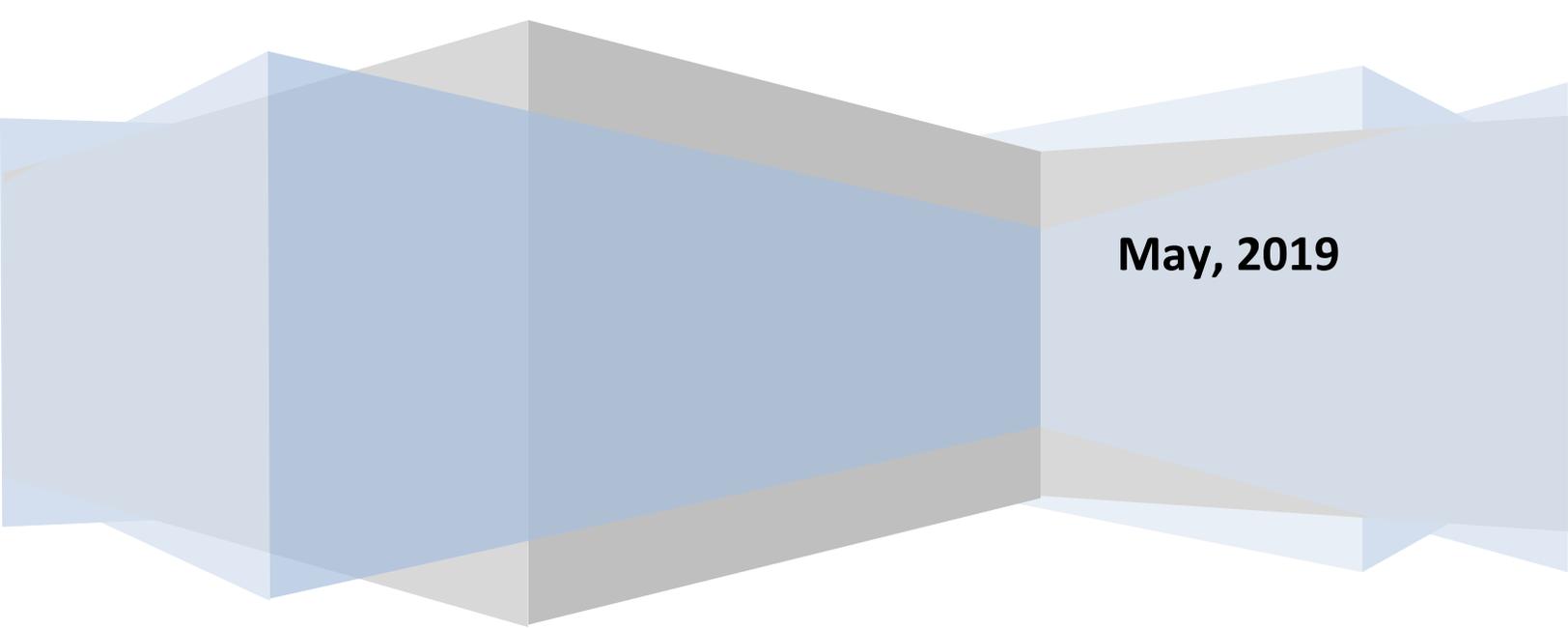


Da Afghanistan Bank
Monetary Policy Department
Research Unit

Secondary Market in Afghanistan

A study of obstacles and challenges to the establishment and further development of the secondary market in Afghanistan

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Abstract:

As it is well known fact that the economy of Afghanistan has been affected negatively from the past civil war and the country still suffers a lot from the international terrorism. The financial market is in the initial phase of development in Afghanistan. The primary market has already been established by the efforts of the Central Bank of Afghanistan. The central bank issues Capital Notes with various maturities in the form of regular auctions and the commercial banks participate in the auction of Capital Notes. The Capital Notes are considered to be the only primary market instrument. Despite the Central Bank's efforts, the secondary market has not been established in Afghanistan so far.

There are a number of challenges in the way of the establishment and further development of the secondary market in Afghanistan. The most important obstacle to the development of the secondary market is the lack of security and political stability in the country. The lack of security and political stability discourages the domestic and foreign investors to carry out medium sized and large investments in Afghanistan. Therefore, without the sufficient domestic and foreign investments inside the country, it seems quite difficult to establish the market for corporate securities. Moreover, the establishment of the market for government securities is also affected by the unfavorable security and political conditions in the country in a negative manner.

In addition, this paper also finds other important obstacles and challenges to the development of the secondary market in Afghanistan which are listed below:

- Unfamiliarity of the general public with the secondary market and its instruments
- Lack of legal and regulatory framework
- Lack of issuers of tradable secondary market instruments
- Lack of investors in financial assets

However, despite the above mentioned obstacles and challenges, the Central Bank in co-operation with the Ministry of Finance can play a great role in the establishment and further development of the secondary market in Afghanistan.

Introduction:

Financial markets play a key role in the overall development of an economy. Not only efficient financial markets promote liquidity in the economy, but also pave the way for capital formation which is crucial for carrying out large investments such as the airlines, railways, etc. In addition, the financial markets, particularly the secondary market, provide loan facility from domestic sources for the government to finance the government budget deficit.

Majority of the developing countries strive to further develop their financial markets for either increasing availability of domestic debt sources for the government or for the private sector. While many countries have achieved the establishment of the primary markets, but establishing the secondary markets have been more challenging to these countries.

In Afghanistan, the Central Bank strived to establish the primary market and it is in the initial phase of development. The Central Bank issues Capital Notes in the form of regular auctions and only the commercial banks participate in the auction and purchase the Capital Notes. The Central Bank uses the Capital Notes as a monetary policy instrument for various purposes for instance controlling the liquidity. Moreover, the use of mentioned instrument also affects the afghani exchange rate.

However, the investment opportunity is not desirable in Afghanistan due to bad security conditions, therefore the commercial banks are over-liquid. The issuance of Capital Notes by the Central Bank provides an investment opportunity for the commercial banks to invest their extra funds. Despite the Central Bank's efforts, the establishment and further development of the secondary market in Afghanistan seems to be challenging.

This paper studies the challenges and obstacles to the establishment and further development of the secondary market in Afghanistan. In the first section, the main impediments to establishing the secondary market in Afghanistan are described. In the second section, an analysis of the opinions of the survey participants is provided and afterwards a conclusion and policy recommendations are provided at the end of this research paper.

Methodology:

This research paper is more qualitative and less quantitative. A survey was carried out from the participants. The main participants of the survey were commercial banks as well as a sample of the currency exchangers from the foreign exchange market was randomly selected for the survey. A survey questionnaire was prepared in which the following questions were asked:

1. According to your opinion, could the secondary market be established and further developed in Afghanistan, if yes, how or if no, please provide the main reasons?

2. According to your opinion, what are the main obstacles and challenges which prevent the secondary market establishment and development in Afghanistan?
3. In what kind of securities and other valuable notes are you interested to invest (please provide brief explanation)?
4. According to your point of view, what kind of valuable notes should the government (the Central Bank and Ministry of Finance) issue and why?
5. According to your opinion, what specific actions should the Central Bank of Afghanistan take for the establishment and further development of the secondary market in Afghanistan?

Benefits of the Secondary Market:

The secondary market can be beneficial to both public and private sectors. There are a number of benefits of the secondary market. However, the most important ones are briefly described as follows:

✚ **Better Monetary Policy Implementation:** The Central Banks of some countries, such as the Central Bank of Afghanistan, target monetary aggregates for achieving the ultimate target which is the domestic price stability. The Central Bank can use financial instruments available in the secondary market as an effective monetary policy tool for controlling the quantity of monetary aggregates. By selling or purchasing the secondary market instruments, the Central Bank can easily decrease or increase the amount of the currency in circulation and influence inflation in the economy. It is mentionable that when a Central Bank uses the secondary market instruments, it can control the liquidity in the economy in a better manner.

Most of the Central Banks across the world implement monetary policy and use one of the important monetary policy instruments which is the open market operations. By using this instrument, the Central Bank can easily implement contractionary and expansionary monetary policies. For instance, when the level of monetary aggregates is below the predetermined target, the Central Bank purchases the secondary market instruments for increasing the quantity of currency in circulation and when the contractionary monetary policy is considered favorable, the Central Bank begins selling the secondary market instruments for reducing the quantity of currency in circulation. Therefore, the existence of secondary market facilitates the implementation of the monetary policy.

✚ **Availability of debt for the government from domestic sources:** in case the government needs funds for financing the government budget deficit and if the secondary market is developed in the economy, the government can get access to funds in the form of debt from domestic sources by issuing government securities. The government securities are much more reliable and have lower risk and the currency exchangers of the

foreign exchange market, commercial banks, and the general public can purchase the securities with greater confidence.

- ✚ **Capital Formation:** capital formation is one of the most important factors for the growth of the economy. The secondary market can play an important role in capital formation in the economy. Without the existence of the primary and secondary markets, carrying out large investments would be difficult since large investments require large amount of capital, for instance, investment in production of machinery, airplanes, etc. By issuing stocks and bonds, corporations can collect sufficient funds for carrying out large investments. The stocks and bonds issued by new corporations carry greater risks and requires good amount of information. Hence, the demand for these securities could be negligible, but for the development of the secondary market government intervention is required. For example, the government can implement policies to support the newly established corporations for not only increasing the level of output and employment, but also for the development of the secondary market in the economy.
- ✚ **Providing Financial Investment Opportunity:** the secondary market instruments such as government securities and corporate securities provide a good financial investment opportunity for the general public. By carrying out financial investment, the general public can get income from their extra funds. Hence, the establishment of the secondary market creates a good income source for the general public. Increased income means higher level of spending and higher spending causes the economy to grow faster.

Secondary Market in Afghanistan

As it is well-known fact that Afghanistan suffered from the civil war in the past decades and recently, the lack of security and political instability affected the overall economy in a negative manner. The financial system, particularly the development of the primary and secondary markets was also severely affected by bad security and political condition of the country. The Central Bank of Afghanistan played an important role for fostering the financial system in the economy. The Central Bank has created the primary market while the secondary market does not exist in Afghanistan up until now.

The Central Bank issues Capital Notes in the form of regular auction once a week. The issuance of Capital Notes by the Central Bank is considered as the primary market. The participants of the Capital Notes auction are the commercial banks. The Capital Notes are issued for various maturities such as Capital Notes issued for 7 days, 28 days, 91 days, 182 days and 364 days. The Central Bank pays different interest rates on Capital Notes with different maturities, for instance

the Central Bank has paid 0.15 percent on 7 days Capital Notes, 0.34 percent on 28 days Capital Notes, 0.52 percent on 91 days Capital Notes, 0.8 percent on 182 days Capital Notes and 0.67 percent on 364 days Capital Notes. As mentioned above, the interest rates for each category of the Capital Notes vary every week and the above interest rates are provided as an example only.

The following graph illustrates the total amount of the issued Capital Notes by the Central Bank:

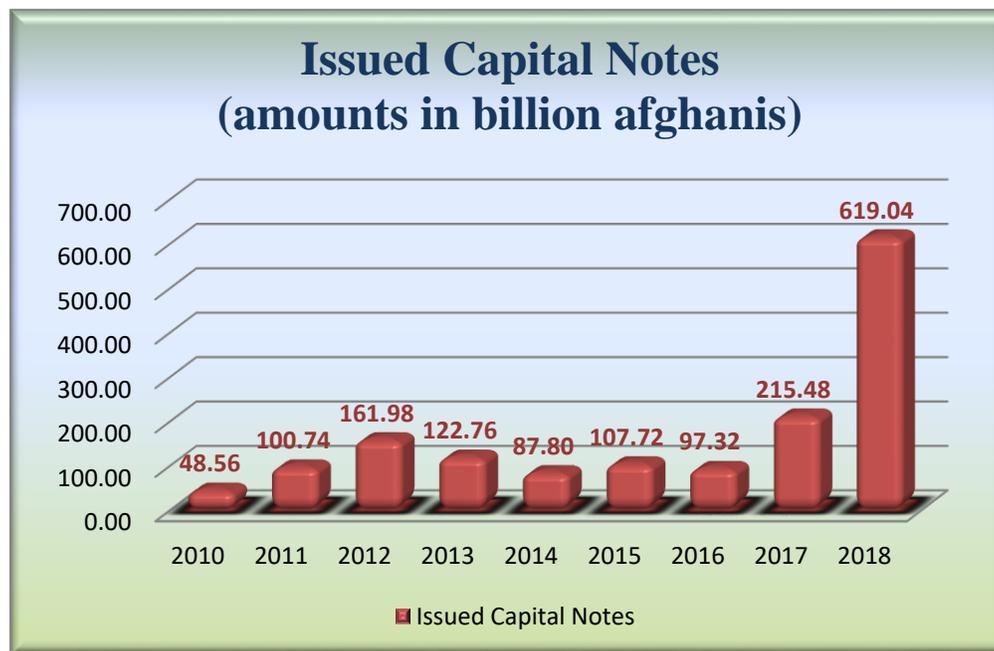


Figure 1: Total Capital Notes Issued by the Central Bank

Data Source: Monetary Sector of the Monetary Policy Department, DAB

The ultimate monetary policy target in Afghanistan is the domestic price stability and the Central Bank targets monetary aggregates for achieving the ultimate target and for controlling the quantity of monetary aggregates, the Central Bank uses the following three main monetary policy instruments:

- i. The issuance of Capital Notes
- ii. The foreign currency auction
- iii. The reserve requirements

As mentioned above, the Capital Notes issuance is one the monetary policy instruments and the Central Bank uses the instrument for various purposes. The issuance of the Capital Notes by the Central Bank has two main benefits which are described briefly as follows:

- a. **Liquidity Management:** whenever the currency in circulation is above the target level, by the issuance of the Capital Notes, the Central Bank can easily reduce the amount of currency in circulation.
- b. **Investment Opportunity for Commercial Banks:** In Afghanistan, the bad security condition has affected the investment level in the country in a negative manner and the demand for loans is much lower which is the main reason that the commercial banks are over-liquid now-a-days. The issuance of Capital Notes by the Central Bank provides a financial investment opportunity for the commercial banks so that the commercial banks could invest their extra funds in Capital Notes and get some profit.

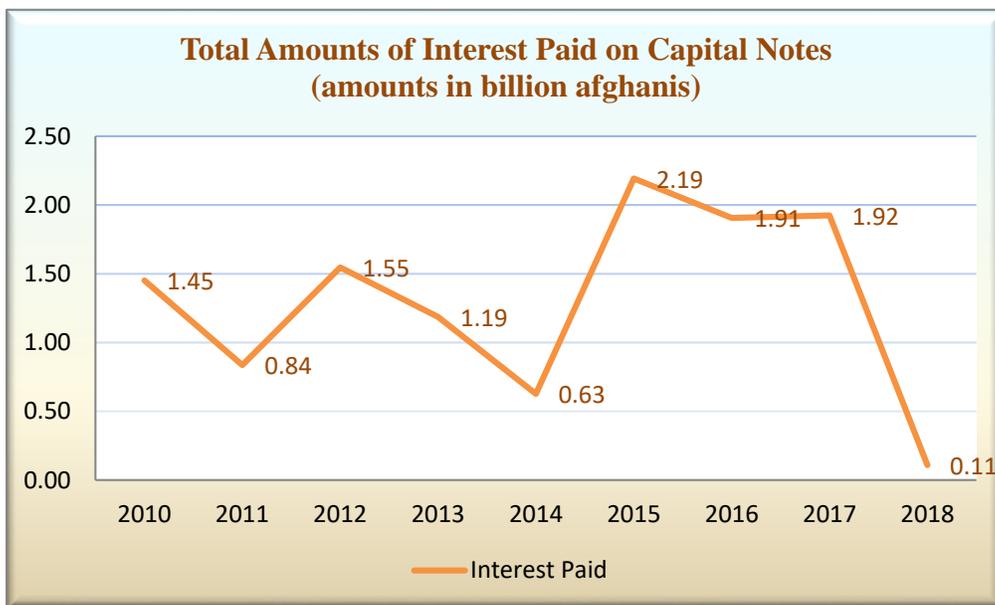


Figure 2: Total Amount of Interest Paid by the Central Bank on Capital Notes

Data Source: Monetary Sector of the Monetary Policy Department, DAB

Despite the efforts of the Central Bank, the establishment and further development of the secondary market in Afghanistan seems to be challenging. The main impediments to the secondary market development are discussed as follows:

Main Obstacles and Challenges to the Secondary Market Development in Afghanistan

In spite of many benefits, the secondary market does not exist in Afghanistan so far. There are a number of impediments to the establishment and further development of the secondary market in Afghanistan. However, the most important ones are discussed below:

i. Lack of Security and Lack Political Stability in Afghanistan

As it is well-known fact that Afghanistan suffered a lot from the civil war in the past decades and still the country suffers from international terrorism. Lack of security kept the domestic and foreign investors away from investing in Afghanistan. Therefore, investments in large and prolonged projects are not carried out in the economy and one of the major segments of the secondary market which is the secondary market for corporate securities is not developed in the Afghanistan. Furthermore, the country is lacking political stability which is another major issue which affected the confidence of the domestic and foreign investors in a negative manner.

ii. Unfamiliarity of the General Public with the Secondary Market and its Instruments

As it is well known fact that Afghanistan is a war torn country and still the country suffers from the international terrorism. That's why the overall economy of Afghanistan, particularly the financial system of the country has been influenced in a negative manner during the past decades. Hence, the general public in Afghanistan is unaware of the secondary market and the instruments that are traded in the market. The Central Bank can play an important role in familiarizing the general public with the financial market instruments by issuing valuable notes such as the prize bonds. The incentive of prize bonds which is the prize of bonds itself can encourage the general public to purchase the bonds. Thus, through the issuance of the prize bonds by Central Bank, the general public can get familiar with valuable notes which can pave the way for the development of the secondary market in the country. It is worth mentioning that the Central Bank can use the prize bonds as a monetary policy instrument as well.

iii. Lack of Legal and Regulatory Framework

Legal and regulatory framework is crucial for the establishment of the secondary market. Clear rules, regulations and settlement procedures encourage market participants for investing their funds in the financial market, especially in the secondary market instruments. The rules, regulations and settlement procedures should be created by the Central Bank in cooperation with the Ministry of Finance. The following two important segments of the secondary market should be considered while creating the rules, regulations and procedures:

- a. **Secondary Market for Government Securities:** The Central Bank in cooperation with the Ministry of Finance should create necessary rules, regulations, and settlement procedures for the securities issued by the Ministry of Finance and the Central Bank.
- b. **Secondary Market for Corporate Securities:** In case, there are clear rules, regulations, and settlement procedures, it will encourage the general public to invest their funds in the secondary market instruments with confidence and the investors would be able to receive funds for their investments with ease. This will encourage the private sector to extend their investments in the country.

Nonetheless, clear rules, regulations, and settlement procedures would also encourage foreign investors to invest their funds in the secondary market instruments in Afghanistan.

iv. **Lack of Issuers of the Tradable Secondary Market Instruments**

Since the security and political conditions in the economy is not desirable, large investments are not carried out in the economy. Therefore, it will be very difficult to establish and further develop the secondary market for corporate securities if not impossible. However, the establishment and further development of the secondary market for government securities seems feasible these days. But still there is a major problem in the establishment and further development of this segment of the market because currently, the government budget deficit is financed through international aids and contributions and the Ministry of Finance is not issuing any kind of government securities for financing the government budget. If the Ministry of Finance issue some kind of securities for financing the government budget, there is a high possibility that the international community would lessen their aids and contributions to the country which would have bad impact on the entire economy, particularly the exchange rate since the aids and contributions of the international community provide good inflow of the foreign currencies into Afghanistan. It is worth mentioning that Afghanistan suffers from perpetual trade balance deficit and in case the foreign donations decrease, the afghani exchange rate would depreciate and the in turn the prices of the imported goods would rise. Hence, it is not reasonable for the Ministry of Finance to issue any kind of securities for financing the government budget deficit now-a-days.

Nonetheless, for the development of the secondary market in Afghanistan, the role of the Central Bank is crucial. The Central Bank already issues Capital Notes in the form of regular auctions and only the commercial banks participate in the auction of the Capital Notes. Actually, the Central Bank does not issue any kind of note in physical form. The Central Bank has only created an account for maintaining the money of commercial banks used for purchasing the

mentioned notes until maturity and after maturity, the money is transferred back from the Capital Notes' account to the current accounts of the commercial banks with certain amounts of interest.

The issuance of Capital Notes by the Central Bank for achieving various monetary policy objectives is considered the primary market. The primary market can be further developed into the secondary market by some more efforts of the Central Bank. For instance, the Central Bank can design and print a physical note for the Capital Note and the Central Bank can allow the currency exchangers of the foreign exchange market to participate in the auction of Capital Notes as well. By creating specific rules, regulations and settlement procedures, the market for Capital Notes can become secondary market and by the passage of time, the general public can become familiar with the secondary market instruments which in turn would pave the way for further development of the secondary market in Afghanistan.

v. Lack of Investors in Financial Assets

When valuable notes are issued, there should be sufficient number of investors for purchasing and further trading those valuable notes. Let's consider the two segments of the secondary market which are the market for government securities and the market for corporate securities and let's suppose that the government is issuing securities for financing the government budget deficit and there are sufficient numbers of corporations that also issue securities.

The demand for corporate securities would be lower compare to the government securities since the main demanders for the government securities would be the currency exchangers of the foreign exchange market and the commercial banks while the currency exchangers of the foreign exchange market and commercial banks would show lower interest in purchasing the corporate securities such as equities and bonds due to higher risk. However, the demand of the general public would be lower for all of the mentioned secondary market instruments because of the two main reasons:

- a. The general public is unaware of the valuable notes and some of them whom are aware of the secondary market instruments would have low confidence on getting their money back if they invest their funds in corporate securities.
- b. Majority of the general public do not want to invest their funds where they could get fixed interests because of religious reasons.

Therefore, the establishment and further development of the secondary market in Afghanistan would be challenging. However, if the government and the corporations issue the valuable notes in accordance with the Islamic rules, the demand for those valuable notes would be much higher but the confidence of the general public in investing their funds in either the government securities and corporate securities would remain lower. Therefore, a longer period of time is needed for the development of the secondary market in Afghanistan.

Survey Results:

Since this research is more qualitative and less quantitative, conducting a survey was considered essential for knowing the opinion of the survey participants. The survey participants were selected in relevance to their involvement in the financial market. For carrying out the survey, two groups of survey participants were selected. One group of the participants included all of the commercial banks in the country and the other group was comprised of the currency exchangers and money services providers of the foreign exchange market. It is worth mentioning that the survey participants from the foreign exchange market were selected randomly. The survey results are briefly discussed in the following sections:

i. Section 1: Survey Results of the Participants from the Foreign Exchange Market

Majority of the currency exchangers and money services providers are uneducated people, that's why, only 10 percent of the selected survey participants were able to answer the questions of the survey questionnaire. However, most of the survey participants pointed out the bad security conditions in the country as well as lack of confidence of the general public and businessmen on the tradable secondary market instruments as the main obstacles to the establishment and further development of the secondary market in Afghanistan.

Some of the survey participants considered the unawareness of the general public of the secondary market and its instruments as well as the lack of sophisticated electronic networking system for the establishment of the secondary market while others explained lack of laws and regulations and lack of stability of the afghani exchange rate as the impediments to the secondary market establishment and further development in the country. One of the participants considered continuous war against terrorists, suicide bombings, and interference of other countries in Afghanistan as main challenges for the establishment and development of the secondary market in the country. Cultural issues were also described as an obstacle to the secondary market establishment and further development in the country by one the survey participant.

Almost all of the survey participants were not willing to invest their funds in the secondary market instruments while one of the survey participants was interested in investing funds in the government securities. Another participant clearly expressed that the participant had no idea of the secondary market instruments.

The survey participants recommended considering and studying the establishment and further development of the secondary markets in other countries for the establishment of the secondary market in Afghanistan while one of the participant considered the current economic condition as inappropriate for the establishment of the secondary market in Afghanistan. Another survey participant recommended that the government should first establish the secondary market and as

the time passes by, the private sector should be encouraged to get involved in the secondary market.

ii. Section 2: Survey Results of the Participants from the Commercial Banks

The main participants of the second part of the survey were the commercial banks. The survey participants responded well to the questions and it is mentionable that only forty percent of the survey participants answered the survey questions.

All of the survey participants expressed that the secondary market in Afghanistan can be established and further developed in the long run with the efforts of the Central Bank and the Ministry of Finance. According to the respondents, the main obstacles to the establishment and further development of the secondary market in Afghanistan are as follows:

- Unfavorable security and political conditions as well as lack of economic stability in Afghanistan
- Deterioration of law and order condition in the country
- Unfamiliarity of the people and even some of the players in the economy with the secondary market and its instruments
- Lack of suitable economic environment for the establishment of the secondary market
- Lack of appropriate market infrastructure
- Absence of market participants
- Lack of good debt management
- Lack of investor base
- Lack of proper monetary operation framework
- Lack of numerous primary market instruments
- Lower rate of return on the primary market instrument

All of the survey participants showed interest in investing their funds in the secondary market instruments, particularly the short-term and long-term securities issued by the government. Moreover, according to the survey participants, the government should issue short and long-term securities such as treasury bills, government bonds, Sukuk etc. with appropriate rate of return and the securities should be exempted from government tax. One of the survey participants explained that not all of the government projects are funded by the donor countries and hence the issuance of the short and long-term securities by the government will be a very good option for funding necessary government projects, which will play a good role in enhancing the overall development of the country. Several survey participants mentioned that the government should issue securities for financing its development expenditure and reducing reliance on foreign aids and contributions. Besides, the cost of financing the development expenditure of the government from domestic sources is lower compared to financing the government development expenditure from foreign sources. Add to that, the establishment and further development of

secondary market in Afghanistan will provide investment opportunity for the individuals and institutions with extra funds.

Another survey participant mentioned that the open market operations is one of the policy tools by which the Central Bank can control the liquidity in the economy in a better manner. The Central Bank and Ministry of Finance can also use the tool for stabilizing the external value of the domestic currency and prevent further depreciation of the afghani.

The survey participants recommended the bellow ways for the establishment and further development of the secondary market in the country:

- The government should strive to become politically stable.
- The government should try to enhance economic stability in the country.
- The government should improve the security condition as well as law enforcement across the country.
- The government should create sound and transparent debt management system.
- The government should encourage both the public and investors to participate in the secondary market.
- The government should create legal and regulatory framework for the establishment of the secondary market.
- The Central Bank should improve the effectiveness of the monetary policy.
- The Central Bank should design and implement programs for increasing the awareness of the general public and domestic investors of the importance of the secondary market in the country as well as the tradeable instruments of the secondary market.
- The Central Bank should take necessary actions for building the market infrastructure.
- The Central Bank should create sound settlement procedures for the secondary market transactions.
- The Central Bank should provide training programs for the employees of the commercial banks and corporations that are interested in investing their funds in the secondary market instruments.
- A secondary market for the Capital Notes, which are issued by the Central Bank, should be established and the rate of return on the Capital Notes should be increased. In addition, the Central Bank should create separate custody accounts for financial institutions for parking of Capital Notes. Moreover, there should be no withholding tax on the Capital Notes because no withholding tax on the Capital Notes would make the security more liquid and easily tradeable in the secondary market.
- The government should periodically review the progress and take reformative measures for better results.
- The Central Bank should conduct studies for being successful in the establishment and further development of the secondary market in the country.

Conclusion:

The secondary market plays an important role in the overall growth of an economy. Secondary market has a number of benefits such as capital formation, better implementation of the monetary policy, better government debt management, providing financial investment opportunity for the general public, encouraging private savings, etc. Despite many advantages, the secondary market is not established in Afghanistan. There are a bunch of obstacles and challenges in the way of establishing and further developing the secondary market in Afghanistan. The most important impediments to the establishment and further development of secondary market in the country are as follows:

- ✚ Lack of security and lack of political stability in Afghanistan
- ✚ Unfamiliarity of the general public with the secondary market and its instruments
- ✚ Lack of legal and regulatory framework
- ✚ Lack of issuers of the valuable notes
- ✚ Lack of investors in financial assets

However, the Central Bank of Afghanistan can play an important role in the establishment and further development of the secondary market in Afghanistan. The Central Bank in co-operation with the Ministry of Finance can create, rules, regulations, and settlement procedures as well as issue tradable secondary market instruments. But, still the mentioned government organizations cannot develop one of the most important segments of the secondary market which is the secondary market for corporate securities since the development of this segment of the market is highly dependent on the security conditions in the country. Anyhow, the government can play an important role in the development of the secondary market for government securities and as the security and political conditions become favorable and the general public becomes aware of the secondary market instruments, the way for the development of the secondary market for the corporate securities would be leveled in the future.

Recommendations:

The establishment and further development of the secondary market is much more challenging considering the current security, political and economic conditions of the country. However, the Central Bank in co-operation with the Ministry of Finance can play an important role in establishment and further development of the secondary market in Afghanistan. If we consider two important segments of the secondary market which are the secondary market for government securities and the secondary market for corporate securities, the Central Bank in co-operation with the Ministry of Finance can establish the secondary market for government securities and pave the way for the establishment and further development of the secondary market for corporate securities.

Anyhow, according to the above analysis, the following recommendations are provided for the establishment and further development of the secondary market in Afghanistan:

- 1- First of all, the Central Bank in co-operation with Ministry of Finance should create rules, regulations and clear settlement procedures for the primary and secondary market instruments. The following two segments of the secondary market should be considered while creating the rules, regulations and settlement procedures:
 - a. Secondary market for government securities
 - b. Secondary market for corporate securities

In the beginning, the creation of rules, regulations and settlements procedures is crucial since the secondary market is established through the government intervention. Later on, the mentioned government organizations can create the rules, regulations and settlement procedures for the corporate securities. However, the mentioned government organizations can also create the rules, regulations and settlement procedures at the same time.

- 2- It is very important to make the general public familiar with the valuable notes. Therefore, the Central Bank can issue prize bonds to make the general public aware of valuable notes. The prize of the mentioned bonds itself is an incentive for encouraging people for purchasing the bonds. It is obvious that the issuance of the prize bonds bears costs, but for making the general public familiar with the prize bonds, the issuance of the prize bonds by the Central Bank is considered very important.
- 3- After the issuance of the prize bonds, the Central Bank should design and print notes for the Capital Notes and supply these notes to the market in the form of auctions. In the auctions of the Capital Notes, the Central Bank should also allow the currency exchanges and the money services providers of the foreign exchange market to participate and purchase the mentioned notes.

- 4- A training program for the commercial banks and the currency exchangers as well as money services providers should be provided for making them understand how to purchase Capital Notes and how they can sell the notes to general public.
- 5- An awareness program should be initiated by the Central Bank for making the general public get sufficient information about Capital Notes and why they should purchase and how they can purchase the Capital Notes, and other valuable notes if available. The Central Bank can use various methods for making the general public understand such as training programs, advertisements, magazines, brochures, and so on.
- 6- As the transactions become large and the market expands, the Central Bank in co-operation with the Ministry of Finance should allocate a specific place for the stock exchange market, and have the commercial banks to open their branches in the mentioned place for carrying out transactions related to purchasing and selling the government securities as well as corporate securities if available.
- 7- By the passage of time and as the security and political conditions become favorable, large investments would be carried out and there is a good enough possibility that the second segment of the secondary market which is the secondary market for corporate securities would be establish and further developed. Still the government intervention for the encouragement of the domestic and foreign investors for carrying out large investments is crucial.

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