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Development of Secondary Markets: Market Structure Approach



Peter Dattels

International Monetary Fund
Monetary and Exchange Affairs Dept.

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Focus of presentation

Essential Elements of Market Structures

- Types of transactions
- Organization of trading

Role of the Authorities

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Primary vs. Secondary Markets: What's the Real Difference?

- Primary markets are about the *issuance of new bonds*
- Secondary markets are about the *transformation of bonds*

Transforming Bonds in Secondary Markets

- **Money/deposit-like properties**
- **Funding and leveraging vehicles**
- **Fungible investments**
- **Markets for interest rates**
- **Safe haven**
- **Links with international markets**

Market Development Objectives

- Maximize special attributes/properties of government bonds
- Two-pronged strategy:
 - Development of instruments of transformation
 - Development of market structures

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Transactions Type: Instruments of transformation

- **Cash trading**
- **Repurchase agreements**
- **Borrowing and lending of securities**
- **Forward and when-issued trading**
- **Short selling**
- **Strips**
- **FRA/swaps/futures options**

Cash versus Futures Markets

Country	Turnover Ratio	Cash/futures Ratio
US	22	3
Canada	22	34
Italy	8	4
Japan	7	1
UK	7	1

Development of Efficient Market Structures

- Widely available pricing information (price transparency)
- Low transactions costs (Bid-Ask spreads)
- Low execution risk (spread between average price and best price)
- Easy and rapid access to trading mechanism

Authorities Involvement in Market Structure

- Architecture of market structure
 - Overall design
 - Transparency practices
- Support of secondary markets
 - Secondary market windows
 - Liquidity back stops
- Provision of market infrastructure
 - State-sponsored dealers
 - Development of brokerage or dealing systems

Strategy of the Authorities

- Move away from gov't sponsored systems (such as creation of gov't sponsored discount houses) in developing countries
- Focus on strengthening natural liquidity
- Greater involvement in overall architecture

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Strategy for Market Structure Development

- Tailor market structure to country circumstances and setting

OR

- “One size fits all”

Periodic versus Continuous Markets

- Consider periodic or call auction markets for early stages
 - Deepens market by accumulating orders
 - Lowers execution risk
 - Provides uniform or single price outcome
 - Facilitates clearing and settlement
 - But has higher market risks
- Country examples: Poland, Israel,

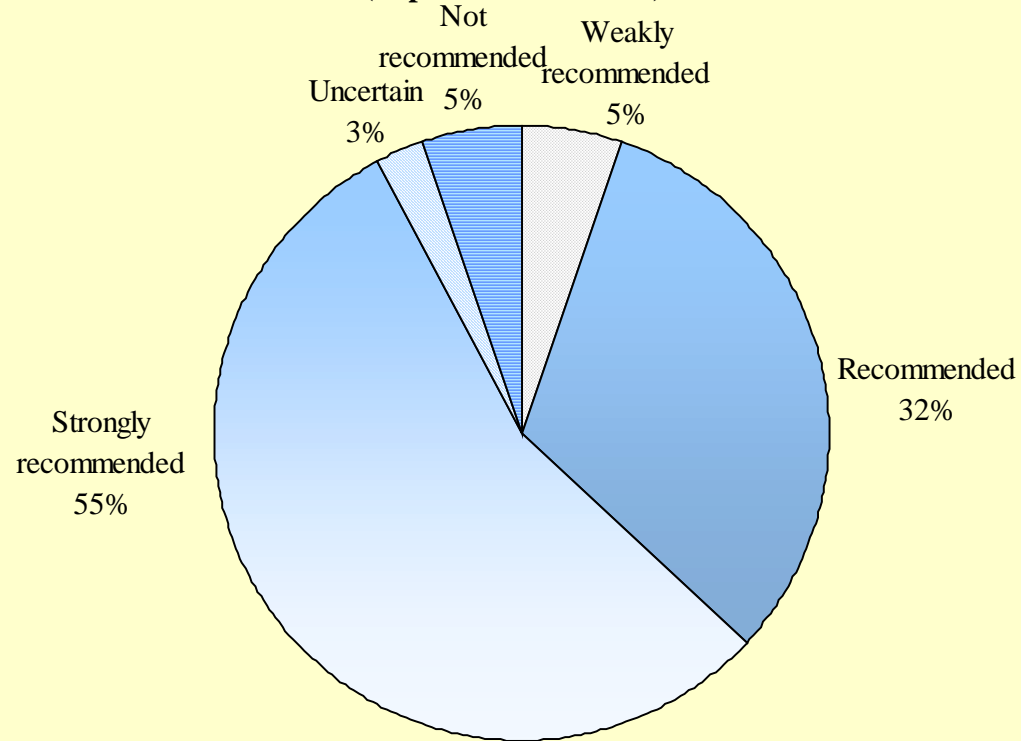
Dealer Markets: Considerations

- Need for primary market underwriting support
- Counterparty for monetary & debt operations
- Need for dealer support (transformation services) to secondary markets
 - Immediacy (continuous quotations)
 - Maturity/coupon switches (asset transformation)
 - Commitment of capital
- Liberalization and market development strategy

Primary Dealer Systems

Chart 1. Recommendation of Primary Dealer System

(In percent of answers)



Auction—Order Matching Markets

- Reduces reliance on dealers:
competition among orders vs. dealers
- Higher levels of transparency: suitable to retail investors
- Economizes on need for dealer capital
- Potential for lower transaction costs
- Well suited for small countries with retail investors
- Reform of auction markets and technology

Conclusions

- Development of derivative instruments and market structures are important part of deepening secondary markets in Govt Sec.
- Development of market structure: national considerations are important (stage of development, investor base, debt and monetary management requirements)
- Technical assistance on market development available from Fund/Bank