Executive Summary

Financial markets in smaller economies are much less developed than in other countries. The underdevelopment of these markets impedes risk transfer, monetary policy, corporate financing, and the capacity to absorb capital inflows. Further, the gap between the development of financial markets in smaller economies and emerging market countries looks to be widening. This gap suggests that the social rate of return on financial market development in smaller economies could be high. However, there has been very little cross-country analysis, or even data collection, on this topic.

This paper aims to serve as a first step toward formulating policies to develop essential smaller economy financial markets by documenting the stylized facts and presenting a framework for assessing the policy issues. It is meant to inform regular financial market surveillance and technical assistance, and be helpful to central banks and government agencies. The paper draws on Financial Sector Assessment Program (FSAP) documents, technical assistance reports, IMF country reports, and central bank websites and documents in order to provide the appropriate cross-country data on smaller economy markets.

The experience of essential financial markets in 107 smaller economy countries is the basis of this paper. The essential markets are the foreign exchange market, which any country with its own currency will have; money and secondary government securities markets, because they are crucial for monetary policy and government financing; and stock exchanges, owing to their role in corporate financing and risk transfer. Regional market integration is also addressed, given its potential to overcome the diseconomies of scale that mark most smaller economies. The 107 countries were chosen based on size and level of development; inevitably, they cover a wide range of development, but can be deemed as facing at least some inherent impediments. Some of them have successfully developed their essential financial markets and thus offer positive policy lessons.

The main theme of this paper is that market development policies should be realistic and tailored to the unique circumstances of smaller economies. In the early stages of market development, governments must take the lead, but as markets develop the market players themselves should take over. Enhanced effectiveness of monetary and fiscal policy is a clear motivation for market development policies.

Stylized Facts

Smaller economy markets are generally smaller and provide a narrower range of services compared to those in other countries. The available information on money and foreign exchange market volume indicates that these markets are thin and narrow. Just 25 percent of smaller economies have secondary government securities markets developed enough to involve foreign institutions. Only 40 percent of smaller economies have a stock exchange, and trading in many of them is so low that their economic impact is minimal. At the same time, some of the larger smaller economies have fairly developed markets that provide a wide array of benefits. Regional integration, so far, has had mixed success in deepening markets in smaller economies.

Many of the obstacles to the development of essential financial markets in most smaller economies are intrinsic, but others can be addressed by policy measures. Intrinsic obstacles include small and uncompetitive banking sectors, highly concentrated economies, and the low number and small size of smaller economy companies. Structural obstacles that can be addressed by policy over the long run include structural excess liquidity, and dollarization. The limited number and competitiveness of smaller economy financial market players and weak financial information disclosure comprise institutional constraints that can be addressed in the medium term. Market development can also be impeded by policy rigidities under the direct control of the authorities and a lack of political will and vested interests.

Policies for Market Development

The drivers of *foreign exchange market* development shift from the government to the central bank to the market players themselves as the market deepens. In the early stages, the government removes impediments such as foreign exchange surrender requirements and tight capital controls. Reorienting the central bank from a market-limiting to a market-supporting role is the next step, which means scaling back direct central bank control of market flows, establishing a market-friendly trading mechanism, shifting the market-making function entirely to banks, and setting up market-based foreign exchange operations. The last phase is market-driven deepening with the authorities' role largely limited to prudential requirements in support of stability. Even in a fixed exchange rate regime, policies can facilitate price discovery within the trading band, and can facilitate the transition to a flexible exchange rate.

The drivers and policy strategies of *money and government securities market* development, which are considered jointly in this paper, follow a similar logic. Policies for the initial development market phase, which mainly involves interbank deposits, tend to focus on government measures to remove impediments and develop the banking system. Once regular trading of securities begins, the central bank, in close coordination with the government and banks and nonbank financial intermediaries, facilitates development by shifting to market-supporting monetary operations. Market players themselves take the lead for formal and sophisticated markets, with the central bank using market-based monetary operations and public agencies working together to ensure stability.

Equity markets are somewhat different from the other essential financial markets in that the market players themselves play a bigger leading role and government policies cover a wider spectrum. Most smaller economies do not have an active stock exchange. For these countries, the primary issue is to establish alternative sources of corporate financing, such as angel and private financing. As markets develop through regular trading, policies should focus on institutions and basic corporate governance. Finally, deep and active secondary market development is led by the market players themselves, with different government agencies improving the provision of information and fostering market stability.

Regional integration has the potential to address some of the obstacles to market development by alleviating diseconomies of scale, but the experience so far has been limited. Regional integration is generally a complement rather than a substitute for local markets. Most cases of successful regional integration are market-led and involve equity markets. Government intervention can be effective when the interests of individual market players conflict with market integration. The preconditions for successful integration seem to be regional economic and political linkages, developed and integrated banking sectors, already existing local markets, and political support to overcome vested interests. Smaller economies may be better off joining an already existing regional market that has already realized the requisite scale economies, rather than trying to integrate small markets across countries.