic product (GDP) in Kazakhstan, around two percent of GDP in the Kyrgyz Republic, and one percent of GDP in Uzbekistan. The paper then discusses factors that have facilitated or constrained capital market development, including the legal and regulatory framework, deregulation, market infrastructure, internationalization, institutional investors, and privatization. Finally, it proposes policy recommendation for developing capital markets in small economies.*

Asian Development Bank

[1] The author would like to thank the regulatory bodies and stock exchanges in the region for their cooperation during fact-finding. An early version of this paper was presented at the international conference on Institution Building and Economic Development in Central Asia in June 2008 in Almaty.

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# I. INTRODUCTION

1. The potential benefits of capital markets have been well established through theoretical and empirical research.[2] Capital markets tend to accelerate economic growth by increasing financial savings and the quantity and quality of investment. Capital markets increase financial savings by providing individuals with additional financial instruments that may better meet their liquidity needs and risk preferences. Capital markets allow growing companies to diversify their sources of investment finance. With access to capital markets, such companies can go beyond financing investments by retained profits or bank loans. This allows them to increase their overall investment and raise capital at lower cost.

2. Over the past two decades, many developing countries worldwide have taken decisive steps to develop their domestic markets for equity (share) capital. More recently, particularly as a response to the Asian financial crisis, efforts have been made to develop domestic bond markets. One additional benefit of capital markets has been stressed in this context: Companies in countries with domestic capital markets, and particular bond markets, are less dependent on bank loans. This reduces the risks associated with a credit crunch. With developed bond markets, companies can still have access to finance even in case of a banking crisis. Domestic bond markets provide an economy with a “spare tire”.[3]

3. This paper is a first effort to outline what has been achieved in Central Asia in terms of capital market development. Despite differences, the countries in Central Asia share one major feature: Financial sector reforms started only about 15 years ago after the dissolution of the Former Soviet Union and the initiation of large scale market reforms. First steps towards equity market development were taken in conjunction with mass privatization programs in the mid-1990s. Government bond markets were launched afterwards, since budget deficits were initially mainly funded by central banks and external development partners. Corporate bond market development was initiated at an even later stage. However, the emphasis of this paper is not on the history of capital market reforms in Central Asia but on achievements that have been made. Apart from stock taking, the main objective of the paper is to facilitate policy dialogue with regulators and policy makers. The paper focuses on Kazakhstan, the Kyrgyz Republic, and Uzbekistan. Information about other Asian countries is included for benchmarking purposes.

4. The paper is structured as follows: Part II provides an overview over the size of equity and bond markets in Central Asia in absolute terms and relative to other parts of their financial systems and other markets in Asia. Part III presents disaggregated data to answers a question that is central from a development point of view: Which role do capital markets play in resource mobilization? Information on market capitalization is often misleading in this respect. Part IV discusses factors that are broadly believed to facilitate capital market development. The aim is to explain the current level of capital market development and prepare the ground for policy recommendation. Part V concludes with policy recommendation for developing capital markets in small economies.

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[2] See, for instance, Ajit Singh. 1997. *Financial Liberalization, Stock Markets, and Economic Development*. The Economic Journal, Vol. 107, pp. 771-782.

[3] Alan Greenspan. 1999. Do Efficient Financial Markets Mitigate Financial Crises? (Remarks before the 1999 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Georgia).

## II. MARKET SIZE

5. The size of capital markets in a particular country depends, among others, on the size of the country and its stage of development.[4] Most countries in Central Asia are small or very small by population and gross domestic product (GDP). This is one reason why their capital markets are comparatively small. At end-2006, total capitalization of corporate equity and bond markets (bonds in circulation) in developing countries in Asia, for instance, amounted to about $4.5 trillion equivalent.[5] The countries in Central Asia and the Caucasus accounted for only about one percent of this total. This was lower than their share in Emerging Asia's population and GDP, which was two and three percent, respectively. Table 1 provides a breakdown for selected countries. It also includes data for market capitalization as percent of GDP. This indicator gives an initial impression of the importance of domestic capital markets for each individual country.

**Table 1: Size of Countries and Capital Markets (2006)**

| | GDP | Population | GDP per Capita | Equity Market Capitalization | | Corporate Bond in Circulation | |
|---|---|---|---|---|---|---|---|
| | US$ Billion | Million | US$ Billion | US$ Billion | %GDP | US$ Billion | %GDP |
| Central and West Asia | | | | | | | |
| Kazakhstan | 77.2 | 15.3 | 5,050 | 56.6 | 70.4 | 12.2 | 15.0 |
| Azerbaijan | 20.1 | 8.5 | 2,360 | 0.4 | 1.9 | 0.0 | 0.2 |
| Uzbekistan | 17.2 | 26.5 | 650 | 1.6 | 10.2 | 0.0 | 0.2 |
| Georgia | 7.6 | 4.4 | 1,730 | 0.7 | 8.9 | 0.0 | 0.0 |
| Armenia | 6.4 | 8.5 | 750 | 0.1 | 0.8 | 0.0 | 0.0 |
| Kyrgyz Republic | 2.7 | 5.2 | 550 | 0.1 | 3.1 | 0.0 | 0.1 |
| Other Asian Countries | | | | | | | |
| China | 2,668.1 | 1,311.8 | 2,030 | 2,426.3 | 90.9 | 397.9 | 14.9 |
| India | 906.3 | 1,109.8 | 820 | 818.9 | 90.4 | 20.8 | 2.3 |
| Indonesia | 364.5 | 223.0 | 1,630 | 138.9 | 38.1 | 6.8 | 1.9 |
| Thailand | 206.2 | 64.7 | 3,190 | 139.6 | 67.7 | 36.9 | 17.9 |
| Malaysia | 148.9 | 25.8 | 5,770 | 235.4 | 158.0 | 60.9 | 40.9 |
| Pakistan | 128.8 | 159.0 | 810 | 45.5 | 35.3 | 0.5 | 0.4 |
| Philippines | 116.9 | 84.6 | 1,380 | 68.4 | 58.5 | 1.5 | 1.3 |
| Vietnam | 60.9 | 84.1 | 720 | 9.1 | 15.0 | 0.4 | 0.7 |

Source: International Monetary Fund, World Bank, national securities market regulators.

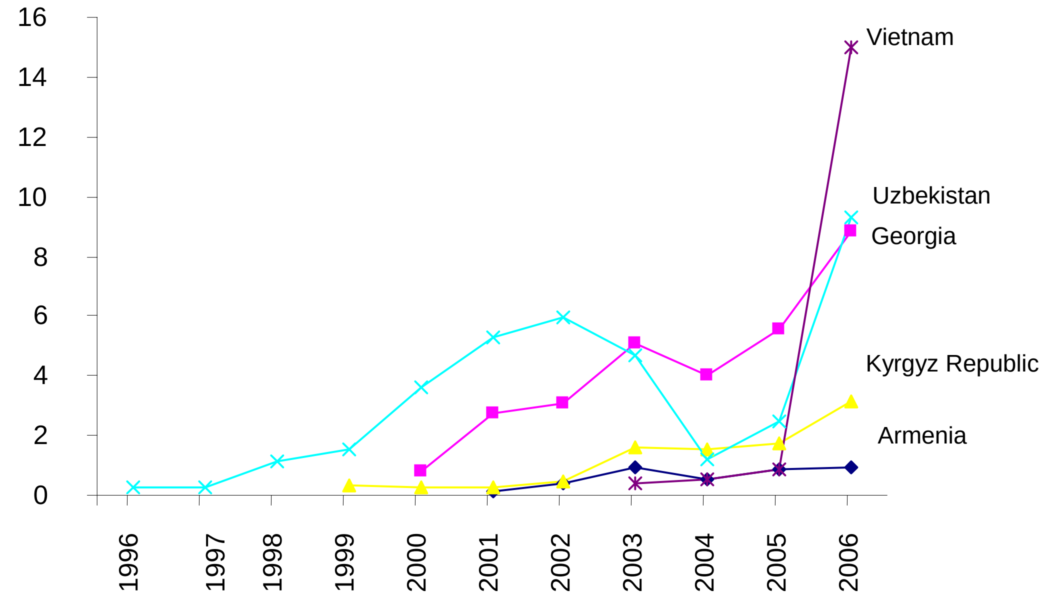
6. Low income implies limited demand for financial services. This is why low per capita GDP is usually associated with less developed financial markets. Kazakhstan has the highest GDP in Central Asia, both in absolute terms and per capita. It is, therefore, not surprising that Kazakhstan also has the most developed equity and bond markets. Kazakhstan's market capitalization as percent of GDP is already higher then that of some larger countries in Asia with lower GDP per capita. The bigger surprise is the weak development of capital markets in Azerbaijan, which comes second in the wider Central Asian region in terms of GDP per capita.[6] The capital markets in the other Central Asian countries are still very small, even measured against their comparatively small GDP. This is, of cause, at least partly due to the fact that market development started only about a decade ago. Chart 1 and 2 are based on the relatively short time series for equity market development in the region. Time series for bonds markets would be even shorter.

[4] Bank for International Settlement. 2006. *Developing Corporate Bond Markets in Asia.* Basel (BIS Papers No 26).

[5] Not including Japan, South Korea, Hong Kong, Singapore, Australia, and New Zealand.

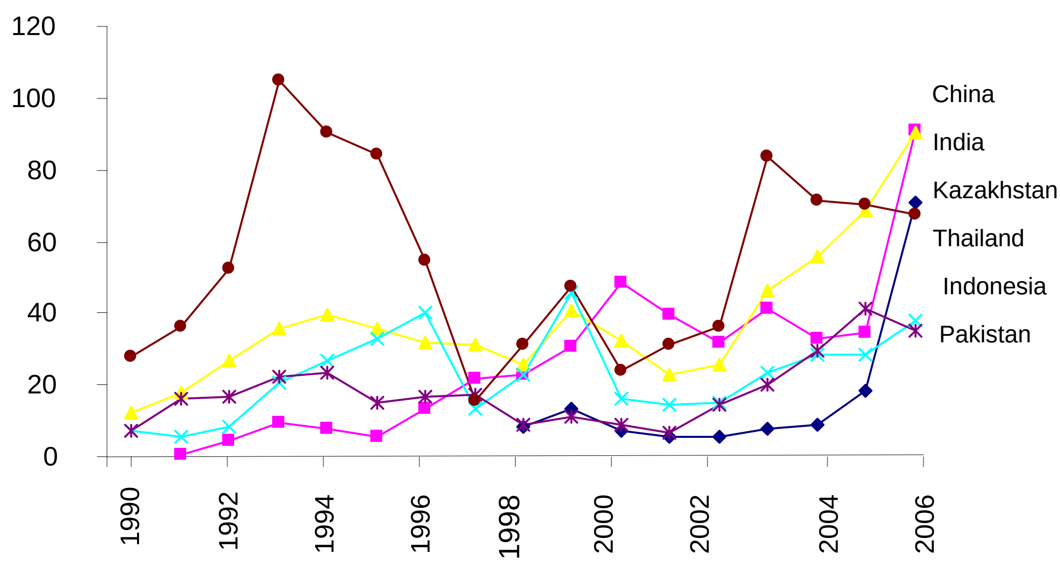
[6] Azerbaijan's gross domestic product per capita was below $1000 until 2004. The recent substantial increase should have a positive impact on financial sector development in the medium-term.

**Chart 1: Equity Market Capitalization in Selected Asian Countries (1996-2006, % GDP)**




Sources: Bank for International Settlement, Federation of Euro-Asian Stock Exchanges, World Bank.

**Chart 2: Equity Market Capitalization in Selected Asian Countries (1990-2006, % GDP)**

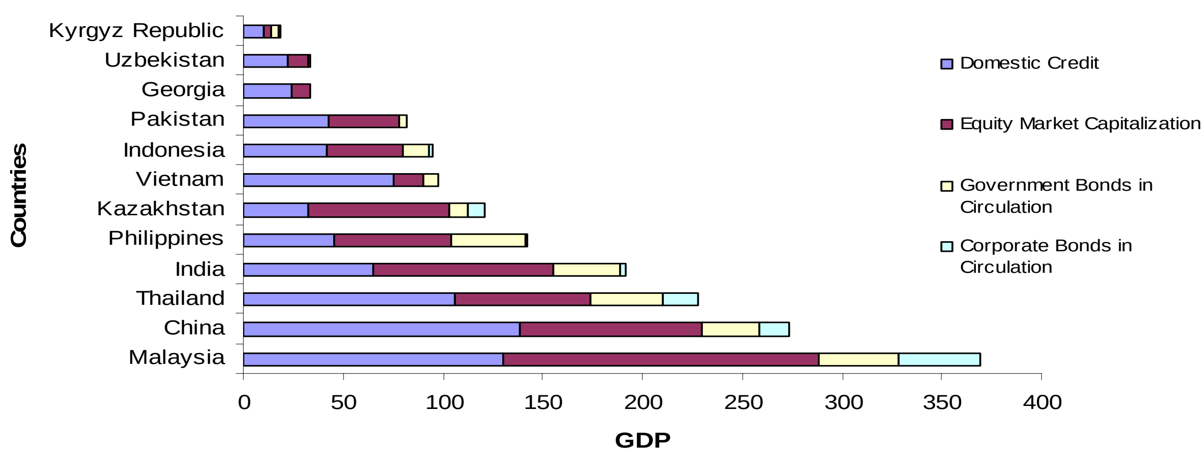



Sources: Bank for International Settlement, Federation of Euro-Asian Stock Exchanges, World Bank.

7. However, some countries were able to make substantial progress with market development over a comparatively short period, others were not. The sometimes spectacular increases in market capitalization in countries like People's Republic of China, Vietnam, or India, for instance, were the result of economic growth that led to significant increases in share prices and motivated more companies to seek capital through equity issues. Deliberate government policies that involved the listing of state-owned enterprises (SOEs) at stock exchanges also played a role. With the right policy mix and supporting economic framework conditions, capital markets can apparently be developed relatively quickly.

8. Apart from the size of the economy and the level of market development, the size of capital markets is also affected by the composition of financial alternatives on either the issuer or the investor side.[7] Chart 3 presents data for equity and bond market capitalization, government bonds in circulation, and domestic credit, all as a percentage of GDP. As such, it covers all main sources of local currency funding provided by the financial sector.

**Chart 3: Channels of Local Currency Funding (end-2006, % GDP)**




Sources: Asian Development Bank, Bank for International Settlement, World Bank, national statistics.

9. The question how different parts of the financial sector precisely influence each other cannot be answered here. However, Chart 3 gives some clues that help to explain the size of capital markets in Central Asia. More developed economies tend to have more balanced financial system. Countries that have been successful in developing some areas of the financial sector have typically also been successful in developing other areas of the financial sector. This is due to interdependencies between these areas. Banking system development, for instance, typically gains from developed securities markets and vice versa. In many countries, banks are the most active issuers of securities and clearly interested in developing additional sources of revenue from investment services. Similarly, corporate bond markets typically gain from (or even depend on) developed markets for government bonds. Pricing corporate bonds with various maturities requires a benchmark. In most countries, this is the yield curve for government bonds.

[7] J. Gyntelberg, G. Ma and E. Remolona, Developing corporate bond markets in Asia. In: Bank for International Settlements. 2006. *Developing Corporate Bond Markets in Asia*. Basel.

10. The small size of corporate securities markets in Uzbekistan and the Kyrgyz Republic has, therefore, to be seen in context with the small size of other parts of their financial systems, including banking. Banking sector assets were equivalent to 31% of GDP in the Kyrgyz Republic and 33% in Uzbekistan in 2007. This contrasted with 92% of GDP in Kazakhstan. Government bond markets are relatively well developed in Kazakhstan and highly liquid. They are still very small in the Kyrgyz Republic and Uzbekistan.

11. Similarly, successfully developing equity and bond markets require well performing and developing money, foreign exchange, and derivatives markets. Repurchase transactions for instance, are an essential tool for liquidity management on money markets. Such transactions are typically collateralized though government securities. With liquid money markets, in turn, it is easier for financial institutions to warehouse government and other fixed-income securities. Active money markets are a prerequisite for liquid foreign exchange markets and for anchoring the medium- and long-term interest rates of local bond markets. Foreign issues of securities need deep and liquid foreign exchange markets to convert their proceeds. Domestic issuers of securities may need currency markets to hedge their liabilities. Markets for derivatives such as forwards, futures, swaps, and options all depend on bond markets for pricing and hedging. Government securities markets provide a market determined term structure of interest rates that reflect the opportunity cost of money. Derivatives, in turn, help to manage risks involved in transactions on money, foreign exchange, and securities markets.

12. Foreign exchange and money markets are much more developed in Kazakhstan than elsewhere in the region. Less than 1,800 transactions totaling $615 million equivalent (17% of GDP) took place at the Kyrgyz interbank foreign exchange market in 2007. This contrasts with a currency market turnover of $750 billion (720% of GDP) in Kazakhstan. Further, at the Kyrgyz interbank market for local currency, 102 transactions totaling $44 million equivalent (1.2% of GDP) took place in 2007. This contrasts with a money market turnover of more then $50 billion equivalent (48% of GDP) in Kazakhstan in 2007. Similarly, a high demand for local currency government and corporate bonds in Kazakhstan (despite negative real interest rates) and the unusually high liquidity of the secondary market for these bonds are mainly due to the fact that such bonds are actively used as collateral for repurchase transactions on the money market. The same applies, at a different level, for government securities markets in the Kyrgyz Republic and Uzbekistan. Markets for derivatives do not exist in the Kyrgyz Republic and Uzbekistan, and are very small in Kazakhstan. This is a development constraint for other parts of the financial systems in all three countries.

## III. THE ROLE OF CAPITAL MARKETS IN RESOURCE MOBILIZATION IN KAZAKHSTAN, KYRGYZ REPUBLIC, AND UZBEKISTAN

13. The above overview over the size of capital markets in Central Asia is based on highly aggregated data for equity and bond market capitalization (or bonds in circulation). Such data are frequently used as a proxy for market development. The assumption is that market capitalization reflects the extent to which the market provides finance to the real economy. This assumption is questionable.

14. Equity market capitalization, which is usually calculated as the number of shares multiplied by their market price, can be particularly misleading as an indicator for market development. Equity market capitalization can substantially increase (or decrease) due to changes in share prices. Capitalization can also increase as the result of the (partial) listing of SOEs. Neither would involve capital mobilization for productive investment. In fact, share prices increased, and in part substantially, in many Asian countries for years until 2007. Similarly,

listing of SOEs has played an important role in privatization policies of many countries, including People's Republic of China, Vietnam, India, and Pakistan. Privatization proceeds, however, do not necessarily finance investments. Further, privatization policies frequently foresee an initial public offering of a small package of SOE shares, usually 5–10%, to establish a market price. This market price can then be taken as a reference point for subsequent sales of larger share packages to portfolio or strategic investors. In many cases, however, these subsequent sales have occurred with a delay, if at all. The partial listing of SOE shares has, nevertheless, substantially increased market capitalization. In conclusion, the development of market capitalization may paint a too positive picture of market development.

15. However, the opposite may also be the case. Market capitalization is typically based on public offers of securities and fails to include private placements. Capitalization may, as such, fail to capture the whole amount of capital mobilized through issuance of securities. Regulatory bodies, which collect market information, are indeed supposed to regulate and supervise public offers more closely than private placements. The rationale is protection of small investors, which tend to be less sophisticated then larger investors to which private placements are geared. Regulators, consequently, know more about public offers then private placements. This can gave an impact on available information. Similarly, figures for shares and bond in circulation can be based on registration rather then actual placement.

16. Finally, capitalization does not tell us anything about market liquidity, which is an important determinant of market development. Investors must be able to dispose of, or acquire, holdings without causing large, adverse price movements. An illiquid market is less attractive then a liquid one as a place both for raising capital through an issue of securities and for buying and selling securities. A liquid market performs better in terms of price determination, which is a key function of any market. Share turnover is a widely used measure for market liquidity. Rising capitalization does not necessarily help to deepen the market by increasing the public float, which is the portion of the share capital of a company that is freely available for trading in the market. Given the strong positive relationship that usually exists between free float and stock market turnover, partial listing of SOEs, for instance, which increases market capitalization (para. 13), is frequently associated with thin share turnover, i.e. illiquid markets.[8]

17. In light of the above, a closer look at the individual country is necessary to determine the level of market development. Only this can clarify which role a particular equity or bond market actually plays in capital mobilization and financial intermediation.

## A. Equity Markets

18. Due to mass privatization programs of the 1990s, the number of broadly divested joint stock companies (JSCs) is large in Kazakhstan, the Kyrgyz Republic, and Uzbekistan (Table 2). However, the number of listed companies is comparatively small in Kazakhstan and very small in the Kyrgyz Republic and Uzbekistan. Non-listed companies account for the majority of equity issues. Many broadly divested companies issue shares without being listed at an exchange. The concept of a public company, which is crucial from a regulatory point of view, has not yet been introduced in the Kyrgyz Republic and Uzbekistan, and is not applied in Kazakhstan. Most large companies are still fully or partly state-owned. SOEs account for a large proportion of equity issues in Kazakhstan and Uzbekistan. While privatization policies have not yet let to a

[8] The increase in market capitalization in Pakistan since 2003, for instance, was largely the result of the listing of a number of large state-owned enterprises together with the growth in share prices rather than successful capital mobilization through equity issues. The market has remained narrow. The ten largest companies accounted for 55% of market capitalization at end-2006. Only an average of 20% of their shares had been floated.

systematic listing of SOEs, many equity issues are still linked to privatization. Shares are also issued to avoid taxes and strip assets. Accounting requirements also play a role, at least in the Kyrgyz Republic and Uzbekistan. Capitalizing retained profits, for instance, usually requires a company to issue additional free shares to its shareholders. Similarly, if assets of a company are believed to have increased in value, a revaluation is undertaken. This frequently triggers a new issue of free shares, which are distributed to the existing shareholders.[9]

**Table 2: Equity Markets (2007)**

| | Kazakhstan | Kyrgyz Republic | Uzbekistan |
|---|---|---|---|
| Number of joint stock companies | 2,200 | 909 | 1925 |
| of which state owned | 75% | 40-60% | 75% |
| of which open | n.a. | 909 | most |
| of which public | n.a. | 71 [b] | 788 [c] |
| Number of listed companies | 69 | 10 | 10 |
| Capitalization (official) | $54 billion | $150 million | $1.6 billion |
| as percent of gross domestic product | 51% | 4% | 9% |
| Number of equity issues | 144 | 77 | 163 |
| Total amount of equity issues | $4.1 billion | $57 million | $380 million |
| of which aimed at capital mobilization [a] | $2-3 billion | $35 million | $220 million |
| Number of companies traded at exchange | 73 | 200-300 | 420 |
| Secondary market volume | $6.7 billion | $150 million | $71 million |
| as percent of capitalization | 13% | 24% [d] | 4% |
| Transactions per day at main exchange | 22 [e] | 20 | 40 |

[a] Staff estimates.
[b] With more than 200 shareholders and traded
[c] With more than 800 shareholders.
[d] Only shares of listed companies.
[e] 2006
Sources: Asian Development Bank, national securities market regulators and exchanges

19. However, shares are also and increasingly issued to mobilize capital. The amount of capital raised by equity issues in 2007 is estimated at two to three percent of GDP in Kazakhstan, and around one percent of GDP in the Kyrgyz Republic and Uzbekistan.

20. Secondary markets are characterized by thin turnover, a small absolute number of transactions, and many transactions that are directly negotiated between the seller and buyer and not expose to a market-wide bid or offer price. This substantially undermines market transparency and the capacity of the markets to determine fair market prices. A legal requirement in the Kyrgyz Republic and Uzbekistan to undertake all share transactions through licensed exchanges has failed to increase market liquidity and transparency.

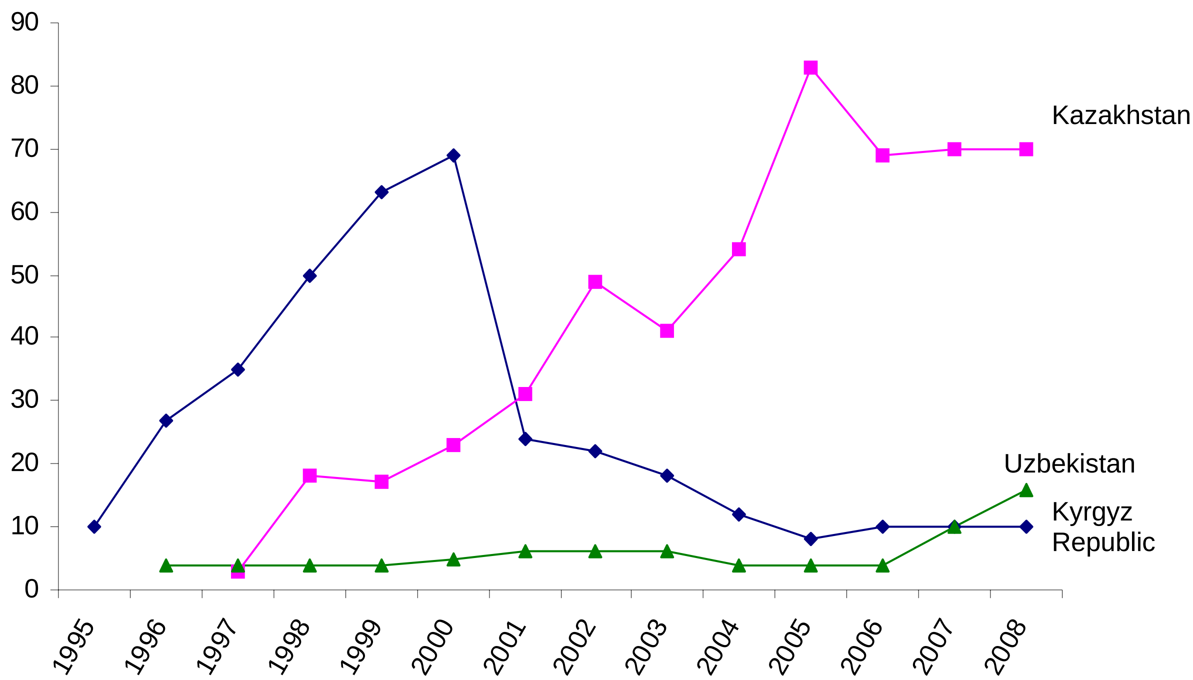
### 1. Kazakhstan

21. At end-2007, there were 2,200 JSCs in Kazakhstan. [275] JSCs were registered at the central depositary [at end-2006]. Their shares had a total nominal value of $36 billion

[9] This tends to keep market prices for shares close to their nominal value, particularly in the Kyrgyz Republic and Uzbekistan. This indicates that price determination is not yet fully entrusted to market forces.

equivalent. 75% of this amount was state-owned. The distinction between open and closed JSCs was abolished by the new Law on Joint Stock Companies (2003). Instead, the law has introduced the concept of public companies. However, based on the criteria established by the law there are no public companies in Kazakhstan, although many large JSCs are broadly divested.[10] At end-2007, 69 JSCs were listed at the main exchange. This number has remained almost unchanged over the last three years (Chart 4). Market capitalization, i.e. the aggregate capitalization of all listed companies amounted to $53.8 billion (51% of GDP) equivalent at end-2007. Market capitalization increased by almost 440 percent in 2006 but fell by 5% in 2007. This was mainly due to changes in share prices. Financial institutions accounted for 44% of market capitalization in 2007, followed by the natural resources sector and the energy sector, which accounted for 24% and 23% of capitalization, respectively.

**Chart 4: Number of Listed Companies**




Sources: Kazakhstan Stock Exchange, Kyrgyz Stock Exchange, Republican Stock Exchange Tashkent.

22. In 2007, 144 equity issues equivalent to $4.1 billion or 3.9% of GDP took place, up from 106 issues equivalent to $2.4 billion or 2.9% of GDP in 2006. All issues were legally private placements, given that there are no public companies in Kazakhstan under the company law. No information is available on how many issues were effectively public offers, i.e. made by broadly divested enterprises to the public. However, all equity issues were made outside the stock exchange. In 2007, SOEs accounted for 31 of the equity issues in the amount of $1.6 billion (or 38% of the total). This was lower then in 2006, when SOEs accounted for 75% of the total. SOEs are not normally listed at KASE. Only two of the top ten listed companies by capitalization, which together accounted for 87% of total market capitalization in 2006, had a

[10] A public company in Kazakhstan must have (i) shares issued to the public; (ii) at least 30% of shares held by investors which do not hold more then 5% of the shares each; (ii) a minimum amount of shares (to be specified by the regulatory body) in free float; (iii) a listing; (iv) a codex of corporate governance, (v) a corporate secretary, (vi) a corporate web site, and (vii) no golden shares.

state-shareholding.[11] These two SOEs were Kazmunaygaz Exploration Company (Razvedka Dobycha KazmunayGaz) and Kazakhtelecom. Given the size of these two SOEs, their listing has significantly increased market capitalization. Kazmunaygaz Exploration Company, which was listed in 2006, accounted for 23% of total market capitalization at-end 2007,Kazakhtelecom for 6%. The sale of an additional 0.9% of share capital of Kazakhtelecom in March 2007 was the only privatization related transaction at KASE in 2007.All other top-ten companies and almost all other listed companies were private, at least predominantly. It is not clear how many share issues mobilized capital for investment purposes. However, a best guess would be between two and three percent of GDP in 2007.

23. Secondary trading of shares at the exchange amounted to $2.3 billion equivalent in 2006 and $6.7 billion equivalent in 2007. The market is relatively illiquid, with a ratio of trading volume to capitalization of 4% in 2006 and 12.6% in 2007.[12] This was mainly due to a low free float of shares even of private companies. According to disclosed information, about 65% of the shares of the largest ten companies are owned by shareholders who hold more then 5% of the shares of the individual companies. This theoretically means that about 35% of the shares were more broadly divested. In reality, owner concentration seems much higher. A widespread market view is that one or two percent of market capitalization is freely floating.[13]

24. Low market liquidity was also reflected in the small number of secondary market transactions (deals), although progress has been made. The total number of market deals per average trading day increased from five in 2005 to 22 in 2006 and 80 in 2007. However, this is still a small number. The ten most liquid shares accounted for 74% of the transactions in 2007. That means that for most listed companies, there is a transaction once every few weeks. For each of the ten most liquid shares, there were 6 transactions on average per trading day. Further, until 2006, a significant proportion of transactions was pre-arranged outside the exchange between the buyer and the seller (locally called “direct deals”) and only transacted through the exchange. In 2006, direct deals accounted for 24% of transactions by number and 69% by volume. In 2007, the share of direct deals fell to 4% by number and 7% by volume, i.e. market deals dominated. This turnaround at the exchange is remarkable, even if market participants indicate that many “market deals” are also actually pre-arranged and involve only two parties. Nevertheless, market transparency and liquidity have started to improve. This was mainly due to higher transaction fees for direct deals and, most importantly, a change in tax policies to the effect that only market deals are now exempted from capital gains tax. On the other hand, most share transactions still take place outside the stock exchange.

25. In February 2007, a regional trading platform became operational in Kazakhstan. Most of the 14 enterprises listed at this platform at end-2007 were double-listed at the main exchange.

[11] Very few of the other listed companies had state shareholdings with the exceptions of some companies like Astana-Finants and Pawlodar Oil and Chemical Company which had minority state shareholdings. There may be indirect state shareholding in some other cases. However, the opaque ownership structure of most companies does not allow definite statements.

[12] Information about transactions with corporate securities outside the exchange is not available. Only four percent of all securities transactions took place outside the exchange in 2006. However, transactions in corporate securities accounted for only 12% of the total, and government securities for the rest. A significant percentage of transaction with corporate securities could, therefore, have taken place outside the exchange.

[13] The stock exchange is considering introducing free float rules as listing criteria (or at least as criteria for being included in the official share price index) over time to boost market liquidity. This would follow the example of other exchanges. According to FTSE free float rule, a company cannot be included in the index if its free float is less then 5%. According to European Union regulations, the number of shares made available is adequate from a listing perspective if the free float represents 25% of equity or if it is sufficiently high to ensure orderly market operations. The main Kazakhstani exchange already applies a free-float rule for its share-price index. Such a rule will also be included in listing rules. This is already the case at the regional trading platform.

Total share turnover at the regional platform amounted to $113 million in 2007, i.e. only 1.3% of that at the main exchange.

26. Overall, low market liquidity still has negative implications for price determination, market transparency and, thus, investor protection in Kazakhstan. Transparency is the degree to which information about trading (pre-trade and post-trade) is made publicly available on a real-time basis.[14] However, pre-trade transparency has improved recently due to the increase in the number of market deals.

### 2. Kyrgyz Republic

27. At end-2007, 1,222 JSCs were registered in the Kyrgyz Republic, 909 of which as open JSCs. The nominal share value of all JSCs was equivalent to $820 million or 22% of GDP. Open JSC accounted for 86% of this total. According to expert estimates state shareholding accounted for 40-60% of nominal share value. 71 open JSCs had more than 200 shareholders and repeatedly issued shares that were traded at the exchange (at least once per year). Due to unreliability of market prices, the market capitalization of these “public companies” is not available.[15] However, the nominal value of their shares was equivalent to $350 million (9% of GDP), i.e. they accounted for 43% of total share value of all JSCs.

28. Only ten companies were actually listed at end-2007. The market capitalization of these companies amounted to $150 million equivalent or 3.8% of GDP. The only listed SOE, Kyrgyz Telecom, accounted for 44% of market capitalization, followed by five financial institutions, which together accounted for 34% capitalization. Shares of several hundred unlisted companies were traded through the main exchange and two other licensed trading platforms, which do not have a listing mechanism. The market capitalization of listed companies is, therefore, much smaller that that of all companies whose shares are actually traded.

29. In 2007, 77 equity issues took place in the Kyrgyz Republic. This was slightly higher then the annual average during the preceding five years, which was 74. The total amount of these issues was equivalent to $57 million or 1.6% of GDP. Only five issues equivalent to $6 million were related to privatization. This was substantially less than in the preceding years. 12 of the issues equivalent to $17 million were public offers, which were primarily made by commercial banks and other financial institutions. The remaining issues were private placements. Many issues were apparently not aimed at mobilizing capital, i.e. they were triggered by the capitalization of retained profits or tax avoidance schemes. The total amount of capital mobilized through equity issues was presumably equivalent to about one percent of GDP.

30. All primary and secondary market transactions take place through licensed trade organizers or stock exchanges in the Kyrgyz Republic. This is due to a Presidential decree adopted in 1999, which requires all share transactions to be undertaken through a licensed exchange, i.e. disallows OTC trading. The aim was to concentrate market activity and liquidity and, thereby, increase market transparency and efficiency. These objectives have not been met. All secondary and even primary market transactions are indeed registered at licensed

[14] Pre-trade information concerns the posting of firm bids and offers as a means to enable investors to know, which some degree of certainty, whether and at what prices they can deal. Post-trade information is related to the prices and volume of all individual transactions actually concluded. Regulation should ensure the highest levels of transparency.

[15] The concept of a public company does not yet exists in Kyrgyz legislation. However, it will be introduced through new securities market legislation that is currently before Parliament.

exchanges.[16] However, almost all transactions take place in form of direct deals (locally called "registered deals").[17] Like in Kazakhstan, buyer and seller of a security negotiate its price directly or through a broker and subsequently register the transaction at an exchange. Such registered deals do not provide timely pre- or post-trade price transparency. Further, the total number of securities transactions per trading day is even lower then in Kazakhstan. There were only about 20 transactions on average per trading day at the main exchange, which accounted for 57% of all share transactions, in 2007 (up from 9 in 2006). All three exchanges in the Kyrgyz Republic can, therefore, be characterized as OTC markets.

31. The secondary market turnover was equivalent to about $150 million in 2007, up from $100 million in 2006. Only 20% of turnover was in shares of listed companies. The ratio of secondary market trading volume of listed companies and their market capitalization was 24%. This is low from an international perspective, but high compared to Kazakhstan. The key reason is that only relative liquid shares are listed in the Kyrgyz Republic.

### 3. Uzbekistan

32. At end-2007, 1925 JSCs were registered in Uzbekistan, most of which as open JSCs. 788 companies had more then 500 shareholders. 921 companies, i.e. most large and medium-sized ones, had a state shareholding. The shares of all JSCs together had a nominal value of $2.5 billion equivalent. State shareholding accounted for 75% of this amount. Shares of ten JSCs were listed at the stock exchange at end-2007. All listed companies were commercial banks, most of which were state-owned or state-controlled. Shares of additional 420 companies were traded at the exchange in 2007. Official stock market capitalization was equivalent to 9.4% of GDP at end-2006 and 8.6% of GDP ($1.6 billion) at end-2007. The calculation includes all companies traded at the exchange over the year (i.e. not only listed companies), which were 621 in 2006 and 430 in 2007.

33. In 2007, 163 shares issuances equivalent to about $380 million were newly registered in Uzbekistan, $301 million (1.4% of GDP) of which were not related to privatization. The largest six issuers were the oil and gas company Uzneftegazkazibchikarish ($77 million equivalent), Uzpromstroybank ($56 million), Pakhtabank ($50 million), Gallabank ($30 million), Mikrokreditbank ($17 million), and Chirchikskiy Transformator Plant ($14 million). Overall, 18 banks issued shares in the amount of $196 million equivalent in 2007. Banks were also the most active equity investors. Both on the issuer and investor side, state-owned or state-controlled banks dominated. As in the years before, only a small amount of shares ($38 million) were issued through the exchange. Unlike in the years before, only a small amount of these issues ($2 million) was related to privatization. Another difference between 2007 and the preceding years was the large amount of share capital issued by banks. The reason behind were policy and regulatory changes: Since end-2006, SOEs have mainly been privatized outside the stock exchange. Further, capital requirements for banks have been increased and banks been required to sell at least 25% of secondary issues through the stock exchange.

[16] Even the privatization of state-owned companies to strategic investors is registered at exchanges. An example is the privatization of Kairat Bank in 2004. Kairat Bank was sold to Halyk Bank Kazakhstan through international competitive tender. Subsequently, the transaction was registered at the main Kyrgyz exchange. This registration (and similar transactions), which did not add value in terms of helping to determine a fair transaction price or increasing transparency, can be characterized as regulatory subsidy for the exchange and the broker involved.

[17] In 2006, 99 percent of share transactions at the main exchange, which is Kyrgyz Stock Exchange, took place in form of registered deals. The ratio was 100 percent for the other two trade organizers.

34. The remaining amount of shares that were newly registered in 2007 but neither related to privatization nor sold through the exchange ($263 million) does not necessarily reflect private placements aimed at raising capital. Many issues were related to the revaluation of company assets and tax avoidance schemes. Further, some shares may were registered but not sold. However, capital mobilization through equity issues is clearly gaining momentum in Uzbekistan. A best guess for the amount of capital raised in 2007 would be one percent of GDP.

35. Secondary market turnover was equivalent to $71 million in 2007, of which the main exchange accounted for 86% and the formal OTC market, which is a licensed electronic trading system, for the rest. Shares of less then 100 companies were traded at the formal OTC market, all of which are also traded at the main exchange. Deals at the formal OTC market must be closed at the latest available price determined at the main exchange. Before 2003, an informal OTC market (or kerb market) accounted for the majority of secondary market transaction. However, a government resolution adopted in April 2003 requires all transactions in shares of open JSCs to be carried out through licensed trading platforms. Like in the Kyrgyz Republic, this measure has yet to increase market liquidity and transparency. An informal OTC market for shares of closed JSC still exists, but trading information is not available. Less than 9,000 transactions were carried out at the main exchange in 2007, i.e. around 40 on average per trading day. An additional 1,200 transactions took place at the formal OTC market. In contrast to Kazakhstan and the Kyrgyz Republic, regulation does not allow direct deals in Uzbekistan. All transactions are, therefore, formally market transactions. The small volume and number of secondary market transactions puts this into perspective.

## B. Bond Markets

36. Corporate bond markets are relatively well developed in Kazakhstan, where capital raised through bond issues was equivalent to 1.7 percent of GDP in 2007. In the Kyrgyz Republic and Uzbekistan, corporate bonds markets are dormant. This is mainly due to defaults of bonds in 2003-2005 and weaknesses in the regulatory and policy framework. In 2007, capital mobilized through government bond issues was equivalent to 0.6% and 0.7% of GDP, respectively, in Kazakhstan and the Kyrgyz Republic, and 0.1% of GDP in Uzbekistan. Yields for government bonds (and corporate bonds where in circulation) tend to be very low or negative in real terms. Investment in bonds is mostly done by financial institutions, which hold fixed-income securities for liquidity management purposes. This is the reason why bonds are well in demand and secondary markets relatively liquid in all three countries. Table 3 provides an overview over corporate bond markets.

**Table 3: Bond Markets (2007)**

| | Kazakhstan | Kyrgyz Republic | Uzbekistan |
|---|---|---|---|
| Corporate bonds in circulation | | | |
| Number | 286 | None | 33 |
| Volume | Not available | None | $0.02 billion |
| Corporate bond issues | | | |
| Number | 79 | None | 2 |
| Volume | $1,200 million | None | $1 million |
| Government bonds in circulation | | | |
| Volume | $3,500 million | $160 million | $41 million |
| Government bonds issues, volume | $600 million | $160 million | $33 million |

Sources: National securities market regulators.

### 1. Kazakhstan

37. At end-2007, 286 corporate bonds in the total amount of $12 billion were “active” in Kazakhstan according to official information. However, the amount of corporate bonds in circulation was much lower. In Kazakhstan, issuers can register either individual bonds or bond (issuance) programs under a shelf-registration mode. Shelf-registration means that registered securities can be sold to investors in tranches, as needed. Information on actual placement of registered individual bonds is available. The regulator also collects information on the placement of individual tranches under bond programs. This information is, however, not usually processed. The actual amount of corporate bonds in circulation is, therefore, not available. Similarly, 202 local currency bonds in the total amount of $8.5 billion equivalent were listed at the main exchange at end-2007. How much of this amount was actually in circulation is not known.

38. In 2007, 79 corporate bonds or bond programs in the total amount of $6.5 billion equivalent or 6.4% of GDP were newly registered in Kazakhstan. This included 14 individual bonds in the total amount of $630 million, of which $390 million or 0.6% of GDP were actually sold. In addition, according to information provided by the regulator, ten bonds equivalent of $820 million or 0.8% of GDP were sold under bond programs. For comparison: In 2006, 89 corporate bonds and bond programs in the total amount of $5.2 billion or 6.4% of GDP equivalent were newly registered. This included 14 individual bonds in the total amount of $760 million equivalent, of which $520 million or 0.6% of GDP were actually sold. In addition, 22 bonds equivalent to $885 million or 1.1% of GDP were sold under bond programs. As such, the amount of capital raised through corporate bonds was equivalent to $1.4 billion or 1.7% of GDP in 2006 and $1.2 billion or 1.4% of GDP in 2007. Maturity periods ranged from one to 15 years in 2006 and two to ten years in 2007. Bonds with longer maturity were registered in 2007, but could not be sold, presumably due to destabilizing expectation on inflation. Financial institutions accounted for most corporate bonds, namely 65% in 2006 and 99% in 2007.

39. Information about the secondary OTC market for corporate bonds is not available. However, the secondary market at the main exchange, where many bonds are listed, is surprisingly active from an international perspective. In 2007, trading volume was equivalent to 25% of the total amount of listed corporate bonds (including international bonds listed at the main exchange). The main reason is that corporate bonds are used as collateral for money market transactions. In 2007, 20% of repurchase transactions in the total amount of $42 million equivalent were collateralized with corporate bonds. That clearly increased the demand for corporate bonds at the primary and secondary market, despite their negative real yields. Local currency corporate bond yields have been negative in real terms since August 2007. Before, they fluctuated between around 0-1 percent p.a..

40. Secondary market transactions were market transactions in the stricter sense of the word, i.e. not pre-arranged direct-deals. There were 13-15 market deals on average per trading day. The existence of a five-minute window before orders are matched allows some pre-trade transparency. Total bond turnover at the regional trading platform amounted to $400 million in 2007, i.e. nine percent of that at the main exchange.

41. 232 corporate bonds in the total amount of $14.9 billion equivalent were listed at the main exchange. However, that obviously included many international issues. It is, however, interesting to note that financial institutions accounted for 87% of capitalization of listed bonds in 2007 and 86% of secondary market trading.

42. At end-2007, local currency government bonds equivalent to $3.5 billion were in circulation. 30% of this amount was reserved for pension funds. Maturity periods ranged from two to ten years. Foreign currency government bonds and municipal bonds existed, but their amounts were negligible.[18] The amount raised through government bonds in 2007 was equivalent to $0.6 billion or 0.6% of GDP, down from $1.1 billion or 1.4% of GDP in 2006. Most government bonds were issued and traded at the exchange. The volume of secondary market trading was about 20 times higher then the amount of bonds in circulation. The main reason is that government bonds are extensively used as collateral for money market transactions. As for corporate bonds, yields for government bonds have been negative for several years across all maturities, and increasingly so in 2007 due to sharply rising inflation. Yields for government bonds ranged from 4-9% per annum in December 2007, while annual inflation stood at 19%. As a response, the Government has issued an increasing amount of inflation-indexed bonds.

### 2. Kyrgyz Republic

43. The corporate bond market in Kyrgyz Republic is currently dormant. A total of $3 million equivalent was raised through 15 corporate bond issues in 1999-2004. Four of the issuers were financial institutions, the others companies in manufacturing and services. The longest ever corporate bond maturity was three years (in 2001 and 2002). No corporate bonds were issued in 2005-2007. Two companies registered corporate bond issues in 2005 but were unable to sell them. The single most important reason for the failure to develop corporate bond markets in the Kyrgyz Republic is the default in 2003 of two issues made by a company named Renton Group in 2001. These defaults exposed serious gaps in the regulatory and supervisory framework.[19]

44. The Kyrgyz government bond market consists of treasury bonds with maturity periods of 18 to 24 months and promissory notes. The equivalent of about $160 million (0.4% of GDP) of these securities was issued in 2007. The same amount was in circulation at end-2007.[20] Secondary market turnover of government securities (including treasury bills and bonds, since a breakdown by instruments or maturities is not available) amounted to $200 million equivalent in 2007. The market was liquid with a turnover ratio of 120%. The explanation is that 99% of the turnover was related to money market transaction, i.e. liquidity management of banks. Real interest rates for government securities were strongly negative. Nominal yields for 24-month government bonds were slightly above 13% at end-2007, while annual inflation was 20%.

### 3. Uzbekistan

45. Corporate bonds do not yet play a significant role in corporate finance in Uzbekistan. In 2005, a number of bond issuers defaulted. This has made potential investors reluctant to buy corporate bonds.[21] In 1999-2007, 101 corporate bonds equivalent to $71 million were issued in Uzbekistan.[22] Most of these bonds had maturity periods of less then one year. Capital raised through bond issuance peaked in 2004 at $26 million (0.23% of GDP) equivalent. Since then,

[18] In contrast to other countries in the region, municipal bonds do exist in Kazakhstan. 14 municipal bonds have been issued so far. None has been issued since 2003. International bonds (Eurobonds) issued by the Government were also in circulation and listed at KASE since the late 1990ies, when such bonds were needed for budget deficit financing. However, the last sovereign Eurobond was redeemed in May 2007.
[19] The products offered by Renton Group exhibited characteristics traditionally associated with securities and banking and where not adequately supervised by neither the securities market nor the banking sector regulator.
[20] The amount of treasury bills in circulation was $20 million equivalent.
[21] As a response, new regulatory requirements were established for issuers. Only open JSC that have complied with specified financial performance ratios over the preceding three years can issue bonds up to a total amount equivalent to their capital.
[22] 117 corporate bonds were registered, 16 of which were subsequently annulled.

amounts have been declining. Only two corporate bonds equivalent to $1 million were issued in 2007, one by a pharmacy company, the other by Kapitalbank. The bond of Kapitalbank had a maturity of ten years. The amount of bonds in circulation peaked in 2004 at $40 million (0.35% of GDP) equivalent. At end-2007, 33 bonds equivalent to $20 million were in circulation.

46. Corporate bonds can be traded at the main exchange and an interbank trading platform. However, trading is thin with only three transactions totaling $600,000 equivalent in 2007.

47. In January 2004, the Uzbek Government decided to issue government securities with maturities of up to five years. Within the year, the first Treasury Bonds with a maturity of 18 months were issued. At end-2006, government bonds in circulation amounted to UZS46 billion, which was equivalent to $37 million 0.22% of GDP. In 2007, maturity periods were extended to two and three years. 27 government bonds equivalent to $33 million (0.1% of GDP) were issued in 2007. Bonds equivalent to $41 million were in circulation at end-2007. Overall, despite recent progress, the government bond market is still very small. The main investors are state-owned or controlled domestic banks, their state-owned customers, and other domestic financial institutions such as state-owned insurance companies. Banks and insurance companies are required to hold a specified percentage of their reserves and assets, respectively, in government securities.

48. This has helped to keep nominal yields of government securities very low. Real rates are strongly negative. Rates of corporate securities are typically about ten percentage points above that of government securities. Therefore, issues are usually heavily oversubscribed. However, state-owned companies have better options for financing than issuing bonds. While lending rates for commercial bank credit are only few percentage-points below corporate bonds rates, many companies have access to loans at lower rates under government sponsored lending programs. The issuance of corporate bonds is, therefore, the domain of private companies. However, very few private companies in Uzbekistan are large enough to issue bonds.

## IV. FACTORS FACILITATING MARKET DEVELOPMENT

49. A number of key factors that explain successful capital market development in more advanced countries have been established through economic research and in-depth country studies:

(i) Legal and regulatory reforms, including the establishment of independent, accountable, and effective regulatory agencies.
(ii) Deregulation.
(iii) Listing of SOEs at and their privatization through stock exchanges.
(iv) Development of market infrastructure.
(v) Internationalization of markets.
(vi) Introduction of new financial products, including derivatives.
(vii) Emergence and increasing role of new actors, particularly institutional investors.

50. An overview of achievements made in these areas in Kazakhstan, the Kyrgyz Republic, and Uzbekistan should help to explain the progress that has been made with capital market development in these countries (as outlined in Part II and III of this paper) and prepare the ground for policy recommendations (Part V).

## A. Legal and Regulatory Reforms

51. There is broad recognition worldwide of the importance of a sound and effective legal and regulatory framework for securities markets, and the confidence it brings for market integrity, growth, and development. Over the past two decades, the most important international trend has been the harmonization of standards of market regulation and supervision. The undisputed benchmarks for this harmonization are the principles of securities regulation established by the International Organization of Securities Commissions (IOSCO Principles). These principles have the objectives to (i) protect investors; (ii) ensure that markets are fair, efficient, and transparent; and (iii) reduce systemic risk.

52. The regulatory bodies in Kazakhstan, the Kyrgyz Republic, and Uzbekistan, are ordinary members of IOSCO. They have officially committed to use their best endeavors to ensure adherence to IOSCO Principles. To the extent that current legislation, policy or regulatory arrangements may impede adherence to these principles, they officially intend to seek changes.[23] All three countries have made progress in complying with IOSCO Principles. A basic legal and regulatory framework is in place and regulatory agencies have been established. Kazakhstan has already replaced its initial securities market legislation with a "second generation" law that largely complies with IOSCO standards. New securities laws are before Parliament in the Kyrgyz Republic and Uzbekistan.

53. There are significant differences between the countries with regard to legal status, powers, and capacity of the regulator. While Kazakhstan fully or substantially complies with IOSCO Principles in this area, substantial progress has yet to be made in the other two countries. None of the three countries has made significant progress in establishing a two-level system of regulation. Such a system consists of a regulatory body and frontline-regulators, i.e. industry organizations such as stock exchanges, associations of brokers, etc. that carry regulatory responsibilities. Such self-regulatory organizations (SROs) can be a valuable complement to the regulator in achieving the objectives of securities regulation and supervision, since it tends to increase the efficiency of regulation and supervision.

54. Similarly, enforcement of legislation and regulation is weak in all three countries. This can partly be explained by the failure to develop a two-level system of regulation. However, from a broader perspective, enforcement issues stem from a number of historical and environmental factors, including the political economy of the respective country, a pronounced desire on the part of company owners in Central Asia to keep company control, lack of transparency of corporate actions, insufficient quality of company data, opaque ownership rights, and a weak judiciary. Addressing such issues head-on may go beyond what a regulator or SRO in Central Asia can realistically do.

55. With regard to the IOSCO Principles related to issuers of securities, and particularly disclosure requirements, additional efforts have to be made in all three countries. Disclosure requirements are steep and international accounting and auditing standards have been officially introduced. In practice, however, the requirement to disclose information which is material to investors' decision, including the security holding of management and of those persons who hold a substantial ownership interest in a company, is mostly not properly enforced. Further, disclosed financial information, which is critical to informed decision making of investors, is not always comparable and reliable. The difficulties with enforcing disclosure requirements are, at

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[23] IOSCO Resolution No. 41. 1998. *Resolution on IOSCO Adoption of the Objectives and Principles of Securities Regulation*.

least partly, due to weak capacity of financial specialists and auditors in the region and lack market pressure.[24] Further, scare regulatory capacity is wasted on regulating a large number of private placements rather then focusing on the few public offers, which should be subject to stricter corporate governance and disclosure standards, and closer supervision to protect investors.

56. Principles related to market intermediaries are generally complied with. However, a remaining weakness, particularly in the Kyrgyz Republic and Uzbekistan, but to a degree also in Kazakhstan, are standards for trade organizers, which should be required to establish and enforce listing standards, and monitor and enforce quality standards with respect to the execution of customers' orders.[25] In none of the three countries does regulation sufficiently promote transparency and integrity of secondary markets. This is reflected in trading conditions, namely the lack of order interaction and the dominance of direct deals. IOSCO clearly recognizes trading conditions as a critical aspect of ensuring fair, orderly, efficient, transparent, and liquid markets.

### 1. Kazakhstan

57. The legal and regulatory framework for securities markets in Kazakhstan was assessed against IOSCO Principles in 2000 and 2004.[26] In 2000, the core legal infrastructure of the securities market was found to be in place, but the regulatory framework was assessed as weak. In 2004, marked improvements in several aspects of the written legislation were identified. This was primarily related to the adoption of a new securities law in July 2003. This law, which was further strengthened in January 2007, provides the regulatory body with a clear and consistent legal framework; enforcement powers; authority to institute sanctions, promote transparency, prohibit manipulation and other unfair trading practices; authority to provide clear objectives, functions, responsibilities, powers and authorities of SROs; and the power to set capital requirements for the central securities depository. Overall, Kazakhstan has modern securities market legislation in place.

58. The institutional architecture for financial market supervision in Kazakhstan has been through several phases. First, various parts of the financial system were regulated and supervised by specialized agencies, including the National Bank of Kazakhstan (NBK), which was in charge for banking, and the National Securities Commission, which was in charge of securities markets. In July 2001, financial sector regulation and supervision was consolidated under the roof of NBK. Finally, in January 2004 regulation and supervision was separated out of National Bank into a newly established Financial Services Agency (FSA), i.e. the Agency on Regulation and Supervision of Financial Markets and Financial Institutions in Kazakhstan.

59. The assessment undertaken in 2004 noted that it was too soon to assess how effectively the FSA will implement legislation. However, it flagged pronounced weaknesses in some areas of regulation and supervision, namely market surveillance, effective and credible use of

[24] Market pressure in favor of proper corporate governance and disclosure tends to be weak where the issuance of securities is not a significant source of corporate finance, the public float of securities is low, and trading volumes are thin.

[25] Market intermediaries should observe high standards of integrity and fair dealing, and act with due care and diligence in the best interests of its customers and the integrity of the market. This means, among others, that customer orders should be expose to a market-wide bid or offer price, if possible, to get the best price, and that customers should be protected from misleading, manipulative or fraudulent practices, including insider trading, front running or trading ahead of customers and the misuse of client assets.

[26] The assessment took place under the Financial Sector Assessment Program of the International Monetary Fund and the World Bank.

enforcement powers, compliance with standards for internal organization and operational conduct of market intermediaries, procedures for dealing with the failure of a market intermediary, transparency of trading, and detection and discouragement of manipulation and other unfair trading practices. Ensuring timely access to information is crucial for the regulation of secondary trading. Timely information about secondary trading, which is mostly absent in Kazakhstan (para. 24), would allow investors to better look after their own interests. This would reduce the risk of manipulative trading practices. Further, adequate use of SROs had yet to be made in Kazakhstan. The stock exchange is not a frontline regulator. The few other SROs in Kazakhstan lack capacity to perform their functions. The management of the stock exchange is actually not interested in becoming a frontline-regulator. This can be understood in light of the factors that complicate enforcement in the country (para. 52). However, the reluctance of the exchange to get involved in enforcement may also be due to the ability of broadly divested companies to raise capital outside the exchange. This is a regulatory issue.

60. Like in other countries in the region, disclosure requirements are weak in Kazakhstan and not properly enforced. As there are officially no public companies in the country (para. 21), all equity issues are technically private placements. In reality, disclosure requirements are too strict and costly for what are effectively private placements, which constraints market development. Further, requirements are not strict enough for what are effectively public offers (made to the public by broadly divested JSCs). This, and the lack of focus on the part of the regulator on what are effectively public offers, is dangerous from an investor protection point of view. There are additional disclosure requirements associated with a listing. Market participants and issuers are of the view that the exchange is reluctant to follow up when listed companies fail to comply. However, the exchange claims that compliance of disclosure requirements is closely monitored by a monitoring unit in its listing department and increasingly enforced.[27]

61. A more general factor has also affected the regulatory framework in Kazakhstan. The very establishment of an FSA can reduce the supervisory effectiveness for during transition period and possibly beyond.[28] This has apparently happened in Kazakhstan. Management and staff capacity have suffered from separating regulation and supervision out of the National Bank (and from brain-drain to the private sector). Further, the banking and pension systems have absorbed most of the FSA’s capacity since its inception.

### 2. Kyrgyz Republic

62. Serious weaknesses in the first Kyrgyz Law on Securities Markets (1998) were identified in preparation of the Banking Sector and Capital Market Development Program for the Kyrgyz Republic, which was approved by Asian Development Bank in 2005.[29] The law does not give the regulatory body sufficient authority to effectively supervise the market and enforce securities market laws and regulations. Further, the law does not establish clear disclosure requirements for the issuer of securities, which would enable investors to make informed investment decisions, nor does it distinguish between private placements and public offers. That means that, as in Kazakhstan, requirements are too loose for public offers and two strict for private

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[27] In 2007, KASE monitored 102 serious violations of disclosure requirements. The exchange can respond to such violations with fines in the amount of up to 100% of listing fees or even delisting of the company. KASE claims to have delisted three companies in 2007 due to failure to comply with disclosure requirements: KazChrom, Aluminiy Kazakhstan, and Kazakh Altyn.

[28] J. de Lune Martinez and T. Rose. 2003. International Survey of Integrated Financial Sector Supervision. Washington (World Bank Policy Research Paper No. 3096).

[29] ADB. 2005. Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grant to the Kyrgyz Republic for the *Banking System and Capital Market Development Program*. Manila (Loan 2224-KGZ[SF], approved on 16 December 2005, for $17.5 million).

placements. Furthermore, the law does not require the issuer and the underwriter to conduct proper due diligence, nor does it provide a clear basis for regulating clearance and settlement of securities traded in the secondary market. To address these weaknesses a new securities markets law was drafted in 2005 and subsequently enhanced through stakeholder consultations. The new law, which complies with IOSCO standards to a significant degree, is currently pending in Parliament.

63. Due to weaknesses in the current Law on Securities Markets, market regulation does not provide adequate entry standards for market intermediaries. Stock exchanges are not required to (and do not) function as SROs, establish and enforce listing standards, and monitor and enforce quality standards with respect customers' orders. All three exchanges are registered as trade organizers rather then stock exchanges. Only one exchange offers a listing mechanism, but most trading is in non-listed securities (para. 30). There are no rules governing the conduct of market participants, which is a key reason for the dominance of registered deals, which do not expose a customer's order to a market-wide bid or offer price. Further, there are few linkages between the different exchanges, as brokers of the main exchange are prohibited from being a member of another. This is anticompetitive and undermines the development of unified prices for shares across different exchanges.

64. To consolidate the fragmented institutional framework for the regulation and supervision of nonbank financial institutions, the State Service for Financial Supervision and Reporting was established in 2005, based on the State Commission for Securities Markets, the State Commission for Accounting and Auditing, and an agency within the Ministry of Finance in charge for insurance and private pensions. For the time being, the Service has remained part of the Government. The authorities intent to transform the Service into a full fledged Nonbank FSA, with adequate authority and funding to effectively regulate and supervise nonbank financial services. However, the draft law that would codify this Nonbank FSA has yet to be submitted to Parliament. The weak legal basis and capacity of the regulator, therefore, remain key constraints for further strengthening and effectively enforcing the legal and regulatory framework for securities markets in the Kyrgyz Republic. This is a key securities market development constraint in the country, together with regulatory gaps and enforcement problems in the area of disclosure requirements and requirements for market intermediaries.

### 3. Uzbekistan

65. The legal framework for securities markets is highly fragmented in Uzbekistan. The Law on Securities and Stock Exchanges (1993) was amended nine times since its enactment. However, it merely defines a range of securities and the key market institutions without establishing principles for their interaction. The law is complemented by the Law on Exchanges and Activity of Exchanges (1992), the Law on the Functioning of Securities Markets (1996), the Law on Activity of Depositories in the Securities Market (1996), the Law on the Rights of Protection of the rights of Investors at the Securities Market (2001), and a large number of Presidential decrees and Government resolutions. All these legal acts were adopted at various points of market development and do not form a consistent body. A new securities law is expected to be enacted in June 2008. The new law will help to increase transparency and eliminate contradictions by consolidating the legal basis for securities markets.

66. Until 1996, the equity market was regulated by the State Commission on Securities, which fell under the jurisdiction of the Ministry of Finance. In 1996, the commission was transformed into the Center for the Coordination and Control of the Functioning of the Securities Market (the Center) and attached to the State Property Committee (SPC). Since then, the

Center has always been headed by a deputy chairperson of the SPC. The SPC is not only the government body responsible for privatization. It is also the dominant political force in the securities markets. The SPC is responsible for supervising the Center and for legislation related to issuance of shares and corporate bonds. It also owns shares in and exercises varying degrees of control over the trade organizers, the central depository, and other professional market participants. Formally, the Center has broad ranging responsibilities typical for securities market regulators, including drafting regulations, protecting investors, licensing and registering market participants and professional, registering securities, overseeing compliance with securities market legislation and regulation, enforcing disclosure standards,[30] and investigating violation of legislation and regulation. In reality, its main concern is to execute the divesture of SOE shares on behalf of the SPC. In fact, until 2007, most of the transactions at the exchanges were related to privatization. It is clear from this context that the trade organizers are neither encouraged nor inclined to transform into SROs. The association of professional market participants is formally an SRO. However, with its diverse membership it does not actually perform the function of a frontline regulator.

67. The lack of independence of the Center from the SPC may make sense, if equity markets are merely an outlet for privatization of SOEs.[31] However, from an international best practice point of view, it leads to conflicts of interest and serious enforcement problems, and constraints market development. The SPC is directly involved in issuing securities that are distributed through and (sometimes) traded at the exchange. The SPC is responsible for the completeness and accuracy of disclosures made to potential investors. At the same time, the Center, which is tightly controlled by the SPC, is required to monitor whether issuers, mostly SOEs controlled by the State Property Committee, disclose all information. The dominant role of the SPC ensures that the Center, in case of conflicts, focuses on the sale of SOE shares rather then the protection of investors and market supervision.

## B. Deregulation

68. While regulation is necessary to ensure the achievement of the three core objectives (para. 49), inappropriate regulation can impose an unjustified burden on the market and inhibit market growth and development. Deregulation has, therefore, been an important driver of capital market development in many countries worldwide.

69. All countries in Central Asia are transition economies. As outlined above (paras. 50-65), regulatory gaps persist and enforcement is weak. Nevertheless, some areas seem overregulated. An example is the comparatively close regulation of private placements of securities, which cannot be justified from an investor protection point of view and absorbs scare regulatory capacity that could be better used for more effectively regulating and supervising public offers. Uzbekistan, the new securities law will even extend the steep disclosure requirements for all open JSC to small and medium-sized enterprises, irrespective of their

[30] There is a wide range of laws and regulations governing corporate disclosure in Uzbekistan. However, in light of the small size of the primary and secondary market in Uzbekistan, market pressure in support of proper disclosure is largely absent. More fundamentally, the importance of disclosure is substantially undermined by the Uzbek overall economic system, which has been tailored to implement industrial policy through extensive state intervention in the economy. This mechanism comprises methods of economic control and institutional arrangements that are, in many respects, variations of the centrally planned system that operated in the Former Soviet Union. C. Lin and J. Conrad. ADB. 2005. *Private Sector Assessment for Uzbekistan*, Manila.

[31] In Uzbekistan, shares in medium and large SOEs have been primarily sold to other SOEs or state organizations, including industry associations, rather then to private investors. This approach has not helped to maximize budget revenues and increase market liquidity.

number of shareholders. This is overregulation, which undermines enforcement and hampers market development.

70. Further, the requirement to have all securities transactions registered at a stock exchange has not increased market liquidity and transparency in the Kyrgyz Republic and Uzbekistan. Deregulation in this area, at least for securities that have not been publicly offered, could reduce transaction cost and facilitate market development. Regulation should, instead, aim to strengthen the trading environment at the exchanges. An added benefit could be the consolidation of market infrastructure, given that a number of professional market participants, including some trade organizers, may exit the market without this regulatory subsidy.

71. Overall, deregulation has yet to drive market development in Central Asia. One of the few exceptions is the introduction of shelf-registration procedures for corporate bonds in Kazakhstan, which has supported market development. More then 90% of the volume of corporate bond is now registered under flexible bond programs. A similar approach should be considered for equity capital. With appropriate reporting requirements, shelf-registration will not lead to a loss of overview on the part of the regulatory body over the number and volume of securities in circulation.

## C. Market Infrastructure

72. From an international perspective, consolidation of market infrastructure has been the main trend over many years. This includes cross-border consolidation.[32] The purpose of consolidation is to have as many investors as possible trade on the same platform to realize economies of scale and reduce cost and fees. This tends to strengthen the competitiveness of a particular market in an environment of increasingly global financial flows. With regard to clearing and settlement of transactions, markets aim to be as close to real time verification as possible. Fully automated links between the trading system and the settlement system will generally assist in such verifications. A short settlement period helps to reduce the risk to participants. Settlement within three days after trading (T+3) is the standard time frame recommended by the Group of Thirty for equities markets.[33] Centralized securities depositories and registries, linked with the clearing and settlement system, provide a strong foundation for secure and efficient clearing and settlement.

73. The trend towards consolidation has yet to fully reach Central Asia. None of the exchanges in the region has a cross-border alliances with other exchanges within our outside the region. The exchanges are typically closed joint stock companies that are owned by local brokers and banks. The exchanges in Kazakhstan and Uzbekistan are partly state owned. Market infrastructure appears fragmented in Uzbekistan and particularly the Kyrgyz Republic. Both countries have more then one exchange for equity, and additional exchanges for debt securities and currency. In the Kyrgyz Republic, even the clearing and settlement infrastructure, including the depository system, is fragmented and only partly automated. Fragmentation compounds the problems both countries face due to the small size of their economies. These

[32] Examples are the establishment of Euronext by merger of the exchanges in Amsterdam, Brussels, and Paris in 2000, and its merger with the Lisbon exchange in 2002; the establishment of OMX in 2003 by merging the exchanges in Copenhagen, Helsinki, Iceland, Stockholm, and the three Baltic countries; and the merger of Euronext with New Year Stock Exchange in 2007.

[33] The Group of Thirty is a private, nonprofit, international body composed of senior representatives of the private and public sectors and academia. It has established a Financial Regulatory Systems Working Group to address the large changes in the world of financial reviews, including institutional reorganization, in light of the rapid evolution of international financial markets, which raises questions about the organization of supervision and regulation.

problems are reflected in relatively high cost for securities transactions. However, even in Kazakhstan, where market infrastructure has been successfully consolidated, transactions cost are high from an international perspective. High transaction cost can be seen as both, a result of or the reason behind the small number of deals at the exchanges in the region. In all three countries, settlement is undertaken on a gross basis (for each individual transaction) and typically on the day of trading (T-0). This seems adequate at this juncture as it reduces systemic risks and the number of transactions is small. However, it may become a constraint in future. Table 4 outlines key market infrastructure.

**Table 4: Key Securities Market Infrastructure**

| | Kazakhstan | Kyrgyz Republic | Uzbekistan |
|---|---|---|---|
| **Trade organizers** | One, with two trading platforms | Three for shares, separate one for government securities (and currency) | Two for shares, separate one for fixed income instruments |
| **Clearing & Settlement** | Gross; electronic | Gross; semi-electronic for market deals in shares, manual for direct deals in shares; electronic for bonds | Gross; semi-electronic |
| **Settlement Circle** | T+0/T+3 days | T+3 days | T+5 days |
| **International Custodian** | No | No | No |
| **Foreign Participation** | No | Yes, in two out of three trade organizers | No |
| **Foreign Exchange Controls** | No | No | Yes |
| **Trading System** | Electronic | Electronic at two exchanges, manual at the third | Electronic |
| **Central Depository** | Yes | No; three for shares (one per trade organizer) | Yes, for shares |
| **Trading Days per Week** | Five | Five at main exchange; others as needed | Five |

### 1. Kazakhstan

74. After being renamed and changing its profile several times since its establishment in 1993, the Kazakhstan Stock Exchange (KASE) has become the main trading platform for corporate and government securities (including securities of some international financial institutions), and money market transactions, which are primarily repurchase agreements collateralized with central bank notes, government securities, or corporate bonds. Foreign exchange and derivatives are also traded at KASE. However, the interbank market now accounts for 90% of foreign exchange turnover.

75. At end 2007, KASE was owned by 72 shareholders, which were 17 more then in 2006. Shareholders are primarily banks and brokerage houses. The National Bank holds a “golden share”, which means that decisions cannot be made against its will. KASE had 102 members, most of which were also shareholders. There are two listing segments at KASE, and a trading platform for non-listed securities. Members of KASE have to trade listed securities through KASE. Trading is undertaken via a remote access electronic trading system, which has been tailor-made for KASE. The system is regularly adjusted to changing requirements. Until 2006, the trading system crashed regularly. This has been reduced to about two crashes per year

according to information provided by KASE.[34] Technical problems are not necessarily due to capacity constraints at KASE. Weak overall telecommunication networks and services in Kazakhstan could be behind as well. Trading at KASE is electronic. However, confirmation of orders by hard-copies is a legal requirement. Brokers who accept orders by phone do this at their own risk. This does not facilitate active trading. Trading fees at KASE are high compared to large foreign stock exchanges in Russia and the Baltics.[35] While there are different view on current trading hours at KASE, low market liquidity and lack of order interaction seems to indicate that trading hours (11.30-17.00) are too long and/or the number of trading days (all workdays) is to high.

76. Kazakhstan has a Central Securities Depository, which was separated out of the National Bank in 1997. Its ownership overlaps with that of KASE. 61 organizations, mostly banks and brokers, had deposits at the Central Securities Depositary at end-2006. Clearing and settlement is fully electronic. It is done on a gross basis, i.e. for each individual transaction straight after it takes place (T+0).

77. In 2006, the Regional Financial Center Almaty (RFCA) was established by legislation.[36] It became operational in February 2007. RFCA was intended to be a separate part of the Kazakhstani financial market with simplified access for non-residents. The RFCA is managed by the Agency on Regulation of the Activity of the RFCA. This is a state body that was created by Presidential decree in February 2002 and reports directly to the President. The FSA is in charge for regulation and supervision of the RFCA. RFCA uses KASE infrastructure and is, de-facto, an additional trading platform of KASE. The only difference with regard to clearing and settlement is that RFCA has a settlement circle of three days (T+3). Due to limited listing and thin trading at RFCA, full integration of the platform into KASE is planned by end-2008. RFCA already represents NBK as shareholder. Full integration may include the unification of the listing and the extension of the tax benefits associated with listing at RFCA to all securities listed at KASE. The authorities have realized that the establishment of RFCA harbors the risk of market fragmentation.

### 2. Kyrgyz Republic

78. In light of the small number of securities market transactions in the Kyrgyz Republic, its trading infrastructure appears highly fragmented. The Kyrgyz equity market is split across three privately owned trade organizers. The first, Kyrgyz Stock Exchange (KSE), was established in 1996. KSE is owned by private investors, mostly brokers and banks. Most of the 32 licensed brokers and 28 dealers in the country are members of KSE. KASE and the Istanbul Stock Exchange are minority shareholders of KSE. However, KSE does not have a strategic alliance or any other form of systematic cooperation with these foreign exchanges. The second trade organizer, Stock Exchange Trading System (SETS), became operational in 2001. SETS has four owners and ten members. The third trade organizer is Central Asia Stock Exchange (CASE), which was established in 2005. Some of its five members are Russian owned brokerage houses. Two members of CASE are also represented at SETS. KSE does not allow its members to directly work at other exchanges. However, some members of KASE have

[34] According to a Market Model Review and IT Assessment, undertaken by OMX Technology in Kazakhstan in 2006, system uptime varied between 60-85%. This compared to an international industry standard of 99% OMX Technology is a division of OMX AB, a Swedish-Finnish financial services company. The other division operates seven stock exchanges in the Nordic and Baltic countries.

[35] According to a Market Model Review and IT Assessment, undertaken by OMX Technology.

[36] Through the Law on the Regional Financial Centre of Almaty and the Law on Amendments to some Legislative Acts regarding the Creation of the Regional Financial Centre of Almaty, both enacted in June 2006.

established subsidiaries for this purpose. Share transactions are required by a Presidential decree to take place through a licensed trade organizer or stock exchange.

79. Trading at KSE is undertaken via a remote access electronic trading system, which has been purchased from KASE against an ownership share. CASE's trading system was developed by a Russian company. SETS works fully manual. Only ten companies are listed at KSE, but most trading is in non-listed companies. The other two exchanges do not have a listing mechanism. After initially successes, SETS and CASE have been marginalized. In 2006-2007, KSE accounted for more then 90 percent of equity market turnover. CASE's trading system is switched on as needed, whereas KSE and SETS offer five trading days per week, despite the extremely small number of securities transactions (para. 29).

80. Trading in government securities, foreign exchange and money market instruments takes place at trading platforms inside the National Bank of the Kyrgyz Republic, i.e. the central bank, although KSE's trading software accommodates bond and currency trading, as can be observed at KASE. The central bank has been reluctant to authorized trading in government securities and foreign exchange outside its own trading platforms. This was mainly due to a perceived need to tightly control these markets, given their importance for achieving monetary policy objectives. However, a pilot project was launched at end-2007 under which treasury bills with a maturity of nine months are issued and traded at KSE.

81. The three trade organizers are each catered by their own (licensed) depositary. A fourth depositary (non-licensed) operates within the central bank for government securities. Depositary transactions are electronic. Clearing and settlement is semi-electronic. For market deals clearing takes place deal by deal through a bank (Aman bank), triggered by a depositary transaction. For registered deals, settlement is manual. The settlement of treasury bills traded at KSE is fully electronic.

### 3. Uzbekistan

82. There are two trading platforms for shares in Uzbekistan. The main one is the Republican Stock Exchange Toshkent (RSET), which was established in 1994 as an outlet for privatization of SOEs. The State Committee of Privatization still holds a sizeable ownership share in RSET. Since 1998, RSET is an open JSC. RSET's trading system is fully automated with remote access via satellite connections. The secondary market technology is based on XETRA, i.e. a trading platform that has been successfully implemented at an increasing number of stock exchanges worldwide.[37] RSET has branch offices in all 12 regions of Uzbekistan. It had 102 members at end-2007, mostly brokers and financial companies.

83. The second platform is Elsis-Savdo, which was launched in 2000, following a decision of an interministerial working group that a trading platform for smaller investors is needed. Further, in light of the small number of transactions at Elsis Savdo (about 1200 in 2007) and the average transaction volume ($60,000) Elsis-Savdo does not seem to be more focused on retail investors than RSET, where the average transaction volume was $11,000 in 2007 (both primary and secondary market for shares). The founders of Elsis-Savdo are the State Property Committee and a number of state-owned or state-controlled banks, including National Bank for Foreign Economic Activity (NBU), Pakhta Bank, Uzpromstroybank, and Galla Bank. The fully state-

[37] Xetra was created for the Frankfurt Stock Exchange. It is based on a system designed and built by Deutsche Boerse Systems. The Xetra system has been successfully implemented on the Irish Stock Exchange, Vienna Stock Exchange, European Energy Exchange, Budapest Stock Exchange, and a number of other exchanges. It will also be installed at Shanghai Stock Exchange in 2008.

owned NBU, which is the largest bank in Uzbekistan, is the dominating shareholder. The other banks are state-controlled. Elsis-Savdo works directly with investors, i.e. without intermediaries or brokers. It is, therefore, labeled formal OTC market. Elsis-Savdo has 15 order reception offices throughout Uzbekistan, all of which are embedded in branches of NBU. Transaction costs on Elsis-Savdo are substantially lower than on RSET. Elsis-Savdo has a tailor made, computer based trading system. However, there are plans to purchase internationally tested standard trading software by end-2008. Moreover, based on this software, Elsis-Savdo plans to establish a trading platform for corporate bonds by end-2008.

84. At end-2005, the Interbank Trading System (MTS) was established by the Uzbek Banking Association and a number of commercial banks, including, Asakabank, Ipak Yuli Bank, Ipoteka Bank, Kapitalbank, Halyk Bank, Microkreditbank, and Uzpromstroybank. Asakabank is the second largest bank in Uzbekistan and, like NBU, fully state-owned. The other banks are state-controlled. MTS became operational in November 2007 as a formal online trading platform for corporate bonds. Its software was purchased from the company "Easytrading". 14 banks and four brokerage houses participate in MTS. Three corporate bonds were listed at MTS at end-2007. However, there were only four transactions at MTS in 2007, three at the primary market and one at the secondary market. MTS's infrastructure is largely idle. This may be why MTS plans to allow trading in shares, i.e. enter into competition with RSET and Elsis-Savdo.

85. An informal OTC market (kerb market) existed before 2003 government resolution banned transactions outside RSET and Elsis-Savdo. Government bonds are traded at the currency exchange, which has an automated trading system. Around 50 individual brokers and brokerage houses are active in Uzbekistan, although a larger number has a license.

86. Uzbekistan has a two-tier depositary system, which consists of the State Central Depositary and 39 second-tier depositories (as of end-2007). Clearing and settlement of share transactions undertaken at RSET or Elsis-Savdo takes place through the agency Elsis-Clearing which cooperates with a number of settlement banks. Clearing and settlement is fully computerized. The settlement circle is T+5, but most transactions are settled after three days or less. Purchase of shares through RSET and Elsis-Savdo requires a 30% and 100% prepayment, respectively. For MTS clearance and settlement is undertaken by the banks that are involved in trading. The settlement circle is T+0. Prepayment is not required.

## D. Internationalization

87. Many smaller economies worldwide have increased investment opportunities, liquidity, and economies of scale by improving the access of foreign investors and issuers to the national markets. Internationalization of markets can lead to a virtuous circle of market development.

88. The Kazakhstani authorities have long acknowledged the potential benefits of internationalization for developing its financial sector and taken steps to establish Almaty as a financial hub for the wider Central Asian region, including parts of Russia. The establishment of the regional trading platform RFCA has to be seen in this context. However, RFCA has yet to make a significant contributed to internationalizing the market. In 2007, share turnover at RFCA was merely 1.3% of that at KASE and bond turnover was 9.3% of that at KASE. Further, most securities listed at RFCA were issued by domestic issuers, which have been attracted to RFCA by tax benefits. 24 of the 27 issuers listed at the regional trading platform were double-listed at KASE. Further, most investors are active both at KASE and RFCA. Ironically, the establishment of the regional trading platform may even undermine the internationalization of the Kazakhstani market: Spreading thin liquidity across two trading platforms and losing economies of scale

could lead to lower competitiveness of the market in general and, in turn, a loss of key assets to foreign markets.

89. However, from a broader perspective, has attracted foreign investors and even bond issuers. Among the foreign issuers where investment banks like JPMorgan Chase and Merrill Lynch, and international financial institutions such as Asian Development Bank, International Finance Corporation, or European Bank for Reconstruction and Development, which have all issued in Kazakhstan to finance local projects. These bonds are now typically bought by foreign institutional investors, which hold until maturity. Kazakhstani investors such as pension funds, which were initially interested, have long gained access to more liquid markets abroad.

90. There is foreign investment in Kazakhstani securities, but low equity market liquidity has been a deterrent. Foreign investors typically want to have easy market access and exit, which are not possible in the current market conditions in Kazakhstan. Further, the current settlement framework of T+0 is a constraint for internationalization of trading in Almaty. It is typically not possible for market intermediaries involved in a transaction to get cash from foreign investors within a day. Intermediaries, therefore, have to trade orders from foreign clients on their own books. This constraints market liquidity.

91. Foreign investors, therefore, typically invest in Kazakhstani securities that have been issued abroad. An increasing number of Kazakhstani companies have gone international by listing at foreign exchanges, usually in London, sometimes in Moscow.[38] At end-2007, eight companies from Kazakhstan were listed on the main market of the London Stock Exchange, were they had raised a total of over $4 billion since the first listing in October 2005.[39] Kazakhstani companies and the Government have also massively issued international bonds. By issuing securities in London, Kazakhstani issuers have benefited from better financial market regulation and supervision at this international market place and a broader investor base. However, in many cases, Kazakhstani investors, including pension funds, are behind investment in Kazakhstani securities issued abroad, although most of these securities are also listed at KASE.[40] It is, therefore, not entirely clear, whether the Kazakhstani issues abroad have helped to internationalize the domestic market or undermined its development.

92. In Uzbekistan, non-residents had 5,300 depositary accounts at end-2007. What is behind, however, is not a deliberate policy to internationalize the market. Instead, the authorities aim to increase foreign currency revenues by selling packages of selected SOEs to foreign investors, which are mostly foreign direct investors. There are special trading platforms at the exchange for privatization of SOE shares against US Dollars and the subsequent secondary market trading in these shares. In 2007, US Dollar trading accounted for 15% of primary market and 20% of secondary market turnover. However, foreign participation is clearly not driving the volume of securities issued in Uzbekistan nor their prices.

93. Foreign investment in Kyrgyz shares exists, but mostly with the aim to take over company control. Investors primarily come from Kazakhstan, People's Republic of China, and

[38] This is usually done through listing global depositary receipts that are backed by shares deposited in Kazakhstan.

[39] The list comprises three mining companies (ENRC Group, Kazakhmys, Kazakhgold), one energy producer (KazMunaiGas E&P), three banks (Kazkommertsbank, Halyk Bank, Aliance Bank), one manufacturing enterprise Kazakhstan Kagazy) and a construction company (Chagala). A number of smaller companies with operations in Kazakhstan have listed at a submarket of London Stock Exchange.

[40] Of the 232 bonds listed at KASE at end-2007, 22 were international bonds. They accounted for 43% of bond market capitalization at KASE, down from 62% in 2005.

the Russian Federation. Takeover efforts have occasionally driven market prices for individual companies. However, they have not driven market development in general.

## E. New Financial Products

94. Over the past 10-15 years, new financial products, and particularly derivatives, have played a major role in supporting market development in many developed economies and leading emerging markets. This trend has yet to reach Central Asia. First derivatives have been introduced in Kazakhstan over the past two years. These are primarily foreign exchange derivatives, which can build on the sizable and liquid local market for US Dollars. Over time, these instruments will facilitate the management of currency risks. However, to introduce derivatives on shares, bonds, or indices, building the liquidity of their underlying (spot) markets will be necessary.[41] In the Kyrgyz Republic and Uzbekistan, derivatives have yet to be introduced.

## F. Institutional Investors

95. Institutional investors such as pension funds, insurance companies, or other institutions offering contractual savings products or collective investment schemes are a driving force behind market development in many countries. In Kazakhstan, various types of institutional investors are active. Some of them, particularly private pension funds, have been driving the market for years. A number of banks have started to offer collective investment schemes, such as mutual funds, to help retail investors to achieve a diversified exposure to investment opportunities. In the Kyrgyz Republic and Uzbekistan, the institutional investor base has remained small and concentrated, and collective investment schemes have yet to be introduced.[42] Banks remain the most important investors in securities in all three countries.

### 1. Kazakhstan

96. Kazakhstan successfully launched a fully funded pension system in 1998. By end-2007, assets managed by the 14 pension funds increased to the equivalent of $9.9 billion (9.5% of GDP). During 2007, pension fund contributions by the over nine million participants were equivalent to $1.9 billion. This was equivalent to 1.8% of GDP and, thus, in line with the average of the five preceding years (1.7%). At end-2007, 32% of the pension fund assets were invested in corporate bonds, including 2% in mortgage bonds, and 25% in government bonds. 16% of the assets were invested in shares. Domestic pension funds are, thus, a key market player. The liquidity of the secondary markets for government securities and corporate bonds has significantly increased with the establishment of pension funds.

97. At end-2007, the total assets of the banking system (without the central bank) amounted to more then $97 billion equivalent, $6.6 billion of which (6.4% of GDP) were held in form of securities. While a portfolio breakdown is not available, it can be assumed that these were primarily domestic securities, including corporate bonds and shares.

[41] Even the more liquid Baltic markets still lack enough liquidity for supporting derivative markets.

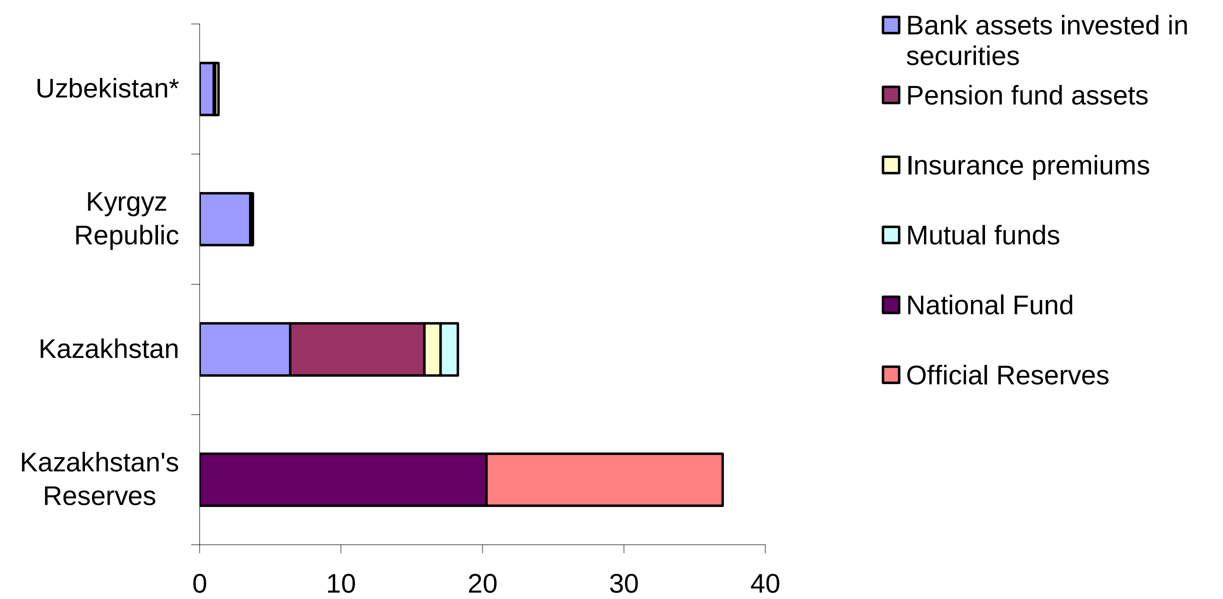
[42] Although shareholding of many JSCs is broadly divested, retail investors are not believed to play a significant role at the market at this juncture. Even in Kazakhstan with its relatively high per-capital to GDP level of almost $7,000 (per year), the number of retail investors is low and support offered by financial institutions to retail investors minimal. In the Kyrgyz Republic and Uzbekistan, GDP per capita is still below $1,000. The competitors for retail investment in securities in all three countries are bank deposits and real estate.

98. The same applies to insurance companies. Total insurance sector assets amounted to $1.8 billion equivalent at end-2007, of which 37% were held in form of securities. Insurance premiums were equivalent to $1.2 billion (1.2% of GDP) at end-2007. Premiums increased by $220 million equivalent (0.2% of GDP) in 2007.

99. The establishment of mutual funds started very recently in Kazakhstan. However, by end-[2006], 100 such funds had been established. They had $[1] billion equivalent under management. While a detailed portfolio breakdown is not available, a significant proportion of these assets were presumably invested in corporate shares and bonds.

100. NBK manages official reserves and the assets of the National Fund, which together amounted to $38.4 billion (37% of GDP) at end-2007. The investment policies and portfolios of official reserves and the fund are not yet disclosed. However, even if only a small proportion of assets managed by NBK is invested in domestic securities, NBK would be the largest institutional investor in Kazakhstan and very well able to drive the market (Chart 5).

**Chart 5: Institutional Investment (% GDP, end-2007)**




* Staff estimates.
Sources: Asian Development Bank, national regulatory bodies.

### 2. Kyrgyz Republic

101. Total assets of commercial banks in the Kyrgyz Republic were equivalent to $1.2 billion (31% of GDP) at end-2007. Of this, $118 million equivalent (3.6% of GDP) was held in form of securities. This included government securities equivalent to $60 million and corporate fixed income securities (presumably promissory notes) equivalent to $300,000, both labeled “held until maturity”. No breakdown is available for the remaining securities, which were held by banks “for trading purposes” or “for sale”. However, given the small size of the securities markets in the Kyrgyz Republic, commercial banks have the potential to drive them.

102. Other institutional investors are clearly not a driving force behind market development. The Kyrgyz insurance industry is small and insurance penetration is extremely low. At end-2006, insurance sector assets and premiums were equivalent to $11.6 million (0.3% of GDP) and $5.5 million (0.14% of GDP), respectively. There is only one fully funded pension fund in the country, which was established by a private company in 1994. At end-2007, the fund had 1,115 contributors and assets equivalent to $405,000. In the 1990s, 27 investment funds were established in the Kyrgyz Republic as part of the mass privatization program, which allowed the free use of vouchers by the Kyrgyz population. Five of these funds remain operational. Total assets under management were equivalent to about $300,000 at end-2007.

### 3. Uzbekistan

103. In Uzbekistan, commercial banks play a significant role at securities markets. Commercial banks account for most investments in bonds (and other fixed income securities), which they hold for liquidity management purposes, although banks typically invest only a small percentage of their assets in securities. In 2004, for instance, the total securities investment of four leading banks, namely National Bank of Uzbekistan, Asakabank, Pakhtabank, and Ipotekabank, was equivalent to $19 million (or 0.2% of GDP). This was equivalent to 24% of government and corporate bonds in circulation, but still less then 1% of the combined assets of these four banks.

104. The small amount of total assets of other institutional investors suggests that they are much less important than banks. Total insurance sector assets were equivalent to $150 million (less then 1% of GDP) at end-2007. Premiums collected in 2007 were equivalent to $56 billion (0.3% of GDP). The 13 investment funds, which were mostly formed in the 1990ies under the mass privatization program, had total net assets equivalent to $2.4 million at end-2007. There is also a state pension fund with assets equivalent to 0.1% of GDP. However, it is not allowed to invest in corporate securities.

## G. Privatization

105. An increasing number of counties, including successful developing economies like People's Republic of China, India, Malaysia, and Vietnam, and virtually all developed economies have realized that the sale of blocks of SOE shares to the public can increase the transparency of privatization and maximize the price of the sale of state assets over the medium and long term. Further, there is a broad consensus that privatization through stock exchanges can foster capital market development. Privatization of SOE shares through the capital market significantly increases the supply of shares while introducing market discipline to firms previously (or still partly) owned by the Government. This last aspect is particularly important for transition economies, which are typically under particular pressure to improve the performance of SOEs and generate investment opportunities for the private sector.

106. Privatization was the key factor behind the establishment of stock exchanges in Central Asia. Most exchanges were initially designed as privatization outlets. Until now, many share issues remain related to privatization. Nevertheless, privatization has not significantly increased market capitalization and failed to contribute to sustainable market development. This is mainly for two reasons. First, while large scale privatization programs have been repeatedly approved in most Central Asian countries, the majority of large JSCs are still SOEs. In Kazakhstan and Uzbekistan, 75% of registered shares are state-owned. For the Kyrgyz Republic, the ratio is estimated at 40-60%. In addition, some very large SOEs have yet to be corporatized, i.e. transformed into JSCs. [Add information!]

107. Second, privatization has not been designed to contribute to capital market development. SOEs have been sold through stock exchanges, but rather on an exceptional basis (at least in Kazakhstan and the Kyrgyz Republic) and mostly without a listing. Privatization policies generally foresee the privatization of (potentially) well performing large enterprises, but mostly by direct sale to so-called strategic investors. Such investors are either difficult to attract to Central Asia, or backed by foreign groups that have direct access to financial markets abroad, i.e. do not need domestic markets. If privatization through the capital market is part of these policies, then mainly for less well-performing, medium-sized companies. Such enterprises frequently do not even attract domestic investors, and if they do, have limited scope for issuing securities.

108. Apart from having a negative impact on capital market development, this approach to privatization also has negative fiscal and governance implications. It tends to lead to implementation problems including the failure to privatization (hence, many companies are still state owned), breeds corruption, and depresses prices for state-owned assets.

109. In conclusion, privatization policies in Central Asia have yet to take into account that well-prepared, sequenced sales of blocks of SOE shares to the public can increase the transparency of privatization, strengthen governance and performance of SOEs, maximize the returns of the sales of state assets over the medium and long term, and drive capital market development.

## V. CONCLUDING REMARKS: DEVELOPING CAPITAL MARKETS IN A SMALL COUNTRY

110. The findings presented above (mainly in Part III and IV) raise a fundamental question: To what extend are capital markets in Central Asia actual markets. While the number of large JSC is significant in all three countries, comparatively few of them are listed. Further, in light of the substantial capital market development efforts that have been made in the region over the past 15 years or so, the contribution of capital markets to resource mobilization for productive investment appears small. Furthermore, due to substantial problems related to price determination, it is questionable whether capital markets in Central Asia have a significant positive impact on efficient resource allocation at this juncture.[43] Are the countries in Central Asia to small to develop efficient capital markets?

111. Market size clearly matters. Larger markets tend to be more efficient than smaller ones due to economies of scale. Larger markets offer larger scope for risk diversification. Investment in market infrastructure pays off more quickly if market turnover is larger. Investors are more easily attracted to larger and more liquid markets that help them to reduce transaction and opportunity cost. Lack of investment opportunities within a small market reduces the market attractiveness for investors and limits market development. This, in turn, affects the willingness of issuers to use the capital market, thus creating a vicious circle. Why, then, should further efforts be made to develop capital markets in Central Asia?

112. The author proposes five main reasons for an affirmative answer:

[43] This refers to the direct effects of fair market prices on financial intermediation through capital raised by issuing securities and the indirect effects such market prices have, for instance, by influencing lending decisions of commercial banks.

(i) Capital market infrastructure does exist in Central Asia, so does a large number of broadly divested open JSCs. This alone necessitates a degree of attention for sound securities market regulation and supervision.

(ii) An increasing number of companies actually issues securities to mobilize capital. In 2007, the amount of capital raised through securities issues was equivalent to four to five percent of GDP in Kazakhstan, around two percent of GDP in the Kyrgyz Republic, and one percent of GDP in Uzbekistan (Chart 6 below).

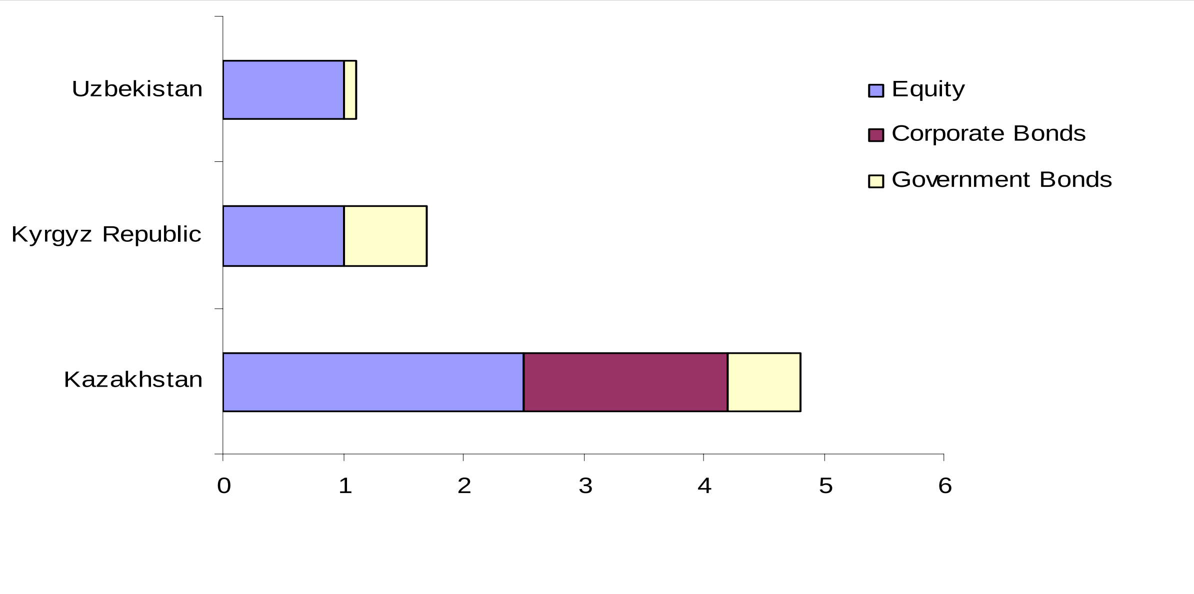
(iii) Developing capital markets in smaller economies does not necessarily pose insurmountable problems, as evidenced by the many small economies worldwide that have successfully developed capital markets.

(iv) Many of the problems that have constrained capital market development in Central Asia so far (as outlined in Part III and IV above) are policy, legal, and regulatory issues than can be addressed by the respective governments and regulatory bodies.

(v) Not developing capital markets means depriving a country of the benefits that are associated with market development, namely increasing the quantity and quality of investment and reducing risks by diversification. Mobilizing capital through securities is a much needed complement to bank lending. Banks can typically not provide much needed equity capital. Further, banks can typically not provide the equity and long-term debt finance that is needed for large infrastructure projects.

(vi) Neglecting the development of capital markets would also have negative implications for the banking sectors in Central Asia. Banks are among the most active issuers of securities. Many banks in the region promote securities markets to diversify their income base. Most securities exchanges in the region are at least partly owned by banks, either directly or through subsidiaries.

**Chart 6: Capital Raised through Securities Issues (2007, % GDP)**




Sources: Asian Development Bank Staff estimate.

113. What should be the key features of a capital market development strategy in Central Asia? – Smaller countries clearly have to make special efforts to overcome the disadvantages

associated with the small size of their domestic market and its limited scope for risk diversification, or at least mitigate its negative effects. One solution would be to integrate the local market into a well developed nearby market. However, being afar from the European Union and established financial centers in Asia, full integration into these large and well developed markets does not seem to be an option for Central Asian countries at this juncture.

114. Another solution is to increase the size of the domestic market by opening up for foreign investors and issuers. Good examples for this approach are Malaysia, where most bonds are now issued by international issuers, or Australia and New Zealand. In Kazakhstan, an effort is underway to establish a regional financial center in Almaty that caters investors and issuers from Central Asia and parts of Russia. First steps have been taken, a learning process is taking place, and initial mistakes are apparently being addressed. The domestic market in Kazakhstan, although small, is the largest in the region. This may facilitate the development of a regional financial hub, since regional centers benefit from the presence of deep local markets.

115. However, it is too early to assess whether the efforts in Kazakhstan will lead to bottom-up financial integration through a financial hub that successfully competes for foreign issuers and investors. Remaining weaknesses in the regulatory and supervisory framework for securities markets in Kazakhstan will have to be addressed to ensure that they do not continue to undermine the competitiveness of Almaty as a marketplace and limit its scope for internationalization. Further, if foreign investors and issuers actually start gravitating towards Almaty, which has yet to happen, their home governments may have to be persuaded not to take steps to hamper this process. The issue is that establishing Almaty as a financial center for issuers and investors from other countries in the region challenges vested interests in these other countries. Further, policy and law makers may see the risk of losing national decision-making power. Indeed, the more investors and issuers from country A depend on services provided by country B, the stronger the impact on country A of decisions made in country B. The successful internationalization of a market, therefore, requires mutual trust and confidence, which has to be further strengthened in Central Asia.

116. The question, therefore, remains whether the size of individual countries in the region is sufficient to become a thriving market place on their own. Most Central Asian countries already have a basic legal, regulatory, and institutional infrastructure that can be used to further develop local markets. That does not necessarily preclude regional efforts to coordinate capital market development, including regional knowledge sharing in the area of legal and regulatory reforms. Such coordination may ultimately even prepare the ground for (partial) regional integration. However, for the foreseeable future, the emphasis of capital market reforms in most Central Asia countries will, in all probability, be on preserving and further developing local markets.

117. A good starting point for successful local market development initiatives would be to fully acknowledge that small size is a disadvantage. Fully digesting this reality may help policy and law makers, regulators, and trade organizers to understand that they have to undertake special and concerted efforts. Simply speaking, capital market developers in Central Asia can be only successful, if they are better then their counterparts in larger counties. Examples for this are, again, Malaysia, and, even more spectacularly, small city states like Hong Kong or Singapore.

118. In light of the findings of this paper, the following areas may have to be prioritized to accelerate capital market development in Central Asia:

(i) **Market infrastructure.** Smaller markets cannot afford the luxury of fragmentation. Activities need to be concentrated as much as possible to justify investment in market infrastructure, including trading, clearing, settlement, and depositary systems. Concentration of activities helps to realize economies of scale and reduce transaction costs. Lower costs will tend to increase liquidity and allow much smaller average sizes of issues to be competitive against bank lending.[44]

(ii) **Legal and regulatory framework.** The shortcomings of the legal and regulatory framework, which are frequently more than residual, need to be addressed. That should include making adequate use of SROs, starting with stock exchanges, to bridge enforcement gaps that lawmakers and regulators may not be able to close. Further, taking regulatory steps to encourage order-book trading, at least for shares of public companies, is essential for increasing market transparency and investor protection. The structure of fees for security trading could also be changed to align block trading with order-book trading, or at least reduce the dominance of negotiated deals. In contrast, informal trading in shares issued by closely held companies and bonds should be allowed.[45] This should be complemented by other measures of deregulation, including simplified disclosure requirements for private placements of securities and shelf-registration for bond and equity issues.

(iii) **Privatization policies.** Policies for SOE privatization through stock exchanges should be developed in line with international best practice. Such privatization should take into account market conditions and investor demand, and the need to achieve a balance between shares offered in international financial centers and shares offered domestically. The potential benefits of a more capital market oriented privatization approach include (a) higher prices for shares and, thus, higher budget revenues, since investors will tend to pay more for shares if they have a credible expectation that additional packages will be offered in the foreseeable future up to a specified minimum total; (b) increased market liquidity and lower volatility through a significant increase in supply of shares, which should facilitate overall capital market development, (c) improved performance of enterprise managers by introducing market discipline to companies even if they are still partly state owned; and (d) limiting the scope for corruption by increasing transparency of privatization and reducing discretion of civil servants involved. The policy may also foresee offering SOE shares through a book building process to domestic institutional buyers, so they exist, and allow the use of shelf-registrations procedures. This will increase the efficiency of the process.

(iv) **Institutional investors.** Deepening local capital markets requires measures to enlarge the investor base. Capital market development in Kazakhstan has significantly benefited from successful pension reforms. Where pension reforms are believed to be too time consuming and/or politically too difficult to manage, given their social and fiscal implications, the further development of the insurance industry and mutual funds may produce quicker results.

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[44] From the very beginning, the largest segments of trading at Kazakhstan Stock Exchange have been currency trading and trading in government securities. This is the main reason why KASE has been profitable and able to invest in infrastructure. Trading in government securities at KASE is primarily related to liquidity management of banks. In other words, the infrastructure of the exchange is not only the backbone of capital markets in Kazakhstan but also an integral part of currency and money markets. This is a good example for efficient use of market infrastructure. The decision to allow at least some trading in government securities at the Kyrgyz Stock Exchange since early 2008 is, therefore, clearly a step into the right direction.

[45] However, reporting requirements for such trades (type, amount, and price of securities traded) should be established to provide a minimum level of transparency.

119. Capital market development in Central Asia has great potential benefits and is, perhaps, a necessity. However, measures to accelerate market development have to be taken quickly, or else issuers and investors will gravitate towards better developed market in other countries and regions. This is, however, realistic only for larger companies. Medium-sized and smaller enterprises would be left behind.