Regional integration has the potential to deepen essential financial markets for many smaller economies. Regional integration encompasses arrangements that allow a market player from one country to conduct a market transaction with those in another country without additional expense. The success of regional integration can be gauged by the convergence of market prices across the member countries.

There are relatively few cases of longstanding regional integration projects on which to draw lessons, especially for smaller economies. Market integration of European Union (EU) countries is quite advanced and offers policy lessons. For smaller economies, a number of regional initiatives have emerged to date, mainly in the area of the exchange rate arrangement, monetary policy, and trade policy, but experiences in terms of financial market integration are mixed. The Baltic markets have integrated to some degree with those of the Nordic area. Market integration of WAEMU, the Central African Economic and Monetary Community (CEMAC), the Common Monetary Area (CMA) in southern Africa, the Common Market for Eastern and Southern Africa, and the Southern African Development Community have not always met expectations, as evidenced by divergent asset prices, but efforts are under way. The Eastern Caribbean Currency Union recently established the Eastern Caribbean Securities Exchange and Regional Government Securities Market, but trading activities are still small. The Caribbean Community Single Market and Economy, Central America, and the Maghreb countries are in the early stages of integration. Introduction of cross-listing of smaller economy companies in the stock exchanges of other smaller economies can be viewed as nascent market integration. Annex IV includes case studies for the European Union, the Baltics, and Central America.

The following themes arise from the consideration of regional integration for smaller economies:

- Regional integration is generally a complement to rather than a substitute for local markets.
- Successful regional integration is market-led and in most cases has involved equity markets.
- Government intervention can be warranted when the interests of individual market players conflict with market integration.
- The preconditions for successful integration are regional economic and political linkages, developed and integrated banking sectors, already existing local markets, and political commitments to overcome vested interests.
- Smaller economies may be better off joining an already existing regional market, including large countries that have already realized the requisite scale economies, rather than trying to integrate small markets across countries, which often involves extensive negotiation and overcoming diseconomies of scale.

The Potential Benefits of Regional Integration for Smaller Economies

Smaller economy market integration can alleviate diseconomies of scale. Regional integration enables smaller economy markets to attract more listings and boost trading volume and liquidity. Integrating small markets across the region is a potential policy option if the costs to develop individual markets in each smaller economy are deemed to exceed the envisaged benefits. Another option for smaller economies is to join existing neighbor regional markets or global financial centers. In either case, meeting local markets’ demands is crucial for benefiting from the regional integration and for positive complementary effects on domestic financial markets.

For issuers, successful regional integration improves access to and reduces the cost of financing. By broadening the investor base, integration increases the number of potential investors and improves the stability of issuer financing. In addition, integration reduces the cost of raising capital by streamlining public offering and listing requirements, which has been the case in the Baltics.

Integration can improve the balance of investor risk and return. Risk diversification is enhanced by the intro-
diction of new countries, as well as by additional products and services. Thus, integration of varied national markets can overcome the high degree of concentration in many smaller economies that hinders domestic market development. The reduction in risk concentration will, in and of itself, enhance systemic stability. Return is enhanced by the availability of new investments, and by lower cross-border transaction costs.

Regional integration has the potential to bring smaller economies into global markets. The visibility of all the countries in the region to international investors is improved by active regional markets. Regional integration can motivate national reforms that would not have otherwise happened. Finally, regional integration can set in place a strong market-deepening dynamic whereby deeper markets attract more investors, greater economies of scale are realized, and more investors are attracted in a virtuous cycle.

Regional integration can also bring costs and potential risks. The loss of national decision-making power can reduce the effectiveness of policy responses to country-specific developments. If policies do not adjust, deeper and wider markets can potentially undermine systemic stability. The wide availability of the regional markets (through cross-listing, etc.) could prevent smaller economies’ local markets from growing if appropriate domestic policies are not put in place. Finally, resources can be wasted if the preconditions for successful integration are not met.

**Preconditions: Strong Linkages and Potential Business Opportunities**

Successful integration requires fundamental economic and political linkages that give rise to cross-border financial transactions. Trade integration is paramount, as evidenced by the euro area and the Baltics. Cross-country business relationships can also drive financial linkages, and in some cases a single company realizing economies of scale can support or even generate integration. In the Nordic and Baltic areas, one company owns all but one of the eight exchanges. Cultural and linguistic commonalities can help, but are not sufficient. Although a common currency will reduce trading costs, the market integration experience of common currency areas has so far been mixed.

A developed and integrated banking sector is another necessary condition for successful integration. Bank development precedes market development on a national basis and this sequence holds true for regional integration as well. Further, longstanding cross-border relationships between banks typically serve as a first step for market relationships. Strengthening the regional banking system is important for the further integration of the WAEMU and CEMAC areas and Maghreb countries, while the dominant presence of Nordic banks in the Baltics has facilitated that market’s integration.

Successful integration requires that the aggregated market be of a sufficient quality and magnitude to be viable. Regional integration will be limited by local institutional deficiencies and small local markets. Thus, successful integration requires a critical mass of issuers and investors at the outset. Market participants must believe that there are business opportunities being missed by the lack of “connection” of the markets. For example, the stock exchange for the entire WAEMU, the Bourse Régionale des Valeurs Mobilières (BVRM), so far does not have sufficient volume and capitalization to make the costs of setting it up worthwhile, reflecting the limited number and size of market players within the region. Deeper financial markets will foster further integration of Maghreb financial markets.

Finally, political will is needed to overcome vested interests that impede regional integration. The influence of narrow vested interests whose rents would be wiped out by market integration can slow or stymie integration. For example, the creation of two independent stock markets in CEMAC reduces the total size of the potential market, in addition to diminishing the maximum size of each market by creating legal uncertainty for investors.

**Government Policies: Markets Lead and Governments Supervise**

Successful regional integration generally is driven by the judgment of many market players that the benefits of integration exceed the costs. As discussed in the previous chapters, governments can play a crucial role in the early stages of the building of domestic markets. However, the complexity of regional integration leaves market players in a better position to judge whether integration will work or not. For example, stock exchange integration via common trading platforms and listing requirements, as in the Nordic-Baltic area, required no leading role for governments. Indeed, a single company has driven much of the integration in that region. In Central America, the private sector has in the past effectively tried to bypass the need for regulatory harmonization by finding solutions that at least in the first stage did not require regulatory intervention. Government-led integration efforts sometimes have not realized expectations because policies turned out not to meet market needs, or because preconditions were not fully in place.

Supervision and regulation is one area where governments do play the leading role. As markets linkages emerge, country supervisors can sign a memorandum of understanding (MOU) that spells out information sharing and other arrangements. In Europe, supervisors have signed MOUs regarding the supervision of Euron-
ext and Euroclear. A next step is the “recognition” approach, whereby each local regulator “recognizes” the framework of a foreign country, affording financial intermediaries and products authorized in the foreign country automatic authorization for participation in the local market. Recognition is based on an appraisal of whether the framework of the other country offers a level of protection similar to the local framework. Each regulator might want to supervise all activities carried out in its jurisdiction, but this might create an unnecessary burden for market participants. EU countries mainly employ home country supervision, while the host jurisdiction retains powers to take regulatory actions under certain cases. In the Nordic-Baltic area, supervisors have signed detailed MOUs.

The strengthening of linkages brings a need for a more comprehensive regulatory framework. There is no clear-cut answer as to what the threshold of the degree of integration is, but it should be gauged by “hard” evidence, such as financial instruments sold in many countries (cross-listing), common business ventures (for example, to develop common trading platforms), and feedback from the private sector on the cost of cross-border transactions. The framework should govern not just exchanges and investors but also issuers and intermediaries. In addition, a legal framework, including capital controls, needs to support cross-border financial activities without uncertainty and distortions. One approach is to agree on a minimum common set of requirements (usually defined by areas or topics) enforced by the home regulatory authority. Alternatively, the home country can supervise, but the host regulator by agreement is given scope to exercise certain limited powers. In many cases institutional arrangements are needed to enforce these arrangements, as the European Directives do. Again, cooperation and trust between national regulators is essential.

Most regional markets involve cooperation and linkages between local supervisors. The “single passport” concept of the EU exemplifies the approach of home supervision but with some authority given to the host supervisor. In the Nordic-Baltic area, regulators and central banks have signed a web of MOUs. The WAEMU and CEMAC zones each have a single central bank, similar market rules, and a regional supervisor, although application of regulations is not always perceived as evenhanded.

**Infrastructure Centralization**

The infrastructure of most regionally integrated markets remains largely decentralized. A regional approach may allow some elements of financial infrastructure to be supplied at a much lower unit cost and others to become viable for the first time. Regionalization also increases the human and technical capacity to operate and supervise a more sophisticated payment system. This implies that countries in a region act together to build up a common infrastructure that they would then share or to standardize and link their existing components. Such a regional infrastructure may enable intermediaries located in each participating country to sell and deliver their products and services anywhere in the region at no cost disadvantage with respect to their regional competitors.

The experience with the centralization of infrastructure has been mixed for smaller economies, with trading easier to link compared to clearing and settlements. In Europe, the trading of securities is done on a single platform and set of rules, and clearing is highly centralized. The settling of exchange trades, in contrast, is done on the books of several entities. The WAEMU stock exchange (the BVRM) has modern centralized trading and clearing systems. The Nordic-Baltic country exchanges use a common trading platform, thus providing one point of entry, but clearing and settlements are mostly done with domestic systems that are not compatible. Trading platforms may be easier to integrate because they can be purchased from a single vendor.

Government intervention can be appropriate when the interests of some market players conflict with those of the markets. Establishing centralized clearing and settlements requires overcoming the vested interests of owners of the various components who may not benefit from consolidation. Government intervention may be needed if the owners of infrastructure make decisions that impose excessive and unnecessary costs. For example, the profitability of some of the services provided by the large financial groups in the Nordic-Baltic area would be hurt by full integration. Fully integrated post-trading infrastructures would raise the value of their brokerage and asset management services but reduce the profitability of their custodian and correspondent banking activities. In a similar vein, the “vertical silo” model of European stock exchanges has led to complaints about high costs. In response, the Head of Internal Markets at the European Commission set out a voluntary code of conduct aimed at achieving interoperability. Conflicts can also arise when the central bank owns or oversees both payment systems and CSDs, which is the case in a number of smaller economies. Centralization also requires the establishment of the common legal, regulatory, and supervisory arrangements necessary to make the linked and shared facilities work smoothly and efficiently.

A common currency offers advantages to the centralized approach. Although trading instruments denominated in different currencies on the same platform is possible, clearing and settlement could be quite complex if the cash leg and the securities leg have to be settled locally. Further, a multicurrency setting may not work for money markets and foreign exchange markets if central banks are not willing to give up control.