A pan-Baltic capital market: Sign of progress towards a European capital markets union

The establishment of a pan-Baltic capital market proposed in a recent Memorandum of Understanding between the region's states may be credit positive, according to Scope Ratings. Stronger liquidity may benefit growth and financing availability. The initiative is part of a wider EU plan to create a Capital Markets Union by the end of 2019.

The 6 November 2017 agreement between Latvia (A-/Stable), Lithuania (A-/Stable) and Estonia (A+/Stable) was signed with a view towards developing their capital markets through increased co-operation, as well as designing and implementing strategies to facilitate demand, supply and infrastructure growth.

Key to this is to promote a pan-Baltic asset class, as well as regional legal and regulatory frameworks for covered bonds and structured products, including securitisation. The development of the legal framework and design of the regional asset class will take priority in the development phase and is supported by the EBRD. While there is currently no timeline for this development, expectations point to issuance of pan-Baltic bonds in 2019.[2] The project also conforms to Structural Reform Support Programme guidelines. This development is part of the EU's plans to create a capital markets union in Europe by the end of 2019.[3]

The memorandum also commits to developing new capital market instruments as an alternative to the banking sector that includes equities, derivatives, and other listed vehicles. The Baltic countries are already leaders in FinTech development. The potential for application of distributed ledger approaches (Bitcoin and other cryptocurrencies) to financing has also been emphasised.

If the successful implementation were to lead to a significant increase in the depth of the region's capital markets and a broadening of credit sources, this may lead to a long-term improvement in assigned ratings, according to Scope. The full implications and development of this common market will take time to unfold and for now has no effect on the ratings. In its 2018 Public Finance Outlook, Scope wrote that institutional reform, including the completion of the EU's Banking and Capital Markets unions, is the key area to watch for potential positive rating drivers across the euro bloc of nations.

The dismantling of existing investment barriers is also a stated goal. The memorandum supports increasing financing options for small and medium sized enterprises (SMEs). This should help overall economic development, as smaller companies have provided the largest number of jobs and economic growth during the last decade, with constraints on financing often cited as a limit on growth.

In Scope's opinion, the development of common Baltic financial instruments and a common capital market, while welcome, does not alone point to greater political union. While sharing a common past, major differences remain that argue against enhanced political union beyond that which is already envisaged within Baltic membership in NATO and the EU.

Scope recently updated and rated the three countries: Estonia (A+/Stable), Latvia (A-/Stable) and Lithuania (A-/Stable). More details on these ratings can be found on Scope's website.

[1] Adèle Chevreau also contributed to this report
[2] http://www.thebanker.com/World/Central-Eastern-Europe/Estonia/Baltics-take-first-step-towards-regional-capital-market?ct=true
[3] http://www.consilium.europa.eu/en/press/press-releases/2017/11/20/capital-markets-union-agreement-reached-on-securitisation/#

Analysts[1]

John F. Opie
+49 69 6677389-13
jf.opie@scoperatings.com

Levon Kameryan
+49 69 6677389-21
l.kameryan@scoperatings.com

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Investor Outreach

Michael Pinkus
+49 30 27891 146
m.pinkus@scoperatings.com

Related Research

2018 Public Finance Outlook: European resilience but rising global risks
23 November 2017

Scope Ratings AG

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone + 49 69 6677389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Baltic region convergence

Size of the pan-Baltic market similar to Slovakia

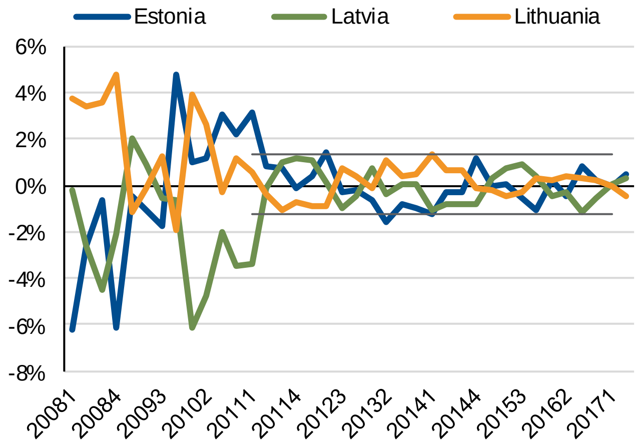
Together, the Baltic countries had an annualised real GDP in Q2 2017 of more than EUR 77bn, with Estonia representing 24.3%, Latvia 29.4% and Lithuania 46.3% of this total. The region's GDP is larger than that of Slovakia or Ukraine, but smaller than that of Hungary. The Baltic average GDP per capita was just over EUR 12,000, below Slovakia. Worker mobility, despite cultural differences, is high. A theoretical pan-Baltic covered bond market for securitised mortgages is estimated at around EUR 18bn, between that of Hungary and Slovakia[4].

The Baltic region, while made up of inherently disparate nation-states with different development issues, has seen significant convergence due to increasing trade and interdependence.[5] The high degree of similarity goes beyond GDP and includes highly correlated private consumption, investment, public consumption and both labour markets and trade. The correlation between the Baltic countries is also much stronger than that within Scandinavia.

There remain, however, asymmetries: Estonia is most exposed to changes in international commerce; Lithuania is less vulnerable to business cycle shocks, but is vulnerable to changes in both Latvia and Estonia; Latvia is least vulnerable to individual shocks, but is vulnerable to Baltic-wide shocks.

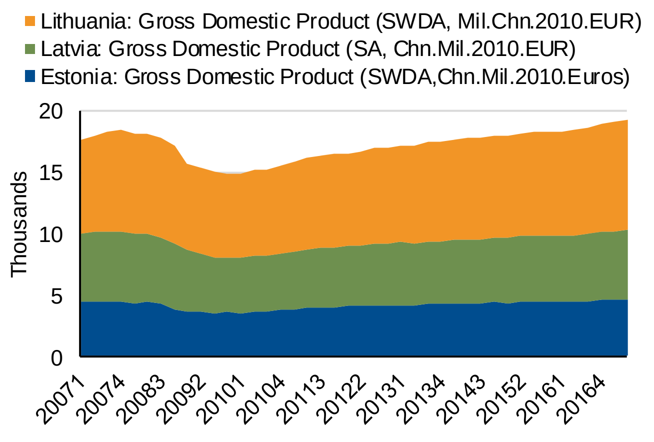
The following charts show the overall growth and convergence within the region. As can be seen in the detrended cyclical position, which subtracts a common weighted growth rate from individual country growth rates, there has already been marked convergence. Since 2011, real national growth rates have been within ±1.3 percentage points of one another. The total nominal GDP of the three nations can be seen in Figure 2.

Figure 1: Detrended real growth rates



Source: Haver Analytics, Scope Ratings AG calculations

Figure 2: Baltic region total nominal GDP, EUR Bn



Source: Haver Analytics

[4] http://www.thebanker.com/World/Central-Eastern-Europe/Estonia/Baltics-take-first-step-towards-regional-capital-market?ct=true
[5] See EC Economic Brief 024/April 2017: The Baltics: Three Countries, One Economy?

Infrastructure projects likely to lead capital market development

Increasing trade and interdependence, including in energy infrastructure

To enhance regional convergence and development, stronger ties may be expected in, for example, infrastructure projects, especially energy infrastructure. While projects of the last several years have already improved interconnectedness, the energy markets of the three countries remain neither adequately interconnected nor adequately linked to those of other neighbouring countries.

The Baltic Energy Market Interconnection Plan (BEMIP)[6] aims at addressing such problems: removal of cross-border restrictions on energy trade; establishing common energy reserves; removing regulated energy tariffs including the opening and liberalisation of retail markets; and integration with the common Nordic energy plans (Nordic Master Plan, which includes connecting Estonian and Finnish electrical nets, as well as Lithuanian and Swedish).

While the financing of infrastructure development will come largely via earmarked EU funds, there is considerable potential demand for new capital instruments going forward. The memorandum of understanding signed by the three Baltic countries underscores their commitment to the European Capital Market Union (CMU)[7], which aims to deepen and integrate capital markets to provide greater choice and lower cost of funding, provide new opportunities for savers and investors within the EU, supporting growth and job creation. The sharing of private risk via the completion of the Banking and Capital Markets unions should help address fundamental challenges facing the EU from low investment levels, low private risk sharing and limited fiscal risk sharing. All Baltic countries would stand to benefit from this development.

Developing the Baltic capital markets

Financial sector concentrated, dominated by Nordics

According to the IMF[8], the financial sector in the Baltic countries is largely bank-based, with non-bank financing only 4% of GDP in Latvia, 10% in Lithuania and 17% in Estonia, well below averages in the emerging markets in Eastern Europe. While the banking sector has developed strongly, it remains highly concentrated, with the largest banks either subsidiaries or branches of Nordic institutions[9], providing most credit to the private sector in all three countries.

Bond markets in general are largely undeveloped with relatively low turnover. In Latvia and Lithuania, public bonds dominate the debt market, but in Estonia, without public bonds, non-financial corporate bonds dominate. The undeveloped status is primarily the legacy of the boom-bust phase of the 1990s that led during the bust phase to largely illiquid markets. Given both the dependence on bank credit and economic cycle of the 1990s, credit has been slow to recover in the Baltics after the GFC[10]. Credit-weak recoveries are generally more fragile and tend to follow significantly deeper recessions than other rebounds.

As growth in the Baltics remains, to a certain degree, constrained by credit supply[11], increasing the breadth of the financial market by via pan-Baltic bonds may lead to stronger economic expansion and less dependency on banks for credit supply. The individual capital markets of the Baltics are small and lack depth.

[6] https://ec.europa.eu/energy/en/topics/infrastructure/baltic-energy-market-interconnection-plan
[7] The CMU is the EU's initiative to tackle investment shortages and diversify the funding sources for Europe's businesses. Further financial integration and complementary bank-financing with alternative sources of finance, including capital markets, venture capital, crowdfunding and asset management, not only widen access to finance but also mitigates the impacts of domestic banking crises.
[8] IMF, Baltic Cluster Report, 2014 Cluster Consultation, IMF Country Report No. 14/117
[9] Swedbank (Sweden), SEB Bank (Sweden), DNB (Norway), Nordea Bank (Finland) are the major banks in the Baltics
[10] Great Financial Crisis, 2007-2011
[11] Credit institutions tightened lending standards severely during the GFC in the Baltics, but have not significantly relaxed these after the GFC, leading to a tightening of the credit supply. The effect in Estonia is less than that in Latvia or Lithuania.

Looking forward, constraints on the supply of capital to SMEs is a concern, as these firms, especially in the small and developing economies of the Baltics, underpin most economic growth and, at the same time, are most vulnerable to bank credit constraints. Given that the Baltic capital markets, taken individually, are too small to support stronger economic development, Scope views the creation of a common debt instrument, which may then be securitised to pool bonds issued by Baltic SMEs together to mitigate concerns about credit risks, to be positive.

The general framework for capital markets in the Baltics is in place, as these are already highly integrated and there is a common Nordic-Baltic trading system[12], allowing market participants to access and trade all Nordic and Baltic securities lists and indexes. Central securities depositories (CSDs) in the Baltics are also highly integrated. The implementation of the euro area single securities settlement infrastructure (Target 2 Securities, TS2) was completed in 2017.[13]

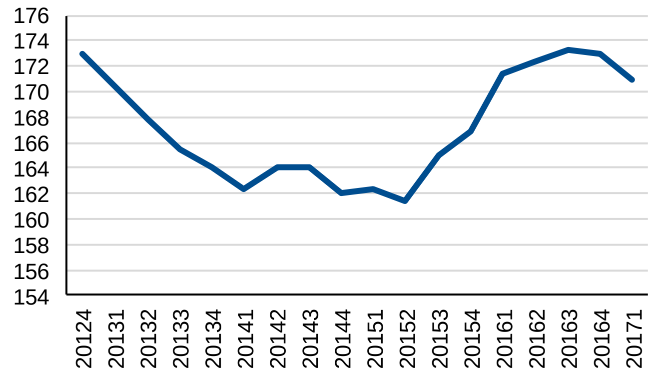
A hypothetical Common Baltic market

Shallow capital markets on a stand-alone basis

While a common Baltic capital market does not exist right now, it is useful to consider what the total – private and public – debt position would look like if it did. Estonia is the smallest of the markets for non-financial corporate debt, with only around 10% market share in a common Baltic market, with both Latvia (46%) and Lithuania (43%) holding significantly larger proportions.[14]

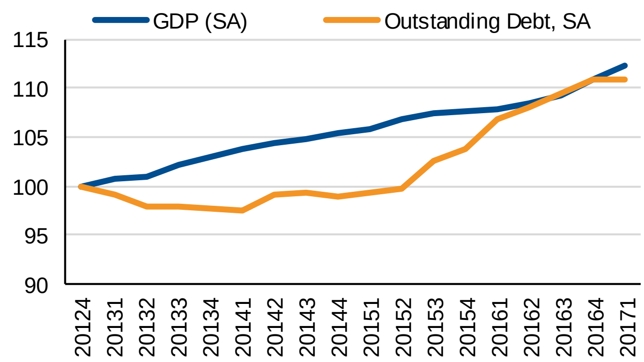
The recent path of overall outstanding debt (the sum of both government and private debt) is somewhat of a concern. After falling modestly from the end of 2012 through the middle of 2015, growth in the region's overall debt has picked up again, reflecting increased borrowing as economic growth picked up. The relationship between GDP growth and debt (Figure 6) shows that while debt increases slowed in the years following the GFC, cumulative growth in overall debt has caught up with GDP growth.

Figure 5: Common Baltic market, overall debt, % of GDP



Source: Source: Haver Analytics, Scope Ratings AG calculations

Figure 6: Common Baltic market: GDP and overall debt



Source: Source: Haver Analytics, Scope Ratings AG calculations

Consolidating debt as a percentage of GDP, aggregated using constant long-term GDP weights, shows the position and development of a common Baltic debt market: one with currently moderate levels of consolidated private (corporate and household) debt, which after exceeding 100% of GDP in 2009 fell to more moderate levels thereafter, reflecting an overall sound position of non-government debt in the region.

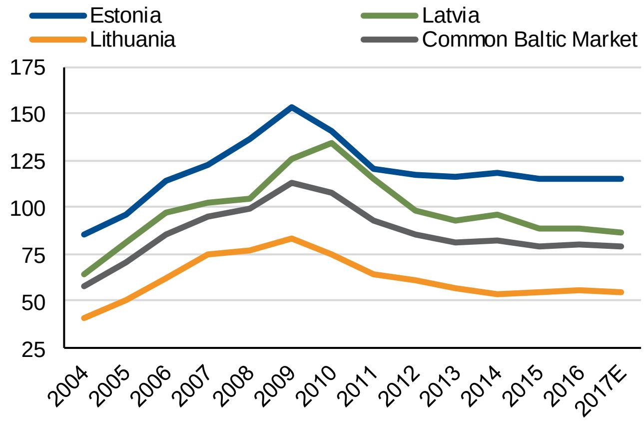
[12] Nasdaq OMX group, INET trading program since 2010

[13] https://www.bank.lv/en/about-us/structure/governor/speeches/10985-target2-securities-an-opportunity-for-the-baltic-capital-market

[14] Estonia has not issued sovereign debt instruments in recent years due to the relatively high underwriting and transaction costs involved for a small country and the ready availability of bank financing for the sovereign. Estonia is, in this respect, unique in Scope's universe of rated countries. There has been, however, a marked increase in Estonian non-financial corporate debt levels over the last several years, from just over EUR 63.6bn outstanding in 2012 to an estimated EUR 73.6bn in 2016, with an average compound annual growth rate of 3.1%. This increase underscores the clear demand for greater access to financing from the non-financial corporate sector.

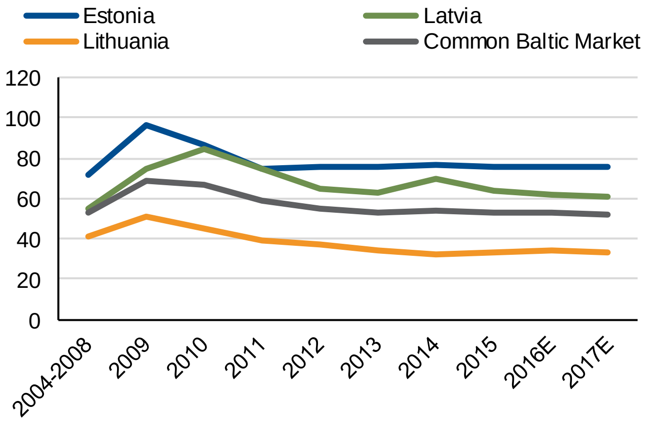
This also holds true for consolidated non-financial corporate debt, which has held steady at under 60% of GDP in recent years. The overall position of private sector debt in a common market would therefore be robust, indicting room for further debt market development supporting growth should plans for integrated markets move forward.

Figure 3: Consolidated private debt, % of GDP



Source: Source: Haver Analytics, Scope Ratings AG calculations

Figure 4: Consolidated non-fin. corporate debt, % of GDP

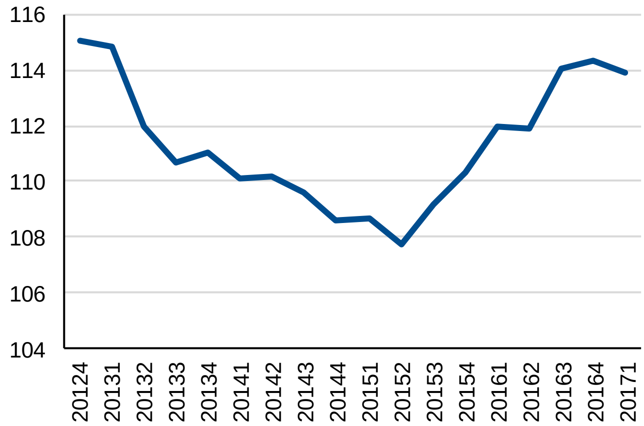


Source: Source: Haver Analytics, Scope Ratings AG calculations

Sound debt positions in a hypothetical pan-Baltic market

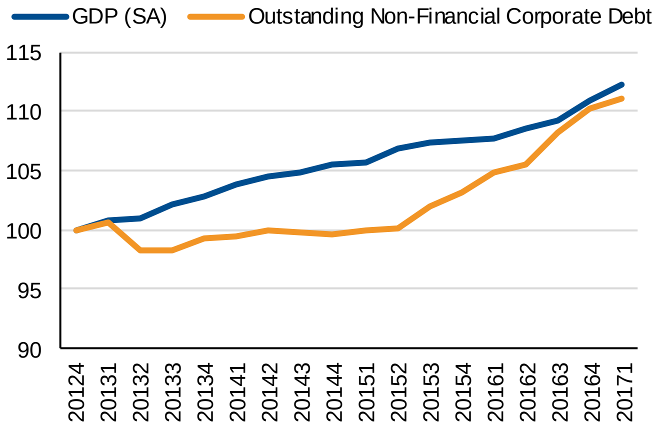
Higher demand for debt is reflected in the strong increase in non-financial corporate debt in the last several years. Here, outstanding levels had similarly stagnated in the years after the GFC until 2015 (Figure 8), when debt increased by over 8.5%. Scope expects the financing needs of non-financial corporations to continue to rise, albeit not quite as strongly as in the recent past, going forward. The introduction of a common Baltic covered bond would increase the instruments available, but it is too early to tell what the overall effect may be, given the need to establish the new instrument and test market acceptance. The potential, however, to help meet growing demand for financing, especially as the basis for securitised instruments, is significant.

Figure 7: Common Baltic market, non-financial corporate debt, % of GDP



Source: Source: Haver Analytics, Scope Ratings AG calculations

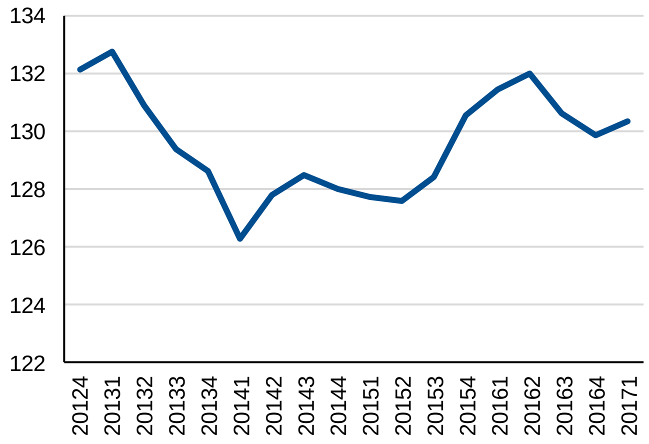
Figure 8: Common Baltic market: GDP and non-financial corporate debt levels



Source: Source: Haver Analytics, Scope Ratings AG calculations

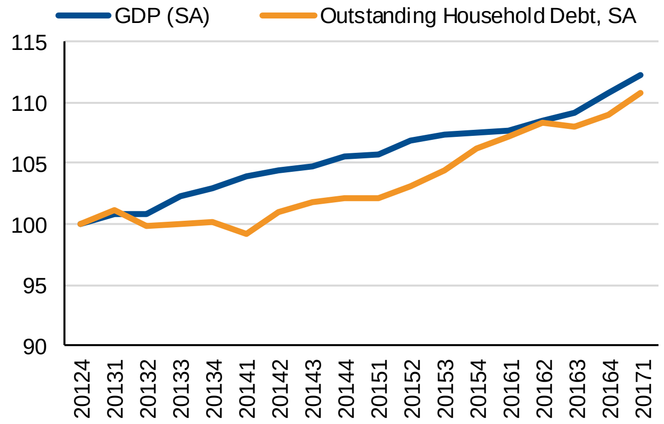
Developments in household debt in relation to GDP are less volatile (Figures 9 and 10) than those in non-financial corporate debt, reflecting the growth in both wages and employment since 2012 during a long upswing period in the region.

Figure 9: Common Baltic market, household debt, % of GDP



Source: Haver Analytics, Scope Ratings AG calculations

Figure 10: Common Baltic market: GDP and household debt levels



Source: Haver Analytics, Scope Ratings AG calculations

Rating implications of a pan-Baltic market

While the development of a pan-Baltic capital market is aimed primarily at improving non-financial and private lending, sovereign lending would also benefit from an increase in the depth of capital markets, improving market access and funding sources. In Scope's recent rating actions for the three Baltic countries, market access and funding sources for the sovereign were given a neutral assessment. Were analysts to decide that there has been a significant improvement in this risk assessment, this could, for each of the Baltic nations, contribute to a one-notch improvement in the rating, all else being equal.

The creation of pan-Baltic debt instruments may lead to increases in Baltic non-financial private indebtedness. This would be outweighed by the benefits to economic growth.

Given the very preliminary status of the process – the memorandum of understanding is just the first step in developing a pan-Baltic capital market – the time horizon for a rating change is long-term. While none of the Baltics explicitly has improved access to capital markets as a rating trigger, other rating drivers would be indirectly impacted.

Estonia has both strong growth without imbalances and the closing of the productivity gap as a rating trigger. Hence improved access to funds and strengthening of the capital market in general would contribute positively to more balanced growth and increased productivity. For Latvia, improvements to potential growth – a current credit weakness – may help the sustainability of Latvian debt. For Lithuania, a deepening and strengthening of capital markets may lead to an improvement in potential growth outlook, which is here a positive rating trigger.

Scope Ratings AG

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris
33 rue La Fayette
F-75009 Paris

Phone +33 1 82 88 55 57

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

Disclaimer

© 2018 Scope SE & Co. KGaA and all its subsidiaries including Scope Ratings AG, Scope Analysis GmbH, Scope Investor Services GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope cannot however independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided "as is" without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or otherwise damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party, as opinions on relative credit risk and not as a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings AG at Lennéstraße 5, D-10785 Berlin.