DEUTSCHE BUNDESBANK
EUROSYSTEM

Financial market development: Areas for action

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Aim of presentation

- **Reflect on how development of financial markets can generally be promoted**
- **Identify and categorize areas for action to develop financial markets**
- **Reflect on roles and initiatives of different market players/agents for financial market development**
- **Reflect on how reforms and measures to promote financial market development should be sequenced**

Financial market development: Areas for action

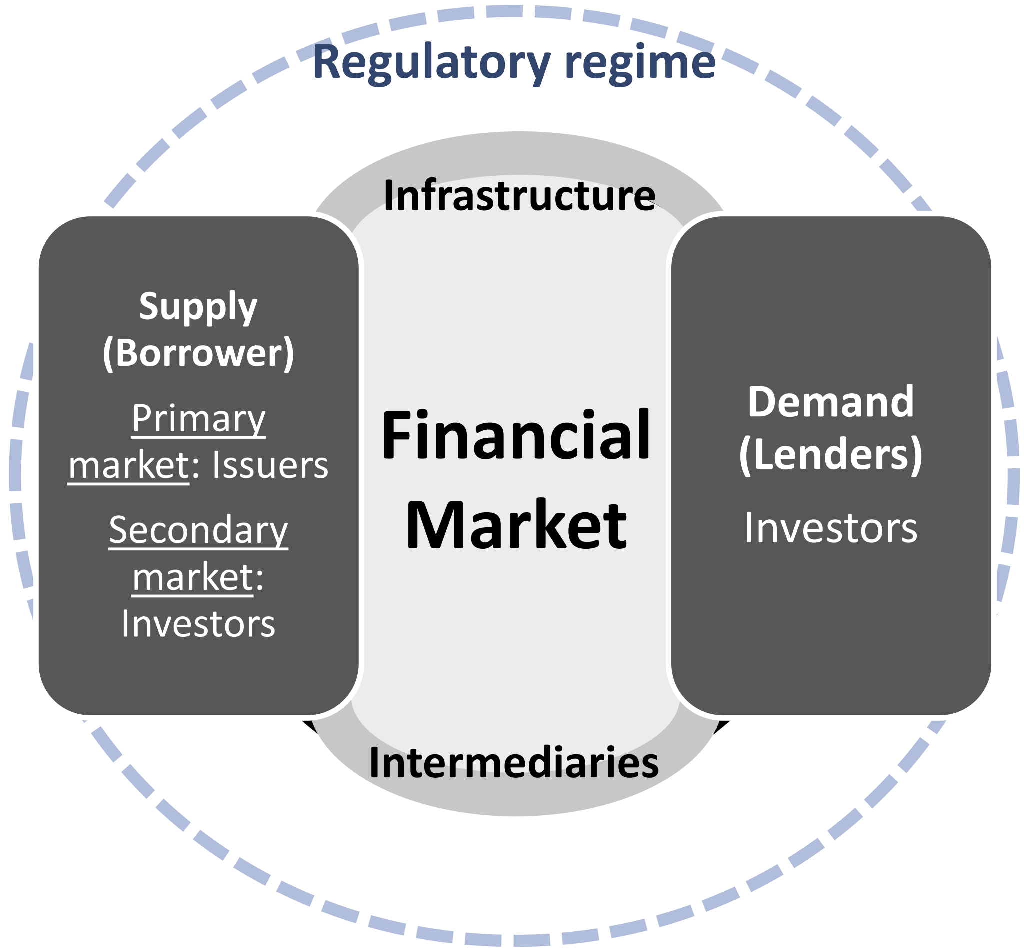
REFLECTION

- **What are key issues/common weaknesses with regards to financial market development?**
- **Which measures have been taken in your countries/by your CBs to promote financial market development?**

How to promote financial market development? An overview of areas for action

How to promote financial market development - Areas for action
RECAP: Characteristics of efficient functioning financial markets

- **Functioning financial markets build on „the four Is“**
  - **Issuers** with short, medium and longer-term financing needs (→ supply)
  - **Investors** with a need to place savings (→ demand)
  - **Intermediaries** bringing issuers and investors together
  - **Infrastructure** providing conducive environment for transactions, settlement and price discovery
- **… in the context of a regulatory regime providing the basic framework**



How to promote financial market development - Areas for action
RECAP: Characteristics of efficient functioning financial markets

What is financial market development trying to achieve?

(1) Competitive market structure

(2) Low transaction costs

- incl. search/information costs, legal costs, transaction & settlement costs, etc.)

(3) Accurate, widely available information

- in particular, accurate pricing of financial assets

(4) Investor protection

(5) Robust/safe market infrastructure

(6) Heterogeneity among market participants

(7) (Low level of fragmentation)

Financial market development: Areas for action

CASE STUDY

- **How can financial market development be actively promoted? What do country reports identify**
  - as **particular weaknesses** in financial market development
- **… and suggest**
  - as **areas for action** to promote financial market development?
  - as **specific policy/reform measures** to promote financial market development?

➡ANNEX

Financial market development: Areas for action
Instruction

CASE STUDY

Read through the text material taken from IMF country reports which you have been given and extract any information you can identify which fits into the following matrix

Issue/Weakness	Area for action	Specific measures

How to promote financial market development - Areas for action

- **No one-size-fits-all solution, but several important building blocks that could be useful in designing policies geared toward closing financial development gaps in LAC and to promote the development of well-functioning financial markets**

Strong property rights	Efficient legal system	Low incidence of corruption
Sufficient financial information	Good corporate governance	Sound prudential regulation and supervision

How to promote financial market development - Areas for action
Market-specific recommendations

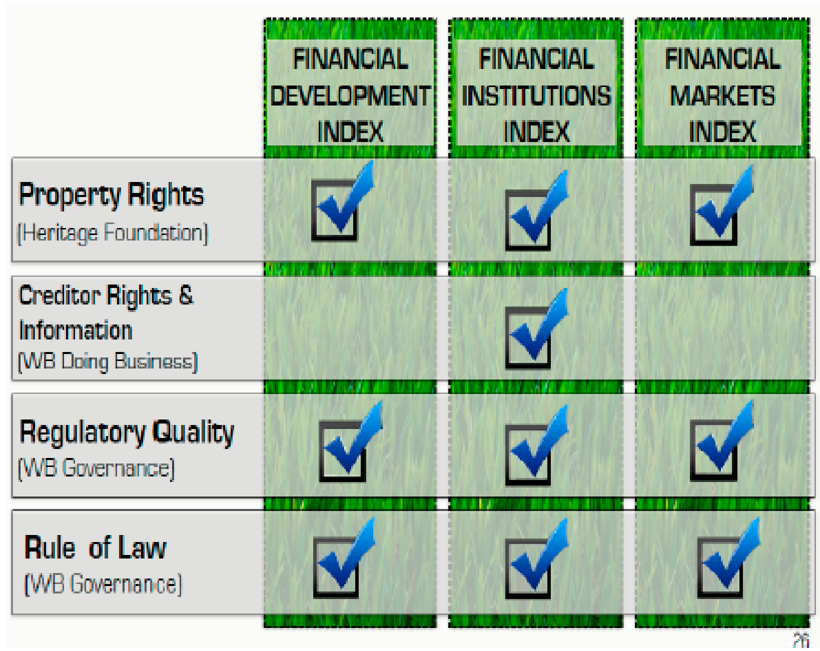
- **Countries with underdeveloped bond markets could benefit from following market-friendly debt management and issuance strategies to help foster secondary markets for government securities such as the use of standardized simple instruments with conventional maturities, as well as strengthening legal and regulatory frameworks**

- **Countries with underdeveloped or inefficient stock markets, could benefit from strong macroeconomic environment, institutional and legal frameworks, which promote investor rights, information disclosure, as well as policies that increase market size (e.g., pension reforms, carefully sequenced financial liberalization, corporate governance and tax reforms)**
  - However, in smaller LAC economies developing domestic equity markets may not be justified due to the small market size.
  - Hence, a careful investigation of specific country circumstances with the view of identifying constraints, including those outside of the financial sector such as poor corporate governance, as well as tradeoffs is needed.

How to promote financial market development - Areas for action
Regulatory environment: Creating an enabling environment

- **Strong positive correlation between financial market development and the regulatory framework**
  – Better protection of property rights, creditor rights and information, and higher regulatory quality and rule of law—are positively associated with greater financial development, both in the overall FD index and with regard to institutions and market (Sahay, Ratna et. al. 2015)

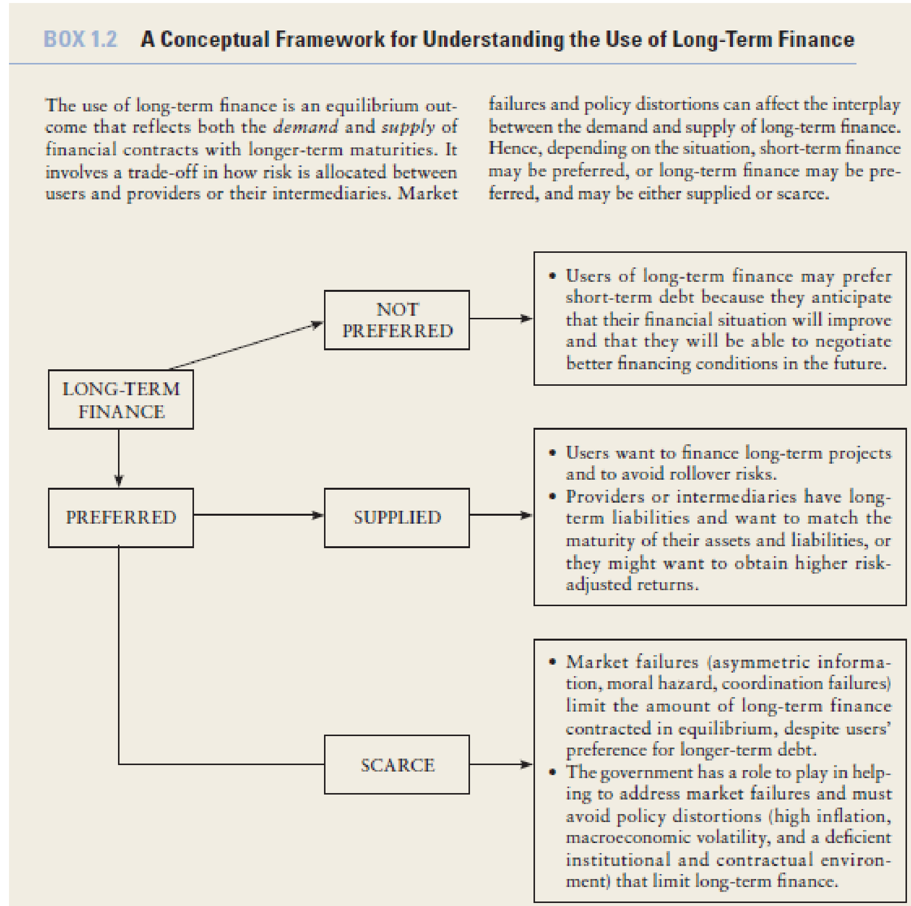
Figure 14. Role of Regulation in Financial Development



Source: IMF staff estimates.

How to promote financial market development - Areas for action
Supply and demand: Example of long term finance

- **Development of deep capital markets is an outcome that reflects both demand for and supply of long-term finance (i.e. financial contracts with longer maturities)**
- **Issue to address: What promotes demand and supply for long term finance?**


BOX 1.2 A Conceptual Framework for Understanding the Use of Long-Term Finance

The use of long-term finance is an equilibrium outcome that reflects both the *demand* and *supply* of financial contracts with longer-term maturities. It involves a trade-off in how risk is allocated between users and providers or their intermediaries. Market failures and policy distortions can affect the interplay between the demand and supply of long-term finance. Hence, depending on the situation, short-term finance may be preferred, or long-term finance may be preferred, and may be either supplied or scarce.

Source: The World Bank (2016): Global financial development report 2015/2016

How to promote financial market development - Areas for action
Special issue: Developing a yield curve

- **Developing a (benchmark) yield curve is an important step in promoting market development**
  - It is decicive for the pricing of financial instruments over different maturities and thus for market activity as willingness to transact depends on price setting (ability)
  - Important financial market indicator from a monetary policy perspective: Main use is to obtain the term structure of interest rates, which can be interpreted in terms of market expectations of monetary policy, economic activity and inflation expectations over short-, medium- and long-term horizons
- **Yield curve development depends on numerous factors**
  - Ability (of CB) to control short term rates
  - Ability (of CB) to guide market expectations about future interest rates
  - Ability (of CB) to influence the price setting along different maturities

Sequencing of reforms

Sequencing is the setting of priorities among financial sector measures, and the appropriate sequencing and coordination of reforms.

Sequencing of reforms
Motivation & objective

- **Financial market development requires a wide range of policy actions, as well as structural and institutional reforms**

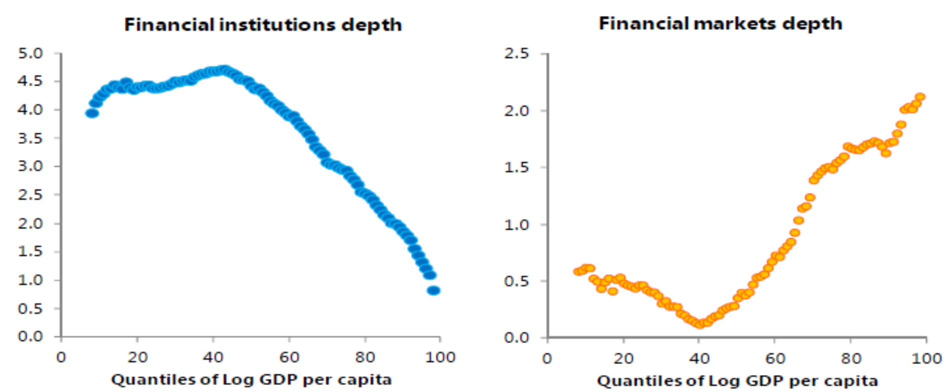
- **Sequencing is important for the following reasons:**
  - Inappropriate sequencing of reforms could cause excessive risk taking and financial instability
  - Limited institutional capacity necessarily requires some prioritization of reform elements - appropriate sequencing and coordination of reforms will facilitate implementation of reforms
  - Given wide range of policy and reforms, setting priorities could facilitate and encourage adoption of reforms

- **Goal of orderly sequencing of policies/reforms is to safeguard monetary and financial stability during financial liberalization and financial sector development**

Principles of sequencing: Developing institutions vs developing markets

- **Proper sequencing would emphasize developing institutions in the early stages, with increasing attention to developing markets as income per capita rises**
  - Benefits from developing financial institutions are larger at low income levels and decline as income increases, whereas the opposite is true for markets

Figure 9. Income Effects of Financial Deepening at Different Levels of Development



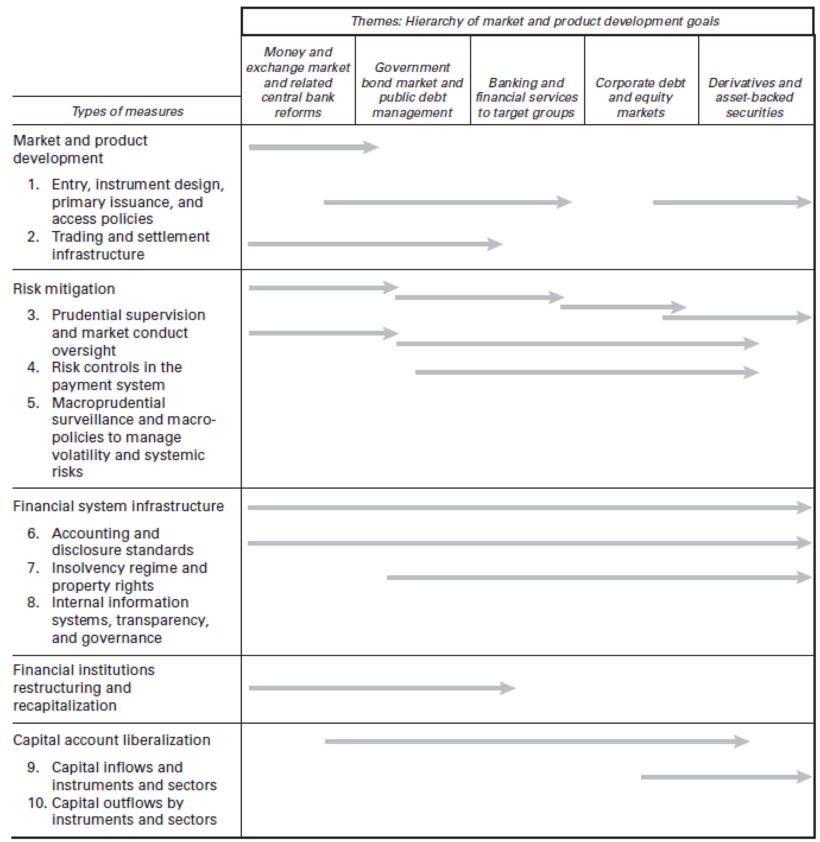
Source: IMF staff estimates.

Source: Sahay, Ratna et. al. (2015)

Sequencing of reforms
Principles of sequencing financial market development

- Different markets (e.g., money, exchange, bond, equity, and derivatives) and various financial products and services that need to be developed may be **hierarchically ordered according to the types and complexity of risks** to be managed when particular markets or products develop and expand, and on the scope of institutional preparations needed for good governance.

Figure 12.1. Financial Development: Stylized Sequencing of Reforms



Note: Arrows represent the listing measures under each theme.

Source: Karacadag, Sundararajan, and Elliott (2003).

Sequencing of reforms
Examples

- **Building and strengthening short-term money markets and risk management in such markets** can set the stage and can facilitate the development and effective risk management—both financial and macroeconomic—of longer-term and more-risky securities
- **Measures to develop government bond markets**, such as promoting primary dealers to provide market-making services, are generally facilitated by the availability of active money markets that are based on treasury bills or other instruments for pricing corporate bonds and other more-risky securities and derivative products, thus facilitating risk management
- **Measures to strengthen the access of target groups** such as rural areas and small firms are medium-term goals that follow a strengthening of the basic banking, money, and government securities markets that help manage macroeconomic risks

Key takeaways

References

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ANNEX: CASE STUDIES - Areas for action to promote financial market development

CASE STUDIES - Areas for action to promote financial market development
Bahamas (IMF Country Report No. 19/199)

- **The financial system operates under weak monetary policy transmission with an underdeveloped securities market, common features in small open economies with pegged exchange rates and strong capital controls**

- **The authorities are undergoing a revamping of their sovereign debt institutional arrangements, issuance strategy, and market infrastructure. Their goal is to promote domestic debt market development by establishing a debt management office within the MOF.**

- **Increasing domestic sovereign debt issuance is an important long-term goal for improving the risk profile of the sovereign, and would also benefit domestic pension and insurance companies, which have few sources of long-duration assets in a small closed financial system. Increasing issuance may be challenging in the short-term given a lack of scale.**

- **The Bahamian presence in the Eurobond market should also be maintained. The authorities may wish to explore increased access to the Eurobond market for domestic investors, provided this does not materially impact the balance of payments.**

Financial market development: Areas for action
Barbados (IMF Country Report No. 14/53)

- **Public debt increased to 128 percent of GDP at end-September 2013, from 55 percent at end-2007.** Although vulnerabilities are tempered by comfortable levels of liquidity in the financial system and capital controls, tensions are emerging in the maturity and the profile of public debt. Domestic financial institutions, including the National Insurance Scheme (NIS) and banks, have been purchasing an increasing share of government securities. Banks have been cautious about taking additional government securities, while capacity of the NIS to absorb additional securities might be limited by balance sheet constraints. High public debt may impair the government's ability to credibly support the financial sector should the need arise.

- **Barbados' sovereign rating was downgraded to non-investment grade** by Moody's and Standard&Poor's in 2012 and again by two notches (to Ba3 and BB-, respectively) in December 2013, both currently with a negative outlook. These actions were predicated on deteriorating growth prospects, inadequate policies, and fiscal imbalances.

- A US$500 million Eurobond offering, announced on September 30, was withdrawn in part due to unfavorable market conditions, but the government was subsequently able to secure a loan commitment of up to $225 million from Credit Suisse.

Financial market development: Areas for action
Barbados (IMF Country Report No. 14/53)

- **Liquidity conditions have been loosened considerably by the CBB in response to the government's funding needs.** In April 2013, the CBB made the 3-month T-bill rate its benchmark and removed the floor on deposit interest rate (except for savings deposits). Under this policy, CBB purchased about 44 percent of T-bills issued in the first 11 months of 2013 directly in the primary market causing yields to decline by nearly 50 basis points. The lending margin (difference between weighted average loan and deposit rates) has gradually declined by 100 bps to below 6 percent since its peak in 2009, reflecting both supply and demand factors.

- **Capital controls have been in place since the adoption of the Exchange Control Act in November 1967.** These include the requirement to register (at the CBB) large capital inflows, including FDI. There are no restrictions on the making of payments and transfers for current international transactions subject to approval under Article VIII. There are exchange controls on some invisibles, but bona fide transactions are approved.

- **The CBB pegs the exchange rate to the U.S. dollar, but external imbalances have widened and foreign reserves declined considerably in 2013.**

CASE STUDIES - Areas for action to promote financial market development
Brazil (IMF Country Report No. 18/339)

- **While financial markets—particularly derivatives—are liquid, concentration is high and government securities play a key role in systemic liquidity management.**
  - BCB term deposits will be useful as a small-scale fine-tuning sterilization tool, but limited for structural sterilization purposes as most banks use government securities repos to channel funds between related investment funds and the BCB. Adjustments to legislation should be considered to allow the BCB to issue securities for structural sterilization and to broaden investor access to the FX spot market for hedging. The overnight unsecured interbank rate is thinly traded and should be replaced by the SELIC government securities repo rate as a benchmark rate.
- **Improving the financial intermediation efficiency, reforming the role of public banks and developing the long-term fixed income market are crucial to improve the efficacy of the financial sector and increase productivity growth.**
  - Government debt securities are the centerpiece of the fixed income market and are the single most important asset class held by investment funds, pension funds and insurance companies.
  - Coordinated actions are required to develop the fixed income market including BNDES operating under a project-finance financing model that engages investment partners, and revamping tax incentives that would lengthen the maturity of open pension funds "liabilities" and increase the appetite for and supply of long-term funding.
- **Financial markets are dominated by short-term assets and derivatives instruments.**
  - Shorter-term floating rate or inflation indexed securities are the predominant asset class, in part reflecting Brazil's history of high inflation. Most instruments are indexed to overnight secured (SELIC) or unsecured (CDI) interest rates. Liquidity is concentrated in the overnight markets making longer-term markets more prone to liquidity fluctuations. FX and fixed income derivatives markets are relatively large and play an important role in shifting risk from risk averse domestic retail investors and pension funds to other domestic institutional and foreign investors and in price discovery.

CASE STUDIES - Areas for action to promote financial market development
Brazil (IMF Country Report No. 18/344)

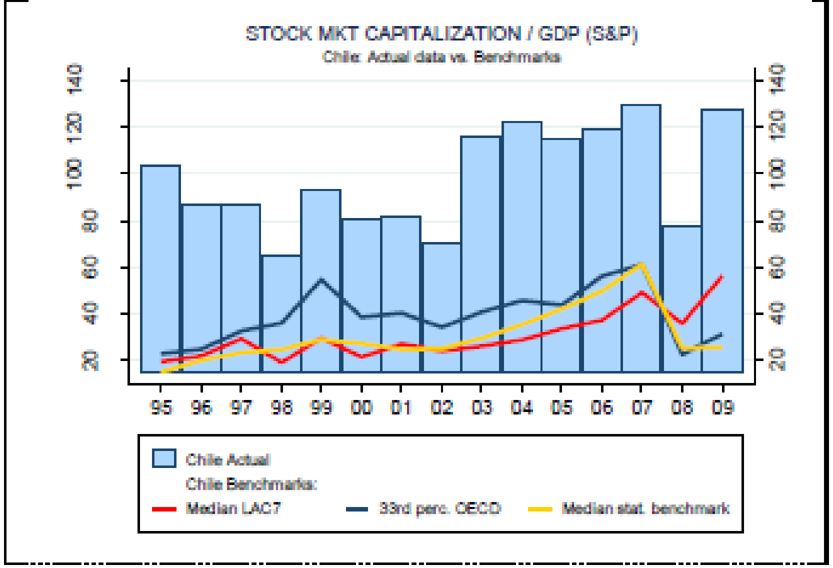
- **Financial markets primarily feature short-term assets and derivatives instruments**
  - The size of financial markets has grown to about 210 percent of GDP. Brazil's history of macrofinancial instability and high inflation has driven investors towards short-term floating-rate or indexed securities, with the latter mainly linked to inflation or exchange rate. In the money market, with the size of 28 percent of GDP, most instruments are indexed to overnight secured (Selic) or unsecured (CDI) interest rates.
  - The corporate bond market is small, with outstanding corporate debt securities of 11 percent of GDP.
  - Government debt securities amount to 52 percent of GDP. Liquidity is mostly concentrated in the short-end market, making longer-term instruments prone to market volatility.
  - Stock market is similarly small, with market capitalization of 39 percent of GDP.
  - Derivatives markets are relatively large, with outstanding contracts amounting to 81 percent of GDP. They play an important role in shifting risks from risk-averse retail investors to institutional investors. Foreign exchange derivatives are heavily traded in Brazil, as regulatory constraints limit nonbanks' participation in the spot foreign exchange market.

	2007				2012				2017			
	Number of Institutions	Financial sector assets			Number of Institutions	Financial sector assets			Number of Institutions	Financial sector assets		
		R$ billion	Percent of total	Percent of GDP		R$ billion	Percent of total	Percent of GDP		R$ billion	Percent of total	Percent of GDP
Money and capital markets 6/												
Money market		443.0	10.6	16.3		886.0	10.3	18.4		1,830.0	14.4	27.9
Government bond market		1,224.9	29.4	45.0		1,916.7	22.4	39.8		3,435.5	27.0	52.4
Corporate bond market		223.0	5.4	8.2		507.6	5.9	10.5		747.9	5.9	11.4
Equity market		1,765.0	42.4	64.9		2,000.6	23.4	41.6		2,575.9	20.3	39.3
Derivatives market 7/		1,728.7	38.8	63.5		3,703.3	38.1	76.9		5,340.6	35.5	81.4

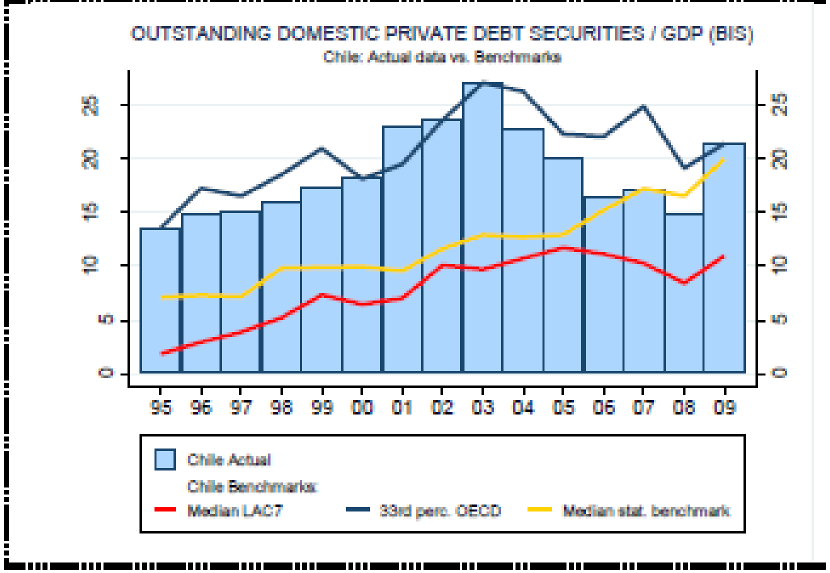
Financial market development: Areas for action
Chile (IMF Country Report No. 11/261)

- **Capital markets in Chile are among the largest (deepest) in the region**

…stock market capitalization is large…



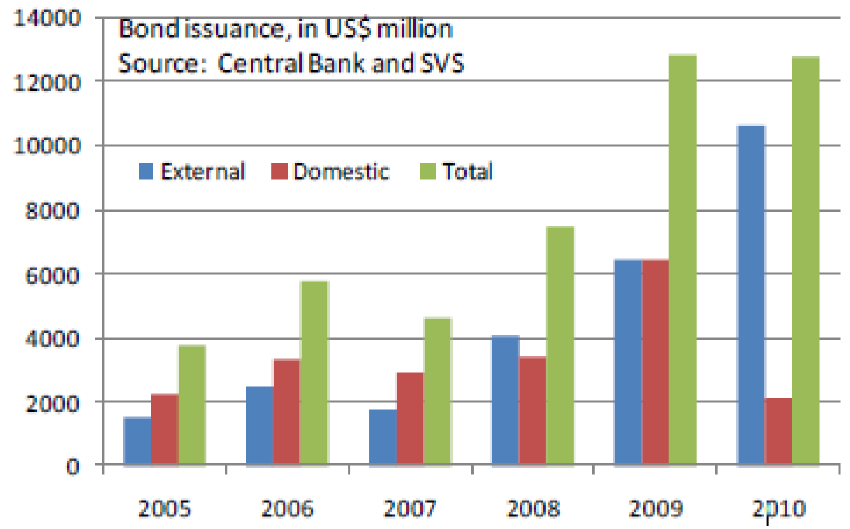
… and domestic debt markets are well-developed.



Financial market development: Areas for action
Chile (IMF Country Report No. 11/261)

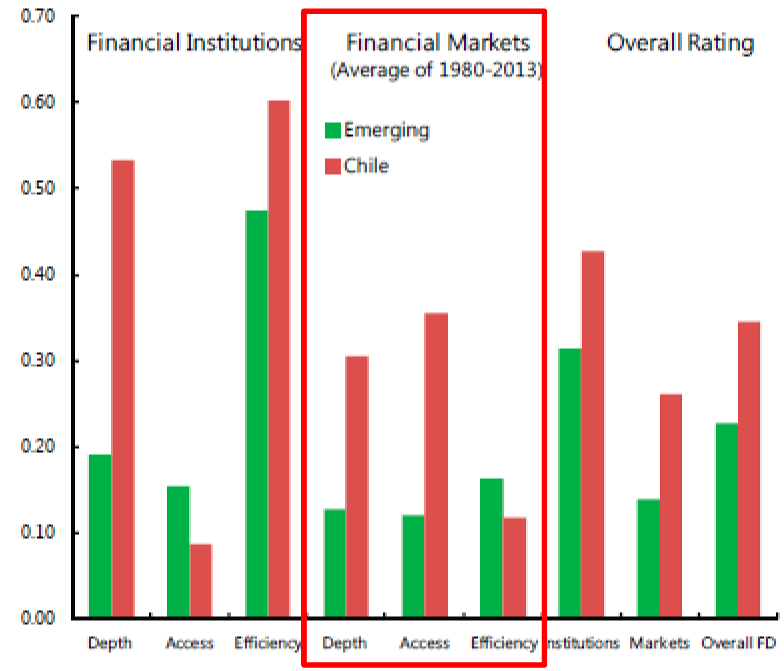
- Corporate bond issuance in 2010, at US$ 12.8 billion, was flat relative to 2009 but the share of external issuance rose to 80 percent from 50 percent (Figure 3). Given easy access to international markets and the availability of currency derivatives, large corporates (reportedly mostly exporters) may well increase their indebtedness abroad in 2011 as local funding costs rise

Figure 3. Chile: Bond Issuance (in US$ million)



Financial market development: Areas for action
Chile (Sahay, Ratna et. al. 2015)

- **Chile's financial development started in earnest in 1974, when a rapid process of financial liberalization ended decades of financial repression.**
  - Following the removal of most banking-sector regulations, including interest rate and credit controls, and the privatization of state-owned banks, financial deregulation continued with equity market reforms, followed by insurance market liberalization, the creation of a fully funded pension system, and measures to facilitate bond issuances.
  - Process was interrupted by the 1982–84 banking crisis, which led to a massive government intervention in the banking sector and the reinstatement of financial controls.
  - However, financial reforms resumed shortly after the crisis, and led to an impressive expansion of Chile's capital market and the creation of a large pool of long-term institutional investors



Source: Sahay, Ratna et. al. (2015)

Financial market development: Areas for action
Chile (Sahay, Ratna et. al. 2015) **(cont.)**

- **Special factors contributed to financial market development**
  - Creation of a fully funded pension system contributed to the early development of a domestic institutional investor base, while the banking crisis of the early 1980s likely accelerated the growth of the equity and corporate bond markets
  - Establishment of a sovereign bond market early on facilitated the development of other markets as well
  - An improvement in contract enforcement, the creation of institutions that reduced information asymmetries, and the increased availability of collateral helped deepen the markets
- **Chile's capital markets are fairly large, but not very liquid**
  - Domestic *bond market* (excluding government securities) represents almost 40 percent of GDP. The market is dominated by long-term and inflation-linked bonds and not very liquid. Long maturities, and the indexation to inflation are the result of high demand from institutional investors, especially life insurance companies that typically have inflation-linked, long-term liabilities.
  - Chile also has a relatively large *equity market* (the market value of its listed companies is about 90 percent of GDP), exceeding by far that of its neighbors. However, the Chilean equity market is still relatively illiquid, with a low and declining turnover.
- **Institutional investors play a significant role in Chile's financial sector**
  - Pension funds, insurance companies, and asset managers (investment funds) account for nearly half of the financial sector assets. The presence of these investors has contributed to the strong development of the local capital market, but may have limited its liquidity because of the buy-and-hold strategies they typically employ.
  - However, there is evidence that the presence of stable investors such as pension funds and insurance companies offers some protection to domestic financial systems against global financial shocks
- **Despite great strides in terms of financial market depth, challenges remain regarding market access**.
  - Low liquidity of equities and corporate bond markets limits the ability of smaller firms to raise capital outside the banking system

Financial market development: Areas for action
Colombia (IMF Country Report No. 13/50)

- **Colombia's capital markets reflect mainly activity in government debt and equity markets, with capitalization reaching 60 percent of GDP at end-2011**. Non-government fixed income remains undeveloped (4 percent of GDP) and dominated by financial sector issues. The investor base comprises mainly domestic investors—the compulsory individual capitalization pension funds (20 percent of GDP), insurance companies (4 percent of GDP) and mutual funds (5 percent of GDP). Financial development is broadly in line with the region and the country's characteristics.

- **The authorities could adopt several steps to foster a deeper interbank money market**
  - The BR plays a central role in the liquidity system, adjusting liquidity under ordinary circumstances to the financial system through several channels, including open market repurchase operations against government securities with all financial institutions and intra-day repurchase operations (also against government securities) to participants in the payments system. The BR is wisely planning to extend access to intra-day repos to market infrastructure institutions, such as clearing houses, which are becoming systemic. The flip side of the BR's prominent role is that the interbank money market is very limited.
  - Although the BR's routine liquidity operations function smoothly, there may be scope to strengthen the role of the interbank money market. Options include narrowing the range of counterparties for open market operations to banks and primary dealers in government securities, because of the liquidity risks they necessarily run and raising the cost of excessive use of overnight credit. Other remedial actions include phasing out the financial transactions tax more quickly than already planned and expanding the issuance of short-term government securities.

Financial market development: Areas for action
Colombia (IMF Country Report No. 13/50)

- The equity market could be prone to excessive price volatility, as it is illiquid with low trading volumes and a small free float. The state petroleum company (Ecopetrol) accounts for 40 percent of market capitalization, adding to the sensitivity to world oil prices, and its shares are liquid and account for almost one-third of trading.

- **With regard to oversight of the securities market, the SFC has the authority to access a wide variety of sources of information to evaluate the conduct of the market, its agents, and associated risks, as well as the capacities of market participants.**
  - The SFC has a comprehensive regulatory framework that appropriately addresses industry risks, and has well-developed supervisory procedures and methodologies

- **FSAP evaluators recognized the SFC's achievements but also indicated that certain weaknesses persisted and supervision should therefore be strengthened e.g.** by reforming its organizational structure and by deepeneing the oversight of the securities market, particularly in regard to the development and increased use of new products and instruments

Financial market development: Areas for action
Dominian Republic (IMF Country Report No. 18/294)

- **A medium-term fiscal framework, which would anchor fiscal policy decision-making in longer-term debt sustainability objectives, would reduce policy uncertainty and strengthen its credibility with the markets**
  - Ongoing efforts to develop such a framework are welcome. Reforms to enhance transparency in the public procurement processes, strengthen public financial management practices and align public statistics with international norms will further contribute to increase policy transparency and predictability, and should be supplemented by wider coverage and timeliness of fiscal statistics.
- **The government is taking steps to gradually reduce its reliance on external FX denominated debt and the associated risks**
  - Nevertheless, these flows are expected to remain important over the medium term as the cost of external finance remains attractive relative to domestic debt, with Dominican Republic's risk premium on international markets below that of its emerging market and regional peers.
  - Risks are also mitigated to some extent by the concentration of external public debt in debt from official creditors.

Financial market development: Areas for action
Dominian Republic (IMF Country Report No. 18/294) (cont.)

- **Strengthening oversight over systemic macro-financial risks will further contribute to financial stability**
  - especially as information on household and firm indebtedness is developed, and as the macroprudential policy framework is finalized to enhance policy flexibility to respond to systemic risks. Continued efforts to improve prudential regulation and supervision will complement these reforms, with the objective of fully aligning the regulatory and supervisory framework with international best practice. Remaining gaps in the supervisory periphery, including the oversight of the largest nonbank institutions, should be filled.
- **Transition towards a more flexible exchange rate**
  - The authorities are in the process of acquiring a foreign exchange trading platform, which will improve market infrastructure and facilitate transition towards a more flexible exchange rate. A foreign exchange trading platform, which will increase transparency of the market, enhance liquidity and price discovery, and support enhanced exchange rate flexibility. The planned foreign exchange trading platform presents an opportunity to strengthen intervention policies aimed at curbing excessive volatility. Staff welcomed the authorities' ongoing efforts to develop a derivatives market for foreign exchange to strengthen the economy's capacity to manage exchange rate risks.

Financial market development: Areas for action
Guatemala (IMF Country Report No. 18/154)

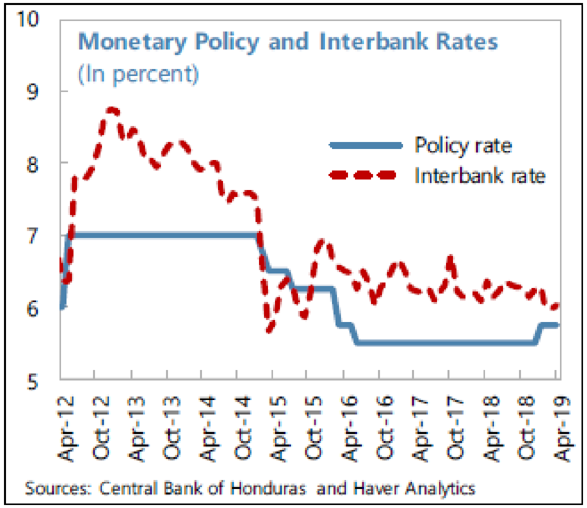
- **Central bank's efforts to gradually widen the band before exchange rate intervention is triggered should be continued to increase exchange rate flexibility to buffer against shocks**
  - Although FX interventions have been sterilized through open market operations and higher government deposits at the Central Bank, a relatively stable exchange rate might have reduced incentives to de-dollarize. Going forward, the authorities should limit FX interventions to smooth excessive volatility and allow for greater currency flexibility. This could be accomplished by a further increase in the size of the exchange rate move after which FX intervention is triggered and by reducing the amount of intervention undertaken once the rule has been triggered
- **Need for continued efforts to improve monetary transmission, including through a reduction in financial dollarization and development of domestic capital markets**
  - Continued efforts to discourage financial dollarization, encourage bank competition, and foster the development of a secondary market through a comprehensive securities market and public debt law, would help deepen financial intermediation and improve monetary policy transmission over the medium term.

Financial market development: Areas for action
Guatemala (IMF Country Report No. 18/154)

- **The authorities could strengthen the macroprudential framework by developing systemic risk indicators and by designating, and clearly defining, the responsibility for macroprudential regulations**
  - The authorities should also implement consolidated supervision, including through a harmonization of consolidation procedures with international standards and the introduction of consolidated regulatory requirements for financial groups.
  - There is also scope to reinforce the supervision of cooperatives and microcredit institutions.

Financial market development: Areas for action
Honduras (IMF Country Report No. 19/236)

- **The authorities are planning to build on recent progress in the transition toward inflation targeting**
  - The BCH has introduced transactions with collateralized securities in the interbank market, reduced FX surrender requirements by 30 percent, and strengthened its technical capacity to prepare a Forecasting and Policy Analysis System
  - It has also introduced an electronic platform for interbank operations. This progress has facilitated a reduction of the gap between the central bank's policy rate and the interbank rate, which will strengthen monetary policy transmission.
  - Going forward, authorities' plan strengthening the coordination between the treasury and the central bank to increase efficiency in money markets by reducing fragmentation between central bank and treasury instruments
  - In line with this, they will assess the benefits of signing an agreement to give the BCH unrestricted access to a pool of government securities to implement monetary policy—as is successfully done in other countries



Financial market development: Areas for action
Honduras (IMF Country Report No. 19/236)

- The authorities have amended the rules applicable to the foreign exchange auction to eliminate the possibility of a spread of more than two percent between bids at which FX is sold within the auction.

- However, an additional MCP arises from the use of previous days' official exchange rates (TCR) in certain FX transactions, which rates may differ by more than two percent from the TCR in force and the interbank market rate on a given day. The authorities have requested temporary Fund approval of this measure, as well as the existing MCP arising from the lack of a mechanism to prevent a spread higher than 2 percent between the official exchange rates and the exchange rates resulting from the central bank FX auction, both of which are maintained for non-balance of payments reasons.

Financial market development: Areas for action
Jamaica (IMF Country Report No. 18/347)

- **An effective macroprudential framework should build on strong micro-prudential foundations of supervisory oversight and go hand-in-hand with heightened commitment to transparency and accountability**
- **Work reinforcing the resilience of securities dealers, the deepening of capital markets and broadening of instruments to manage credit, liquidity and market risks should continue**
- **Adopt a strategy for capital markets deepening, including developing the short end of the yield curve for benchmarking (Government)**
- **The secured money market in Jamaica is small.** There is a primary market for government securities and a deep market for rolling investment contracts. A secondary bond market and a foreign exchange (FX) market are being developed.
- **Given the already shallow state of secondary market trading in Government bond, the liquidity stress test scenario assumes that such instruments are treated as 100 percent illiquid during the shock horizon**
- **There is much work to be done to broaden and deepen financial markets so that institutions are better provided with the financial instruments that they need for managing their credit, liquidity and foreign exchange risks on a day-to-day basis**

Financial market development: Areas for action
Jamaica (IMF Country Report No. 18/347)

- **The expansion of securities dealers' intermediation activities into corporate debt or equity instruments will require:**
  - A viable trade reporting or (preferably) secondary trading platform to aid price discovery;
  - A risk-based supervision framework and a fixed timeline for implementation;
  - Focus on developing liquid markets in these instruments, while ensuring that securities dealers enhance their liquidity management;
  - Implementation of effective group-wide supervision by the BoJ and FSC;
  - Review of the existing foreign exchange requirements to determine whether they place unreasonable impediments on the development of financial products which provide hedging capacity against the US$, especially for Jamaican corporates;
  - Review of the existing risk weightings for corporate debt and equity instruments;
  - If repurchase agreements are used to offer short term fixed interest products backed by long-term corporate debt securities to non-accredited investors, the same trust, standard master repurchase agreement, and mismatch ratio infrastructure should apply to manage the risks of that business.

Financial market development: Areas for action
Jamaica (IMF Country Report No. 18/347)

- **From a financial stability perspective, FX investment opportunities should be gradually broadened to enhance diversification and returns**
  - The phase-in should be aligned with strengthened risk management, regulatory capacity and cooperation, and the deepening of capital markets.
- **The 2015 World Bank FSAP Development Module covered capital markets deepening**
  - One of the key recommendation included the development of movable asset-based financing instruments (e.g., factoring, leasing, and venture capital).
  - More recently IMF TA provided detailed recommendations on the primary dealer system, strengthening sovereign debt markets benchmarks, and developing the secondary market

Financial market development: Areas for action
Jamaica (IMF Country Report No. 18/103)

- **Financial sector stability is a prerequisite for strong and sustained growth. Ongoing prudential and supervisory improvements will enhance systemic stability**

- **Financial sector resilience has been strengthened.**
  - The legal and institutional risks of the securities dealers' industry have been reduced by introducing a trust framework for retail repos.
  - Work is also underway to address liquidity, credit and leverage risks.
  - Financial sector supervision has been enhanced through the Banking Services Act and amendments to the BOJ Act, and the BOJ has been given responsibility for system-wide financial stability

Financial market development: Areas for action
Jamaica (IMF Country Report No. 18/103)

- **Continued development of the FX market, liquidity management and forecasting toolkit, along with upgrading the BOJ's communication practices, will improve policy signaling and enhance credibility**
  - Successful inflation targeting will require a clear commitment to a flexible and market-determined exchange rate with limited involvement of the central bank in the currency market.
  - FX sales should be confined to disorderly market conditions, especially given the reductions in the surrender requirements, and buy auctions should aim to build reserves in a non-disruptive way
- **The monetary policy toolkit has been modernized**
  - To build the institutional framework for inflation targeting, the Bank of Jamaica (BOJ) has upgraded its monetary operations, including switching to the overnight rate as the policy rate.
  - BOJ has been able to reduce its role in the FX market (reducing surrender requirements and moving to a more market- based mechanism for buying and selling reserves)FX auctions were introduced in mid-2017, supporting price discovery and transparency in the currency market

Financial market development: Areas for action
Jamaica (IMF Country Report No. 18/103)

- **Steps are needed to support FX market development**
  - The BOJ has begun to lower FX surrender requirements to encourage a greater volume of transactions to go through the currency market.
  - Further reductions should be based on periodic reviews to balance market development with the need to accumulate FX reserves.
  - Given the transition to a market-based FX reserve accumulation strategy, FX sales should be strictly limited to periods of disorderly market conditions.
  - Over time, FX buy auctions should become the primary tool for reserve accumulation.
  - Public sector enterprises should gradually transition to meeting their FX needs through market purchases (instead of bilaterally from the BOJ).
  - The BOJ should also establish a code of conduct for transacting in the FX market to define the rules and responsibilities of the main counterparties.
- **The central bank remains committed to limiting FX sales to times of excess volatility and agreed to continue phasing out the BOJ’s presence in the FX market in order to facilitate market development.**
  - The BOJ has announced its intent to begin buy-side FX auctions and a FX market code of conduct is to be introduced by end-June.
  - Intensive public communication of central bank policies is ongoing, with a series of educational articles on FX market development, and the central bank has begun to publish a one-year ahead schedule of policy announcements.

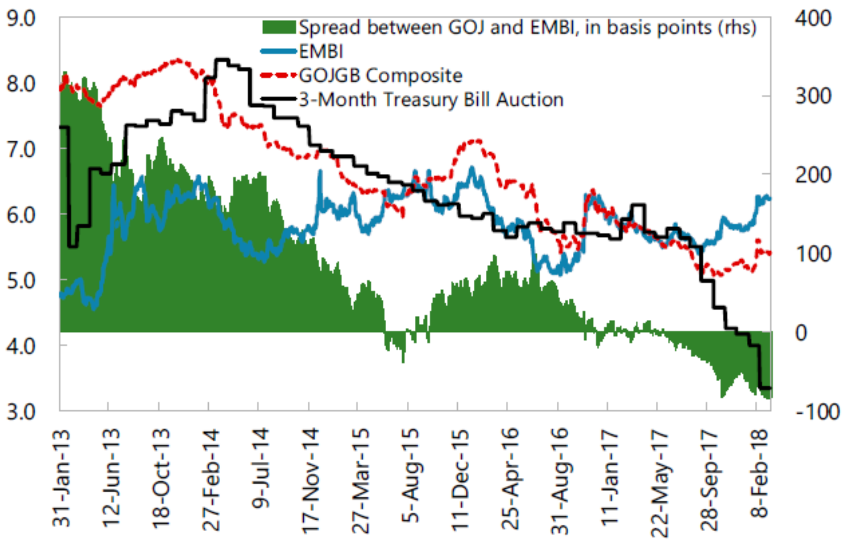
Financial market development: Areas for action
Jamaica (IMF Country Report No. 18/103)

- **Strengthening debt management and deepening domestic debt markets are essential for financial development and stability.**
  - Jamaica’s large FX debt exposure creates risks
  - Where feasible, upcoming bond redemptions should continue to be refinanced in the domestic market to rebalance the debt portfolio from FX to local currency.
  - Efforts should continue to develop a liquid benchmark yield curve to help deepen the interbank debt market and to increase secondary market trading in domestic government debt, accompanied by a stronger primary dealer framework.
- **Concerns about debt and deficits, in addition to sustained periods of high inflation and currency depreciation have contributed to high rates of dollarization**.
  - BOJ stress tests indicate banks are resilient to currency-related shocks.
  - Nonetheless, sustaining the authorities’ track record of policy credibility, macroeconomic stability, and flexible exchange rate will support confidence in local currency instruments.
  - Deepening domestic financial markets for J$ debt and developing FX hedging instruments to reduce currency risk will also support de-dollarization. The authorities should complement these efforts with prudential measures including stricter limits on net open FX positions, higher reserve requirements for FX deposits, and remunerating local currency reserves.

Financial market development: Areas for action
Jamaica (IMF Country Report No. 18/103)

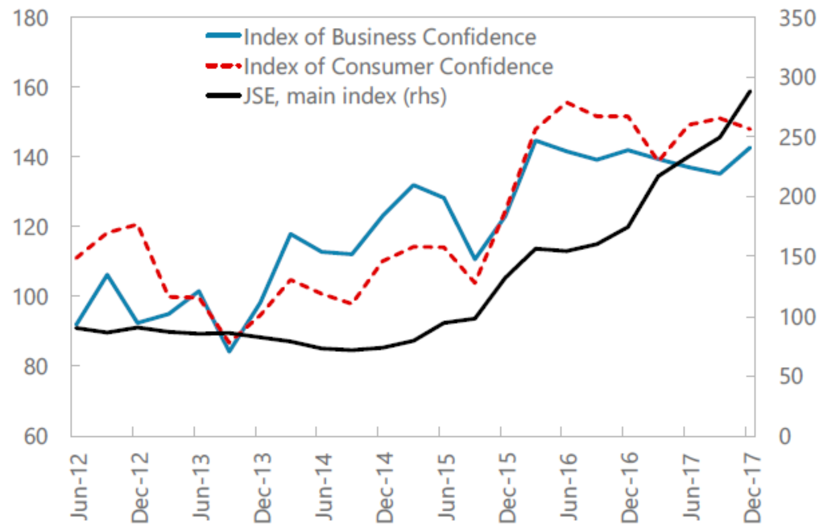
Bond markets remain reassured…

Jamaica borrowing cost
(in percent and basis points)



… and confidence remains high

Confidence and stock market
(index)



Financial market development: Areas for action
Mexico (IMF Country report No. 16/361)

- **Nonresidents hold large shares of local currency sovereign debt.**
  - Commercial banks’ holdings of government bonds are large relative to their balance sheet but small as a share of the sovereign debt portfolio (less than 5 percent).
  - Larger holders of Mexican sovereign debt are nonresidents, pension funds, and mutual funds. In the event of a sharp capital flow reversal, residents would have little room to absorb significant amounts of debt securities.
  - Banks have been reducing their market-making activities, especially those that are part of international groups and subjected to strict home-country regulation.
  - Pension funds follow long-term strategies, and would likely only make limited use of the opportunity to pick up securities cheaply.
  - Mutual funds are mostly in the money markets. They could play a larger role, if investors were to switch toward more debt funds, but given the conservative profile of most mutual fund investors, it seems unlikely
- **Mexico’s financial sector is rapidly integrating into the global financial system, and at a faster pace than many of its EM peers (especially in Latin America).**
  - The Mexican peso is the tenth most traded currency in the world and the first among EMEs and it is a benchmark for large EM currencies.
  - Mexican sovereign instruments are trading in major sovereign bond indexes including the World Government Bonds Index (WGBI) and the JP Morgan’s Government bond EM index. Inclusion in major indexes has encouraged nonresidents large participation in the peso-denominated sovereign debt market, which surged after 2010.
  - Mexican securities are also actively trading offshore.

Financial market development: Areas for action
Mexico (IMF Country report No. 16/361)

- **The 2014 reforms introduced new securities regulations and supervisory powers to the CNBV, except in the derivative markets.**
  - The new Law clearly defines the CNBV's responsibilities and regulatory and supervisory enforceable oversight powers over a broad range of entities but with an important exception: derivatives.
  - The derivatives market regulation relies on general provisions encompassing the SHCP, Banxico and CNBV; a law for OTC derivatives is not yet in place, which could impair the enforcement by the CNBV of current regulations in this area.
  - The CNBV is to formally start applying strengthened risk-based supervision in the securities area for intermediaries in 2017
- **Banxico's liquidity operating framework in normal times fully supports the efficient pricing and distribution of liquidity**
  - Banks have certainty about day-to-day liquidity conditions and have access to a collateralized overdraft in the event of operational problems.
  - Collateral pressure could arise in light of increasing demands on HQLA, combined with the high foreign ownership of government securities. The Banxico could consider broadening the collateral framework to mitigate increased financial risks through higher haircuts

Financial market development: Areas for action
Mexico (IMF Country report No. 16/361)

- **Domestic capital markets are unevenly developed with a very liquid government bond market but shallow corporate debt and equity markets.**
  - Government bond markets are deep and well-diversified in terms of range of instruments and maturities, providing liquidity in all relevant benchmarks.
  - The strong presence of foreigners supported the yield curve lengthening and secondary market liquidity.
  - However, corporate equity and bond markets are still not a reliable source of long-term financing as they are small, expensive and illiquid. For instance, equity markets amount to only 38 percent of GDP, are less dynamic than in peer countries, and are tilted towards large enterprises and family owned corporations.
  - The development of hybrid capital markets instruments, via private equity funds, could provide a promising venue for much needed mature infrastructure investments.
  - There is significant scope to broaden existing debt instruments to include infrastructure debt funds, covered bonds, and standardized securitization bonds to appeal to a larger range of private sector investors.

Financial market development: Areas for action
Nicaragua (IMF Country Report No. 17/173)

- **Strengthening liquidity management tools is important to deepen financial markets**
  - Efforts to strengthen short-term liquidity management should continue, with a stronger focus on calibration, choice of instruments, and monitoring of liquidity developments.
  - Introducing a short-term policy rate and a corridor will reduce interest rate volatility, deepen financial markets and, eventually, may provide some cushion against external shocks.
- **The CBN should continue developing its monetary operations framework and strengthening its capacity**
  - Efforts to strengthen its liquidity management capacity through better liquidity forecasting and introducing shorter-term liquidity management tools are welcome.
  - The CBN should aim to gradually establish a short-term policy rate and a corridor, reduce interest rate volatility, and deepen the interbank and domestic bond markets.
  - Attention should be devoted to improving calibration of the monetary policy tools, monitoring liquidity developments and forecast errors, and publishing daily liquidity forecasts to increase banks' participation. As monetary operations gain importance, efforts to capitalize the CBN should continue

Financial market development: Areas for action
Nicaragua (IMF Country Report No. 17/173)

- **Fostering financial inclusion through well supervised non-banks would increase the demand for financial assets and contribute to developing domestic markets**

- A recent joint technical assistance mission from the Bank, Fund and CEMLA to promote the development of the domestic debt market, identified market segmentation as an issue which needs to be addressed going forward.
  - This is due to the existence of several debt instruments coupled with a small investor base.
  - The mission made recommendations on ways to increase liquidity in this market, including by issuing BRNs with shorter maturities.

Financial market development: Areas for action
Trinidad (IMF Country Report No. 06/29)

- **Medium-term priorities include the further development of the capital and foreign exchange markets and the deepening of the government securities market.**
  - This will improve short-term liquidity management and facilitate a broader and more efficient allocation of resources, especially the increasing energy revenues. Development of financial markets would also help reduce TTO's exposure to currency fluctuations and allow better hedging and financial diversification. Improvements to the informational infrastructure are key to increasing access to finance by small- and medium-sized businesses. In this regard, ongoing improvements to the business credit registry and the recent establishment of an automated credit bureau are very welcome developments.
- **The TTSEC needs to build confidence in the securities markets and in its effectiveness as a regulator.**
  - Concerns regarding unfair trading practices and low levels of investor education partly reflect inadequacies in the current SIA, but also the difficulty that TTSEC has had in establishing itself as a modern securities regulator with current resources
- **The current framework for securities market regulation is inadequate**
  - There are major gaps in the SIA, including in the areas of mutual funds, governance, and enforcement powers. The Act does not provide the TTSEC with the power to conduct on-site supervision of market participants or sufficient powers for regulating the TTSE as a self-regulatory organization.
  - The passage of the revised SIA aimed at strengthening the regulatory framework is, therefore, a matter of priority.
  - The draft legislation could also benefit from further review in the area of risk-based regulation, protection for whistleblowers, and the governance and independence of the TTSEC.

Financial market development: Areas for action
Trinidad (IMF Country Report No. 06/29)

- **Establishing TTO as a regional financial center will require improvements in equity market transparency and governance, further cross-listings, and additional supply of local listings**
  - The development of electronic trading, and TTSEC standards and surveillance capabilities, should improve market transparency and reduce transaction costs. Privatization of public enterprises could contribute to increasing the supply of local listings.
- **A deeper secondary market for bonds would also support the growth and stability of the financial sector.**
  - Primary market activity in fixed interest securities in TTO has been impressive, but secondary market trading has been much less so.
  - Secondary market activity could be stimulated by changing regulations tending to promote buy-and-hold strategies by institutional investors, and by consolidating government-guaranteed debt under a central borrowing authority to maximize their liquidity.
  - The depth of the secondary bond markets could also be assisted by extending the maturity of short-term government securities and exploring the development of an interest rate swap market.
- **Development of the domestic capital market would also benefit the insurance and pension sectors.**
  - Increased supply and liquidity in domestic capital markets would facilitate portfolio diversification by insurers and pensions, and make it easier to establish fair market values for securities after issue.
  - Easing limits on investments in overseas assets would also facilitate portfolio diversification and reduce incentives to acquire imprudently large holdings in local companies, including affiliates.

Financial market development: Areas for action
Trinidad (IMF Country Report No. 06/29)

- **The CBTT and other stakeholders have achieved significant results in the reform of the payments system in TTO.**
  - The most important of these was the launch of a Real Time Gross Settlement system (safe-tt), in October 2004, and a custody and settlement system for government securities (GSS), beginning in December 2004.
  - Also planned for 2005 are the creation by the CBTT of a Virtual Private Network to provide the banking community with a secure information network and an Automated Clearinghouse, owned jointly by the CBTT and commercial banks.
- **The legal framework for payments and settlement presents some important weaknesses.**
  - The legal basis lacks the elements required for the operation of modern electronic payments system and full contingency arrangements are pending finalization.
  - The system is operated by the CBTT, which has established a National Payment System Council as a forum of discussion on payment system matters.