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ANALYSIS OF THE PRIMARY DEALERS FUNCTION²

JEL CLASSIFICATION: D53, O16, H63

ABSTRACT:

The purpose of this paper is to examine the role of primary dealers, whose introduction promotes the development and trading of securities on the primary market while also making government securities easier to place. As a result, primary dealers act as a bridge between the government and large institutional investors. Their active role increases secondary market liquidity, which can potentially lead to an increase in investor base, simplification of the trading process, and reduction of transaction costs. As a result, borrowing costs for securities issuers are reduced, which contributes to the continued development of financial markets. In this paper we will examine the selection criteria and obligations of primary dealers, as well as their role in capital market development and monetary policy implementation. The final section of the paper focuses on the evolution of this function in Serbia. So far, regulatory changes in Serbia have enabled the function of primary dealers to be implemented, but they have not yet been implemented. Their implementation in Serbia would increase primary market liquidity, reduce the risk of debt financing, and contribute to the secondary market's further development.

**KEYWORDS:****PRIMARY DEALER, FINANCIAL MARKETS, SECURITY TRADING, UNDERWRITING, DEBT MANAGEMENT**

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2 The views expressed in this paper are those of the author, and do not necessarily represent the official view of the Economists Association of Belgrade.

1. INTRODUCTION

The introduction and development of the function of primary dealers are very important for the further development of the money market and the capital market. Primary dealers are financial institutions that facilitate the government's selling of government securities. This promotes the expansion of trading on the primary and secondary markets, lowers transaction costs, and simplifies the process of issuing securities. Simultaneously, primary dealers can have a positive impact on the reduction of borrowing costs and thus the reduction of public debt. Primary dealers can positively contribute to increased liquidity in the primary and secondary markets, as well as the expansion of the investor base, by acting in this manner.

This paper's primary goal is to investigate the role of primary dealers. We will look at the selection criteria and obligations of primary dealers, as well as their role in capital market development in the European Union and monetary policy implementation in the United States. The markets mentioned above have a long history of operating as primary dealers and can serve as a model for the introduction of primary dealers into the domestic financial market. This paper is structured as follows. The introduction is followed by a literature review. The third and fourth sections of the paper examine the selection criteria, obligations, and role of primary dealers in capital market development. The fifth section of the paper focuses on the role of the primary dealer in the conduct of monetary policy. The final section of the paper discusses the evolution of primary dealer functions in Serbia. Finally, in the conclusion, the main points of this paper are summarized.

2. LITERATURE REVIEW

The development of money and capital markets is a critical prerequisite for the overall economic development. Ensuring a sufficient amount of capital allows the entire financial system, particularly banks, to be resilient. Because the government borrows from domestic and international markets during fiscal deficit periods, the efficiency of the money and capital markets has an impact on public finance management. The introduction of the function of primary dealers is one method of advancing the development of the money and capital markets.

Primary dealers, according to Arnone and Ugolini (2004), are an agreement between two interested parties in the domestic market of government debt instruments—a debt manager and a group of dealers—to develop a joint strategy to support the functioning and development of the primary and secondary markets of government securities. Primary dealers have been introduced in many countries to encourage trading in government securities. As a result, the primary dealers were given preferential treatment in exchange for accepting certain obligations. Privileges can include the ability to submit noncompetitive bids at government securities auctions, access to inter-dealer broker screens, being the central bank's counterparty in open market operations and repo transactions, as well as performing deposit and credit facilities (e.g., standing facilities). Primary dealers' obligations include submitting reasonable bids on the primary market, ensuring a fair second-

ary market, and providing market information to the central bank's trading desk (Schinasi and Smith, 1998). The function of primary dealers is extremely risky because it may own a portfolio of securities in the primary market that are either overpriced or have no interested buyers. This can happen if the primary dealer miscalculates the market price or investor demand. Something similar can happen in the secondary market. As a result of the foregoing, primary dealers may incur significant losses while trading³.

The main goal of introducing the function of primary dealers is to increase the efficiency and effectiveness of operations in the primary market and enable the smooth functioning of the secondary market (Babuşcu and Hazar, 2012). In addition to the above, primary dealers are also introduced to provide market information, to absorb an occasional liquidity shortfall, and to devote capital resources to underwriting (Arnone and Iden, 2003). The establishment of a secondary market for government bonds is frequently cited as the primary reason for the introduction of the primary dealer function. However, if we consider the arguments of those who oppose the function of primary dealers, the limited competition in the secondary market and the possibility of greater collisions in the primary market stand out⁴.

In many countries, the function of primary dealers has been applied for many years, which is connected to the process of modernization of the local financial market and procedures for issuing debt securities (Santillán, Bayle and Thygesen, 2000). Gupta (2021) conducted research and demonstrated that primary dealers in the United States' financial markets are critical due to their role in conducting open market operations as well as serving as market makers in the bond market, derivatives market, and money market instrument market. According to the analysis of Rantalainen (1993) and Pacini (2006), Finland's primary dealers have contributed to increased confidence in the government bond market for both domestic and international investors. In India, based on Gopinath (2010) research, primary dealers were introduced in 1995 with the aim of making the government securities market more liquid and broader based. At times when the domestic financial market is not enough to finance the economic cycle, international investors are crucial for future development⁵. It is the primary dealers who can help attract international investors.

In developing countries, it often happens that due to the insufficient development of the financial market, there is a problem of currency mismatch between the currency structure of assets and liabilities of a specific country, company, financial institution, or private individual⁶. With their business, primary dealers can help to reduce currency mismatches. In Serbia, for example, the currency mismatch can be reduced by encouraging dinar issues and extending their maturities, and primary dealers can actively work to stimulate the primary and secondary markets for government securities⁷.

3 Trofimchuk (2014), p. 7

4 Breuer (1999), p. 4

5 Cingula and Cingula (2012), p. 28

6 Janković (2014), p. 79

7 Martin (2016), p. 45

3. SELECTION CRITERIA AND OBLIGATIONS OF PRIMARY DEALERS

The criteria used to select primary dealers are based on their role in the primary and secondary markets, as well as the contribution they can make to the financial system's stability. The most important selection criterion in the selection of primary dealers, according to Arnone and Ugolini (2005), is financial capacity, which is expressed as net capital or the value of assets owned by primary dealers. The reasons for the importance of financial capacity are numerous and apply to all candidates for the position of primary dealer. Then, depending on the minimum capital requirements, primary dealers can continue to actively participate in the primary and secondary markets. Equally important is the market's belief in the primary dealers' financial strength, as well as the limitation of future potential financial problems in the primary dealers' operations. The next selection criterion is market activity, which is reflected in the primary and secondary market activities of the primary dealer. The average market share of primary dealers in the trading of government securities, as well as the volume of trading and participation in the secondary market, are used to measure market activity. Adequate management and technological infrastructure are important selection criteria that manifest as the necessary expertise to ensure the smooth trading of government securities. Primary dealers must have access to technological conditions that allow them to submit bids at primary auctions as well as trade on the secondary market in order to ensure uninterrupted trading with government securities. Other considerations include prior experience and references from bond trading, as well as the minimum credit rating that the principal dealer must have (this requirement applies to primary dealers operating in a larger number of other markets).

Primary dealers must fulfill certain obligations after obtaining a work permit. The first obligation refers to the underwriter of government securities, which refers to primary dealers' participation in auctions or other types of arrangements (for example, direct sales). The competent authority for fulfilling this obligation has the authority to determine both the minimum amount underwritten and the minimum amount of the offer. In the first case, the primary dealer must fulfill the minimum amount underwritten, which can be defined as the total amount of securities, within a certain period of time, whereas in the second case, it refers to the provision of the average amount of underwriting for different categories of securities. When determining the criteria for the application of the underwriter of government securities, it is necessary to set an appropriate period for ensuring liquidity so that the ability of primary dealers to provide support to the government over a longer period is not jeopardized. The following obligation is to participate in open or closed auctions, depending on the issuer of the securities. Because it implies that the dealer provides underwriting support for a given auction, a closed auction is most often associated with the function of primary dealers. Another obligation concerns primary dealers' participation in the reopening of certain securities issues, in which the primary dealers are expected to purchase those securities in a short period of time (usually within a day) in order to provide the government with the necessary liquidity. It is necessary for the primary dealer to send its offer in this case, but it is not necessary to provide underwriting for a specific auction. In addition to the aforementioned obligations, it is critical to emphasize primary dealers' obligations when conducting secondary market transactions and reporting. Primary dealers in the secondary market have an obligation to

ensure liquidity for government securities by ensuring continuous trading in that segment of the market. Primary dealer offers on the secondary market can be indicative (made without the obligation to buy or sell a specific security) or firm (an offer is made with the intention of concluding a transaction). Primary dealers are also required to provide trading data (e.g., Ministry of Finance, Public Debt Administration, Central Bank, and Stock Exchange).

4. THE ROLE OF PRIMARY DEALERS IN CAPITAL MARKET DEVELOPMENT

The role of primary dealers in the development of capital markets will be discussed in the context of the European Union, where the primary dealer system was first implemented in the United Kingdom in 1986. Since then, twenty-two other European Union countries have adopted the primary dealer system. Countries attempted to expand their investor base outside of their domestic financial market at the start of the formation of the system of primary dealers. Later, the primary dealer system was primarily implemented in response to the European integration process, and it was associated with the transnationalization of the European market⁸. The number of primary dealers has varied by country since the primary dealer function was established. There are currently 20 primary dealers for Austrian government bonds and 18 primary dealers for Austrian government bills in Austria. Belgium and Finland had 13 primary dealers each, Poland had 11, the Czech Republic and Bulgaria had 9 each, and Denmark had 8 for government bonds and 4 for treasury bills. The establishment of the Economic and Financial Committee's Sub-Committee on EU Sovereign Debt Markets (ESDM) in December 1997 followed the development of the function of primary dealers, with the goal of developing the European Union's government bond market. Primary dealers have been established in European countries to ensure a steady supply of government securities on the primary market and to improve secondary market efficiency⁹.

Through the Next Generation EU program, the European Commission is entering the capital market to raise funds. The European Union's plan for the economic recovery package of the Union from the consequences of the coronavirus, which was adopted by the European Council in December 2020, is presented in the Next Generation EU Program. This recovery package is worth EUR 806.9 billion and covers the years 2021-2027¹⁰. The European Commission established the Primary Dealer Network in accordance with market practice and the fundraising strategy for the Next Generation EU program in order to achieve success in auction realization, increase liquidity in the secondary market, and ensure the placement of debt instruments to the broadest investor base. Thus, the Primary Dealer Network enabled the European Commission to ensure transparency in its relations with the banks that provide support for the borrowing of the European Union. As of January 10, 2022, forty-three institutions make up the Primary Dealer Network¹¹.

8 Preunkert (2020), p. 4

9 Iorgova and Lian Ong (2008), p. 17

10 <https://op.europa.eu/en/publication-detail/-/publication/d3e77637-a963-11eb-9585-01aa75ed71a1/language-en>

11 https://ec.europa.eu/info/strategy/eu-budget/eu-borrower-investor-relations/primary-dealer-network_en#criteria-to-join

The process of new institutions joining the Primary Dealer Network is continuously open, and institutions must meet the conditions shown in Table 1. In April 2021, the European Commission issued Decision (EU, Euratom) 2021/625 on the establishment of the primary dealer network and the definition of eligibility criteria for lead and co-lead mandates for syndicated transactions for the purposes of the Commission's borrowing activities on behalf of the Union and the European Atomic Energy Community¹², which prescribes the rights of primary dealer network members (Article 7), the method of admission of new members, and the method of admission of new members (Article 15). The Next Generation EU program offers the European Union a diverse borrowing strategy in terms of the securities issued (in addition to conventional bonds, the plan envisions the issuance of green instruments in the amount of approximately EUR 250 billion), while the currency of the issuance is only the euro and the agreed maturity of the issued bond ranges from three to thirty years¹³.

▶ **TABLE 1. ELIGIBILITY CRITERIA TO JOIN THE EU PRIMARY DEALER NETWORK**

Being a legal entity established and having its head office in the Union or in a European Economic Area country.
Being a credit institution authorised in the EU and supervised by an EU competent authority or an investment firm authorised in the EU to carry out the activity of underwriting of financial instruments and/or placing of financial instruments
Being a primary dealer for another European issuer.
To commit to buy a minimum of 0.05 % of the volume to be auctioned.

Source: European Commission, Primary Dealer Network, https://ec.europa.eu/info/strategy/eu-budget/eu-borrower-investor-relations/primary-dealer-network_en#criteria-to-join

The obligations of primary dealers differ between the countries of the European Union, but they have in common that they participate in primary auctions, place government securities, and continuously maintain the liquidity of the secondary market by providing constant quotations. Currently, in the European Union, only Croatia, Cyprus, Estonia, Germany, Luxembourg, and Malta do not have an established system of primary dealers. Primary dealers are required to report all purchases and sales of government securities to the Debt Management Offices (DMOs). Based on the information received, Debt Management Offices have data on market trends in the placement of government securities and thus represent an important instrument in the management of relations with investors. The obtained information can be communicated to investors and market participants.

12 <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021D0625&from=EN>

13 Christie, Claeys and Weil (2021), p.7

5. THE ROLE OF PRIMARY DEALERS IN CONDUCTING MONETARY POLICY

Using the United States as an example, the role of primary dealers in the implementation of monetary policy will be examined. The repo market, or the market for concluding repo contracts, is most commonly associated with the role of primary dealers in the implementation of monetary policy¹⁴. The Federal Reserve Bank of New York has authorized primary dealers to participate as qualified participants in open market operations conducted by the bank under the direction of the Federal Open Market Board. The primary dealer system serves as a link between the criteria and the required performance required to conduct open market operations¹⁵. While the Federal Reserve Bank of New York is in charge of administering the work of primary dealers, the Bank of New York Mellon performs the function of clearing bank¹⁶.

In the United States, primary dealers act as trading counterparties in the implementation of the Federal Reserve Bank of New York's monetary policy. Their responsibilities include: (1) participating in open market operations to implement monetary policy in accordance with the guidelines of the Federal Open Market Committee (FOMC); and (2) providing market information and analysis to the Federal Reserve Bank of New York's trading desk, which can be used for monetary policy formulation and implementation. Furthermore, primary dealers participate in all auctions of US government debt securities and make a market for the Federal Reserve Bank of New York when it transacts on behalf of its foreign official account holders¹⁷. The first primary dealers in the United States were established in May 1960, with eighteen institutions performing this function at the time. In the United States, twenty-five institutions, including world-famous banks (for example, Barclays Capital Inc., Citigroup Global Markets Inc., Goldman Sachs & Co. LLC, Morgan Stanley & Co. LLC, and others), serve as primary dealers.

The following are the requirements for an institution to qualify as a primary dealer: (1) be a registered broker-dealer or broker-dealer for government securities with the Securities and Exchange Commission (SEC), have approval for membership from the Financial Industry Regulatory Authority, and have at least USD 50 million in net regulatory capital. If it is a bank, it must have at least USD 1 billion in Tier 1 capital; (2) demonstrate its presence as a market maker, confirming the possibility of securing liquidity in the market for government securities; (3) provide back-office services to the Federal Reserve Bank of New York; and (4) have the financial and operational capacity to provide margin for mortgage-backed securities. From the moment of inclusion, primary dealers are expected to continuously meet the above eligibility criteria¹⁸.

14 Adrian, Burke, and McAndrews (2009), p. 2

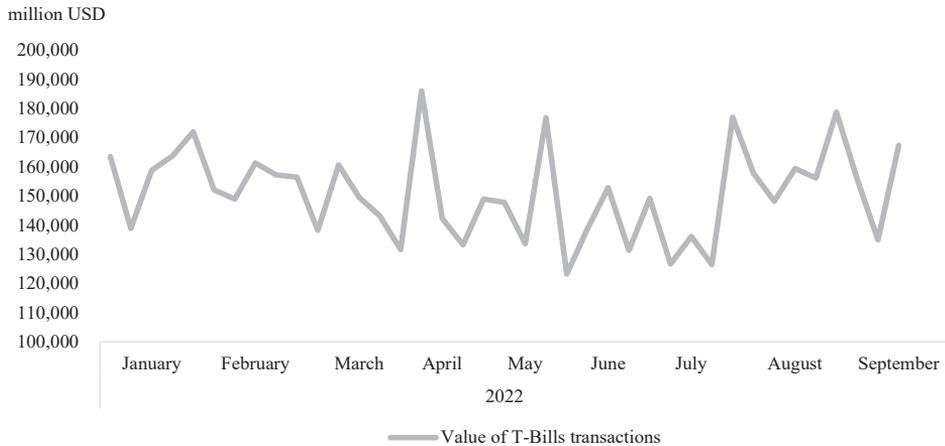
15 Garbade (2016), p. 2

16 Mott (2022), p. 1942

17 <https://www.newyorkfed.org/markets/primarydealers.html#primary-dealers>

18 Ibidem.

▶ GRAPH 1. PRIMARY DEALER STATISTICS – VALUE OF T-BILLS TRANSACTIONS



Source: Federal Reserve Bank of New York

Primary dealers are required to deliver all market activity information to the Federal Reserve Bank of New York, but the Fed does not audit the data that is submitted. Primary dealers report on the trading of US Treasury securities (notes, bills, and bonds), as well as agency MBS securities (Graph 1). Trading data is published if at least three primary dealers submit it by January 28, 1998. Each Thursday at approximately 4:15 p.m., data for the previous week is published.

Prior to the Federal Open Market Committee's monetary policy meeting, primary dealers take part in a survey about their expectations for the economy, monetary policy, and financial market conditions. Since 2011, the findings of that study have been made available online. The survey questions are released two weeks before the Federal Open Market Committee meeting, and the survey results are released three weeks after the meeting¹⁹.

6. ANALYSIS OF THE PRIMARY DEALERS' FUNCTION IN SERBIA

In December 2018, the Law on Amendments to the Law on Public Debt²⁰ introduced the term "primary dealer" in the domestic regulatory framework. According to the mentioned law in Article 2, primary dealers are defined as financial institutions that the ministry in charge of finance has chosen to perform certain activities on the government securities market as well as to improve the primary and secondary markets. The Ministry of Finance in December 2018 announced that it plans to hire banks that will act as primary

19 https://www.newyorkfed.org/markets/primarydealer_survey_questions

20 Law Amending the Law on Public Debt, RS Official Gazette, No 95/2018

dealers in the government bond market with the aim of increasing market liquidity²¹. The Ministry of Finance stated in the aforementioned statement that it intends to introduce primary dealers by the end of 2019 or the beginning of 2020 at the latest, and that the optimal number in the initial phase of introduction will be between five and ten primary dealers, in accordance with the International Monetary Fund's assessment. Furthermore, one of the arguments for the introduction of primary dealers was the low liquidity on the secondary market of government securities in Serbia compared to other countries in the region, because banks purchased government securities for their portfolios at auctions organized by the Public Debt Administration during the mentioned period.

The International Monetary Fund listed activities that will contribute to strengthening public debt management in its first review under the Policy Coordination Instrument (PCI)²² in December 2018. These activities are related to the establishment of a primary dealer system and the formation of an adequate supervisory framework for their work, and then to the improvement of the work of the Public Debt Administration, which organizes primary auctions of government securities in front of the Ministry of Finance, as well as the formation of the Debt Market Committee, which is made up of representatives from the Ministry of Finance and the Public debt administration. In June 2021, the Ministry of Finance stated in the Report on the Implementation of the Public Finance Management Reform Program for 2020²³ that it will continue with the activities of preparing regulations and supporting acts that will enable the introduction of the function of primary dealers on the securities market with constant cooperation with the International Monetary Fund in the coming period.

The International Monetary Fund stated in June 2022, as part of the second revision of the second Policy Coordination Instrument (PCI) program²⁴, that it expects to establish a system of primary dealers in early 2023 to support the first issue of dinar securities, the settlement of which will be handled by Euroclear, one of the world's largest clearing houses. Specifically, at the end of January 2022, the Ministry of Finance signed a document outlining the terms of cooperation with the goal of including the Republic of Serbia's government securities in the Euroclear system. Serbia's entry into the Euroclear system will result in further development of the money and capital markets, as well as an increase in liquidity. Although the role of primary dealers has not yet been officially established in Serbia, the Public Debt Authority issued a bond with a nominal value of EUR 350 million, a maturity of 53 weeks, and a coupon rate of 2.4% at the end of June 2022. This eurobond was issued via a private placement, as defined by Article 38 of the Regulation on General Conditions for the Issue and Sale of Government Securities on the Primary Market.

The introduction of the primary dealer function would help to overcome the domestic securities market's weakness, in which the secondary market is underdeveloped both on and off the stock exchange, as evidenced by the small number of transactions and the

21 Politika, Dileri pomažu državi da proda obveznice, <https://www.politika.rs/sr/clanak/417587/Dileri-pomazu-drzavi-da-proda-obveznice>

22 IMF Country Report No. 18/375, December 2018, <https://www.imf.org/-/media/Files/Publications/CR/2018/cr18375.ashx>

23 Report on the implementation of the public finance management reform program for 2020, https://www.mfin.gov.rs/upload/media/a9p3Wp_60ed30b3429f6.pdf

24 IMF Country Report No. 22/201, June 2022, <https://www.imf.org/-/media/Files/Publications/CR/2022/English/1SRBEA2022001.ashx>

concentration of securities among a small group of investors. Furthermore, it is important to note that if an active and liquid secondary market existed, a potentially larger number of investors would buy securities on the primary market. This would increase investment opportunities for households and encourage them to participate more actively in the financial market²⁵.

7. CONCLUSION

The continuous development of the money and capital markets is required for the economy's overall growth and development. Primary dealers can make a significant contribution to this development. In order to promote the sale of government securities, primary dealers act as an intermediary between the government and institutional investors. Thus, primary dealers help to increase liquidity in the primary and secondary markets, reduce transaction costs, simplify business procedures, and potentially expand the investor base.

This paper examines the selection criteria and obligations of primary dealers, as well as their role in capital market development in the European Union and monetary policy implementation in the United States. Financial capacity, market activity, management, and technological infrastructure are the most important criteria for selecting primary dealers. Primary dealers were first introduced in the European Union in the United Kingdom in 1986. The goal of their introduction was to broaden the investor base outside of the domestic financial market, so that the development of the function of primary dealers would follow the process of integration in Europe later on. Since then, the primary dealer system has been implemented in over twenty-two countries. The European Commission established the Primary Dealer Network in December 2020 as part of the Next Generation EU program to facilitate access to the capital market. The Primary Dealer Network includes 43 institutions, and their obligations vary by member country. All data on trading in government securities must be submitted to the Debt Management Offices by institutions in the Primary Dealer Network. In the United States, primary dealers act as trading counterparties in the Federal Reserve Bank of New York's monetary policy implementation. Primary dealers participate in open market operations in accordance with the guidelines of the Federal Open Market Committee, participate in auctions of government securities, and provide market information and analysis to the Federal Reserve Bank of New York's trading desk. The first primary dealers were introduced to the US market in May 1960, and twenty-five institutions currently perform this function. The Federal Reserve Bank of New York requires primary dealers to report trading data. This information has been available and published since January 1998. The Federal Reserve Bank of New York requires primary dealers to report trading data. This data, which refers to the previous week, has been available since January 1998 and is published every Thursday at approximately 4:15 p.m.

Based on the Law on Amendments to the Law on Public Debt, the function of primary dealers was introduced into the domestic regulatory framework in December 2018. The Ministry of Finance's initial plans for December 2018 included hiring banks to act as primary dealers in the government bond market, with the goal of increasing liquidity. The

Ministry of Finance then announced that it intends to introduce the function of primary dealers by the end of 2019 or, at the very least, at the beginning of 2020, and that the optimal number of primary dealers in the initial phase will be between five and ten, in accordance with the International Monetary Fund's assessment. According to the International Monetary Fund's announcement in June 2022, the primary dealer system will be implemented in early 2023 as part of efforts to support the first issue of dinar securities that will be settled by Euroclear. The Ministry of Finance signed a document outlining the terms of cooperation with the goal of including the Republic of Serbia's state securities in the Euroclear system at the end of January 2022. The establishment of primary dealers in Serbia will help to further develop the capital and money markets, as well as increase liquidity in the primary and secondary markets. At the same time, there may be an increase in the number of investors and a decrease in borrowing costs.

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