Small Steps

The fine balance of developing financial markets in small economies: payoffs with a dose of realism

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A clerk marks prices at the stock exchange in Mbabane, Swaziland.

FINANCIAL markets in smaller economies have the potential, in theory, to provide important benefits. These include more effective monetary and fiscal policies, higher risk transfer, increased corporate financing, and greater integration into the world economy. But the analytical foundations for what it takes to develop financial markets in smaller economies is limited because cross-country research so far has focused on financial market development in advanced and emerging market countries. Moreover, the policies needed to develop financial markets in smaller countries tend to be more country specific because small economies are quite different from one another (see box).

This article addresses that analytical gap and suggests policies for developing "essential" financial markets—foreign exchange, money, government security, and equity—in small economies. These markets are essential because they provide the most basic level of financial services. This article also outlines a sequence of steps that small countries can follow, while recognizing that one-size-fits-all approaches do not work for these countries.

Shallow markets

Financial markets in small economies are generally smaller and provide a narrower range of services compared with those in larger economies. Foreign exchange markets in small economies have much lower turnover compared with emerging market countries, and fewer than 50 percent conduct forward transactions (a purchase or sale of currency in the future according to an exchange rate determined beforehand). Money markets are thin, with most dominated by overnight interbank cash transactions. Just 25 percent of small economies have secondary government security markets developed enough to involve foreign institutions. Only 40 percent of small economies even have a stock exchange, and trading on many of those exchanges is so low that the economic impact is minimal. Regional integration, so far, has had mixed success in deepening markets. Still, there are positive examples, and some small economies (Croatia and Jordan) have fairly developed markets that provide a wide array of benefits.

Why are financial markets in small economies underdeveloped? Many small economies face intrinsic obstacles that are largely beyond the control of policymakers. Banks are the linchpin of market development because they are the main players in most financial markets. However, banking sectors in most small economies are small and uncompetitive: the median number of banks is six and an even smaller number tend to dominate the banking sector. An undiversified real economy also limits the opportunities for risk transfer. State-of-the-art infrastructure and sophisticated regulation may not pay, given the smaller size of the economy. The low number and small size of companies is another inherent obstacle.

Policy measures can help overcome other obstacles to market development. Excess liquidity in the banking sector, which puts all banks on the sell side of money markets, and dollarization, which reduces the scale of local currency financial transactions, can be addressed through appropriate policies implemented over the long run. Institutional constraints, such as a limited number of financial market players and weak disclosure of financial information practices, can be eased over the medium term. Market development can also be impeded by policy rigidities under the direct control of the authorities, and by a lack of political will and vested interests of those who would not benefit from market development.

Which are the smaller economies?

Smaller economies are defined here as countries with GDP and per capita GDP below a certain threshold that can be seen as marking limits on the potential development of their financial markets. A review of basic information on financial markets suggests that most countries below the thresholds of $40 billion for GDP and $10,000 for per capita GDP have relatively underdeveloped financial markets and, in many cases, are lacking markets altogether.

Smaller economies account for 2 percent of world GDP: their total population is 960 million, or 15 percent of the world total. The smaller economies encompass a wide range of countries. A number of the smaller economies have some developed markets and either have joined the ranks of emerging market countries or have the potential to do so. At the other end of the spectrum, 36 smaller economies have a population of less than 1 million, indicating that economies of scale will be difficult to attain.

What works and what doesn't

How can small economies benefit from promoting financial sector development? Much can be gleaned from the experience of individual countries, cross-country comparisons, and work done at the IMF and elsewhere.

The drivers of ***foreign exchange market*** development shift from the central bank and government to the market players as the market deepens. In the early stages, the government removes impediments, such as foreign exchange surrender requirements and tight capital controls (Uganda). The next step is reorienting the central bank from a market-limiting to a market-supporting role, as in the former Yugoslav Republic of Macedonia. This entails scaling back direct central bank control of market flows, establishing a market-friendly trading mechanism, shifting the market-making function entirely to the market, and setting up market-based foreign exchange operations. The last phase is market-driven development, with the authorities' role limited largely to prudential support (Serbia).

The development of ***money and government security markets*** should be integrated because banks tend to dominate both of these markets, the same infrastructure usually supports both markets, and they have a joint role in monetary and fiscal policies and operations. Policies for the initial development market phase, which involve mainly interbank deposits, tend to focus on government measures to remove impediments and develop the banking system, as in Botswana. Once regular trading of securities begins, the central bank, in close coordination with the government and market participants, can boost development by shifting to market-supporting monetary operations (Tunisia), such as repos, and to market-supporting fiscal financing, such as market-driven treasury bill auctions (Serbia). Market players themselves take the lead for formal and sophisticated markets, with public agencies working together to ensure systemic 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. For small economies without an active stock exchange, the primary challenge is to establish alternative sources of corporate financing. As markets develop regular trading, policies should focus on institutions and basic corporate governance, as in Croatia, Mauritius, and Kenya. Finally, deep and active secondary market development is led by the market players themselves, with various government agencies improving the provision of information and fostering market stability (Jamaica, Jordan, and Sri Lanka).

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 mixed. The broad 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. Regional integration should generally complement local markets rather than replace them. Most cases of successful regional integration have been market led and involve equity markets (the Baltics). Government intervention can be effective when the interests of individual market players conflict with market integration. Joining an existing regional market that has already realized the requisite scale economies may make more sense than trying to integrate small markets across countries.

What are the lessons?

The overarching lesson is that market development policies should be realistic and tailored to the often unique circumstances of smaller economies. Effective implementation of such policies can involve three steps. First, a more active market must be judged as viable—that is, there must be enough players to form both sides of the market on an ongoing basis. Second, the broad benefits of realizable market development over the long run must be deemed to outweigh the costs to the public sector. For many small economies, the opportunity costs of expending scarce government financial and human resources on market development can be high. Finally, any potential implications for systemic financial stability of a more active market must be fully factored into policies.

What about alternatives to financial markets if development potential is limited or risky? Tapping the full capabilities of the banking sector can help make up for a lack of developed markets. For example, banks can offer money and foreign exchange products to help corporations manage liquidity. Government policies that promote market-based bank lending can make up for a shortfall of equity financing. Wealthy individuals and small groups of specialized investors are alternative sources of corporate financing that can be promoted by government policies.

Finally, should the current financial turmoil compel a rethink of the role of financial markets in small economies? So far, the impact on smaller economies of global market stress operating through financial linkages seems to have been moderate, owing largely to the relatively small role of private capital flows for these countries. Moreover, financial institutions in smaller economies did not purchase the toxic assets that contributed to the stress in advanced and many emerging market economies. Thus, the ongoing problems in advanced and emerging market economies do not seem to alter the broad case for developing markets in smaller economies. Smaller economies are probably best off sticking to the basics and exploiting their own market potential to the maximum. ■

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