Financial Reforms and Financial Development in Arab Countries

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Abstract

This paper examines the development of financial sectors in Arab countries initiated in the 1980s after more than a decade of reforms. Overall, in spite of reforms, progresses have been limited in the countries surveyed. One theoretical explanation of this observation is that there are multiple equilibriums in financial development. After many years of financial repression, Arab countries which have started liberalizing their financial sectors, were initially trapped in a low-level equilibrium, and this may explain why progress so far obtained, have been minimal. A critical mass of change was needed to escape the financial underdevelopment equilibrium. This critical mass of change implies deep structural changes in the financial sector, including in particular, the de-controlling and privatization of the banking activity. However, such financial liberalization could not be successfully implemented without improvement in the institutional setting, through improved financial infrastructure and legal framework. In addition, for lack of deep or fast enough strengthening of the prudential requirements and supervision, authorities have been confronted with a trade-off between financial liberalization and financial stability, and therefore, as a consequence, delayed and mitigated liberalization measures.

الاصلاحات المالية والتطور المالي في الدول العربية

جون كلود بيرثلمي
نــوال بــن طاهــر

الملخص

تتناول هذه الورقة تطور القطاعات المالية الذي حصل في الدول العربية في الثمانينات بعد عقد من الاصلاحات. وبشكل عام، فإنه بالرغم من هذه الاصلاحات، إلا أن تقدما محدودا قد حصل في الدول تحت الدراسة. والتفسير النظري لهذه الملاحظة هو وجود توازنات متعددة في التطور المالي. فبعد سنوات من القيود المالية، فإن الدول العربية التي قد بدأت تحرير قطاعاتها المالية، قد وجدت نفسها بمستوى متدن من التوازن، الأمر الذي يفسر التقدم المتحصل حتى الآن في حدوده الدنيا. إن هناك حاجة ملحة لتغيرات كبيرة وجوهرية للخروج من هذه الحالة، وهو ما يتطلب تغييرات هيكلية عميقة في القطاع المالي متضمنا على وجه الخصوص إلغاء الرقابة وخصخصة النشاط المصرفي. ومع ذلك، فإن هذا التحرير المالي قد لا ينفذ بنجاح دون تحسين الوضع المؤسسي، من خلال تحسين البنى التحتية المالية والنظام القانوني. كذلك فإنه نتيجة الافتقار إلى القوة الكامنة للمراقبة والمتطلبات المتعلقة، فقد وجهت الهيئات بمقايضة ما بين التحرير المالي والاستقرار المالي، ونتيجة لذلك فقد تم تأخير وتخفيف آلام إجراءات التحرير.

Introduction

Financial sector development is a key factor in economic progress. This is also a sector where governments have frequently intervened, with mixed results. After financial repression policies usually implemented until the 1980s, which prevented financial development in many developing countries, including most Arab countries, governments have started liberalizing their financial sectors. One would have expected that this reversal of previous failed policies would have led to significant improvement in financial sector performance. However, although it has been quite easy to hamper financial development, promoting it has proven to be difficult. This is to a large extent related to institutional issues.

This paper provides an overall assessment of the current situation of financial sectors in Arab countries an also proposes a more in-depth analysis of financial development conditions in the light of the discussion of institutional aspects of the banking sector reforms in four specific countries: Egypt, Jordan, Morocco and Tunisia. Examining such country experiences is essential to uncover the institutional bottlenecks which may explain why it is so difficult to build dynamic financial systems after financial liberalization.

Two alternative approaches with financial liberalization have been advocated in the economic literature and implemented by governments and central banks in developing countries: gradualism *vs.* shock therapy (Grais and Kantur, 2003). Gradualist policies have involved step-by-step liberalization of interest rates and removal of state control on banks' and other financial intermediaries' activities. Shock therapy means, like in the Southern Cone of Latin America in the 1970s or in some transition economies more recently, a much quicker reform process, within a speedy liberalization and opening of money and financial markets, as well as privatization of financial institutions.

Both options have merits and weaknesses. Experiences with shock therapy have shown than it may disrupt financial market stability. However, gradualism may prevent the achievement of a critical mass of change in the financial sector. The bottom line of the argument is that too timid and gradualist approaches to financial liberalization are bound to fail because of path dependency. On the other hand, shock therapy leads to financial crises if an appropriate institutional framework – in particular, regarding prudential regulation and supervision – has not been put in place beforehand.

Financial development requires a critical mass of change because financially repressed economies are locked in a sort of poverty trap, where financial underdevelopment and poor economic performances reinforce each other. There is a two-way interaction between economic development and financial depth, leading to multiple equilibriums (Berthélemy and Varoudakis, 1996), which is further discussed below.

Arab countries have generally chosen gradualism over shock therapy. Today, after more than a decade of financial reforms, a number of these economies are still typically in a low equilibrium, with inadequate financial services, contributing to poor economic performance. To get out of this trap, it is necessary to implement stronger reforms and policy initiatives, rather than merely to eliminate the most obvious flaws of the previously applied financial repression policies.

The Financial Poverty Trap

A well-functioning financial sector stimulates savings and improves capital allocation. Nevertheless, it is equally true that in a poor economic environment, financial intermediaries cannot develop profitable services, for lack of large enough amounts of savings to intermediate as well as of demand of capital. Consequently, the finance and growth nexus typically poses a chicken and egg dilemma.

A consequence of this bi-directional interaction between financial depth and economic progress is that it creates cumulative processes which in turn, can lead to multiple equilibriums. Slow economic progress hampers financial development which subsequently reduces potential growth, and leads to a low-level equilibrium. Conversely, economic development and financial deepening reinforce each other, in a high-level equilibrium.

Theoretically speaking, as shown by Berthélemy and Varoudakis (1996), the existence of multiple equilibriums is likely. The intuition behind this theoretical result may be illustrated in Figure 1, where typical relationships between financial depth and economic performance are represented. Intuitively, it may be assumed that economic performance is linked to financial depth through a logistic function, with asymptotic branches both for low levels and for high levels of financial development. Economic growth has lower and upper bounds, even when financial depth is extremely weak or extremely strong. The same kind of assumption may be made regarding financial depth as a function of economic performance. These two assumptions typically lead to the existence of multiple crossings between the two curves.

The grey curves in Figure 1 represent financial depth as a function of economic growth, while the black curve represents the reverse dependence of economic growth on financial depth. Points A and C correspond typically to stable equilibriums, and point B is an unstable equilibrium. As a consequence, it may be assumed that economies will converge either toward point A (the low-level equilibrium, or poverty trap) or toward point C (the high-level equilibrium).

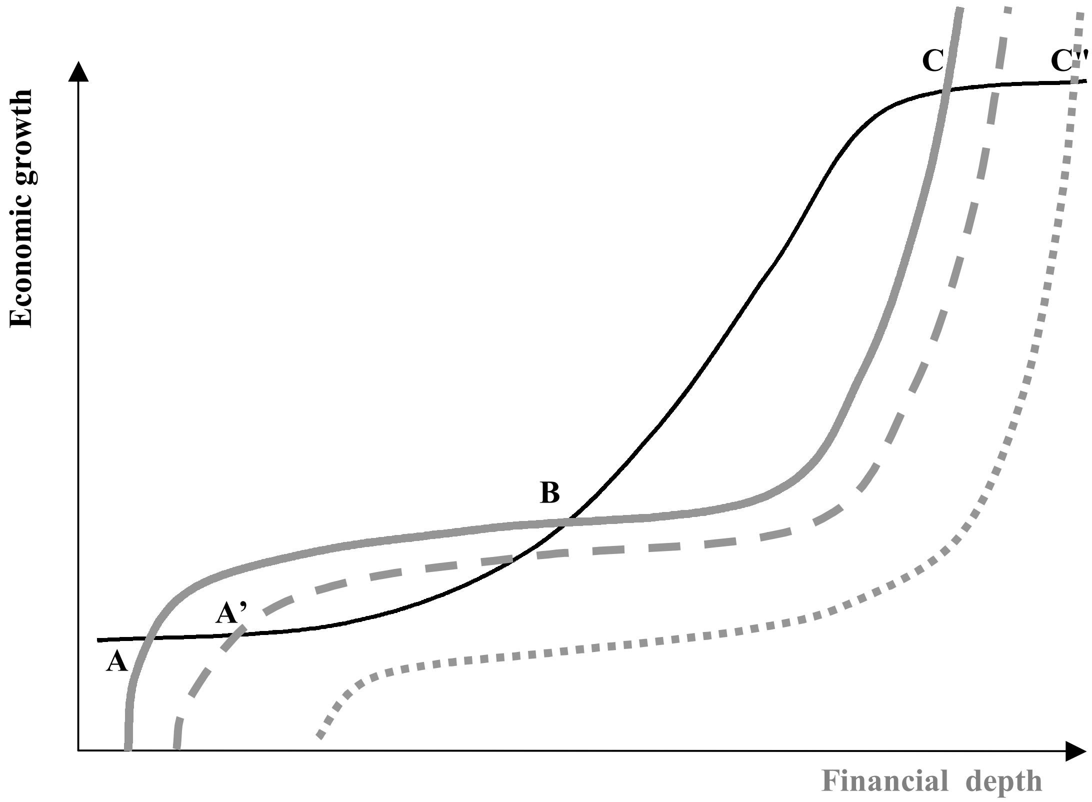

Figure 1. Multiple equilibriums.

The consequences of this theory for the analysis of financial reforms are obvious. Typically, financial repression policies hamper financial activity, and lead to the poverty trap equilibrium. It is even possible that there remains only one (low-level) equilibrium. Such adverse effects will have long-lasting consequences. If the economy has been initially driven to the poverty trap, a mere reversal of initial financial repression policies will probably be insufficient to bring back the economy to the high-level equilibrium.

After a financial repression policy, illustrated by the low-level equilibrium A in Figure 1, if marginal liberalization reforms are implemented, this leads only to a shift from A to A', which does not change much economic performances. What is needed is a critical change, so that the poverty-trap equilibrium disappears, and the economy switches to the high equilibrium C".

The existence of multiple equilibriums may be empirically investigated through tests designed to detect convergence clubs. Countries with poor financial development (typically financially repressed developing economies) tend to cluster in a slow growth–low income group, while countries with more developed financial intermediation systems (typically Asian emerging market economies and OECD countries) will converge together at much higher levels. This approach may of course be generalized to other potential sources of multiple equilibriums. For instance, Berthélemy and Varoudakis (1996) have identified not only two but four convergence clubs, defined both by financial depth and by educational development (see also Berthélemy, 2002). Such results suggest that although a critical mass of change in the financial sector would presumably be insufficient to promote financial development and hence facilitate the growth process, it is not a sufficient condition for economic development. This is because other adverse initial conditions, possibly linked to other multiple equilibrium occurrences, may continue to prevail.

In a more refined approach, Berthélemy and Varoudakis (1997) identified two threshold points related to financial development instead of only one, defined by: (a) the savings collection role of the financial system, which requires only a rudimentary financial industry; and (b) its capacity to improve total factor productivity, which depends on the existence of a more sophisticated financial system, capable of efficiently allocating the intermediated capital. According to data used by Berthélemy and Varoudakis (*op. cit*), which covered six five-year periods over the years 1960 to 1990, three Arab countries namely — Morocco, Syria and Tunisia — were located on the borderline between the upper-level and the intermediate-level convergence clubs, while three others — Algeria, Egypt and Jordan — had a financial depth indicator putting them in the upper-level convergence club.

The ranking of Algeria and Egypt in the upper-level convergence club, as well as the position of Syria close to the borderline between the two convergence clubs, deserves some discussion. The test implemented by Berthélemy and Varoudakis (*op. cit*) was based on a crude measurement of financial depth, the ratio of liquid liabilities to GDP. However, there are a number of other dimensions in financial development, which need more systematic exploration. The issue is not only the amount of capital that is intermediated, but also the experience and efficiency of financial intermediaries, their capability of offering adequate and diversified financial services, the existence of well-functioning legal and informational infrastructures that underlie the development of a credit market, and the ability of financial intermediaries and supervision authorities to prevent financial fragility and systemic crises. In the pre-reform period, the liquidity ratio was presumably, a meaningless indicator of the true financial depth in countries where money and credit were tightly controlled or directly decided by the government, e.g. Algeria, Egypt and Syria.

Among the six countries considered above, two have not really implemented significant financial reforms (Algeria and Syria), but the four others (Egypt, Jordan, Morocco and Tunisia) have started reforming their financial sectors relatively early. Therefore, it is time to draw lessons from these reforms.

Aggregate and Micro-Level Indicators of Financial Development in Arab Countries

Until the end of the 1980s, most Arab countries had repressed their financial systems through interest rates controls, state-ownership of banks, directed credit, and protection from foreign competition. Since the mid-1980s, however, significant reforms have been implemented (Chalk *et al*., 1996; Creane *et al*., 2003).

Liberalization policies have removed some of the constraints on banking intermediation imposed by previous policies. Most often, interest rate controls and constraints previously enforced by governments and Central Banks over bank operations, have been dismantled or softened. Also, some banks have been privatized, and some constraints on foreign participation in the financial sector have been removed. Although only a qualitative and country-specific assessment can tell whether such reforms have been significant, simple data analysis does provide useful preliminary answers to this question.

This is illustrated in Table 1, where the ratio of domestic credit to private sector is reported. In this table, Arab countries are ranked in three classes, based on an evaluation of financial development levels recently implemented by the IMF (see Creane *et al.,* 2003). The IMF evaluation is based on a large dataset of 36 indicators.[1] The information used to build these indicators cover quantitative and qualitative information on the monetary sector, the banking sector size, structure and efficiency, the quality of banking regulation and supervision, the development of non-bank financial intermediation, financial openness, and the institutional environment. Given that some of their indicators are based on unpublished evaluation by IMF staff, the authors have not attempted to reproduce their exercise. The ranking it provides is, however, reasonable. GCC countries as well as Jordan and Lebanon, which are known for their financial sector dynamism, are found in the first group. The second group lists countries which have started liberalizing their financial sector, but where this reform process is unfinished. Non-reforming countries are found in the last group. To some

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(1) In their paper, Creane et al. do not mention Tunisia. However, given that, based on the authors' later analysis, it is found that Tunisia has a level of financial development comparable to Morocco, and hence placed in the second group. Neither do Creane et al. consider the Comoros, because it is not part of the IMF MENA region, but given its very rudimentary financial sector, it has been included in the third group.

extent, the fact that all GCC countries are put in the first group, although some of them would actually need financial reforms, confirms that financial development depends on the wealth of the economy.

Table 1 also shows comparative data for Asian emerging market economies, many of which have also implemented financial reforms, but with much more success than Arab countries. All such Asian emerging market economies compare favorably with Arab countries, even those Arab countries which are put by the IMF in the group of highly financially developed countries. According to the indicators reported in Table 1, they are much closer to OECD high-income countries than to Arab countries. The only relative exception is the Philippines, which is known for being the less developed of the Asian emerging economies. It is also worth noting that this ratio has first declined at the start of the reforms in several countries (notably Algeria, Egypt and Tunisia), where bank assets were previously inflated by government directed credits. This is particularly the case in Algeria, which used to have a centrally planned economy, resulting in a significant monetary overhang (see Jbili, Enders and Treichel, 1997). Since then, the domestic credit ratio has particularly progressed in Egypt, Morocco and Oman, with a growth higher than 50%, suggesting the possible existence of a critical change in the banking sector of these countries over the past 10 to 15 years. However, none has reached a ratio close to those observed on the average in Asian emerging market economies or in high-income OECD countries.(2) Therefore so far, there is not enough evidence that the above-mentioned countries have achieved enough structural change in their financial systems to promote a sustained banking sector development.

One may argue that longer time is necessary to converge to a financial development stage comparable to the advanced countries' level. However, if a critical mass of change had been achieved in the above-mentioned reforming countries, this would have, at least, accelerated the speed of convergence of their financial depth towards the OECD level.(3) Overall, this has not been the case. Only one country, Egypt, had a speed of convergence of its financial depth indicator higher than 2% over the past ten years. Even in this case, financial depth has decelerated since 1998, while it is still at a rather low level in comparison with the OECD average country. Moreover, in Egypt, the significance of monetary aggregate evolutions is dubious. Domestic-currency denominated liquidity has increased partly as a result of a reduction in the dollarization of the economy. Also, the ratio of bank credit to GDP has mechanically increased as a result of the depreciation of the Egyptian pound (20% of loans are in foreign currency).

The size of banking activity provides, however, only very partial information on the banking sector efficiency. Another indicator that may be considered is the interest rate spread charged by banks, given that most Arab countries have liberalized their interest rates since the end of the 1980s. This is true in particular of Algeria, Egypt, Jordan, Morocco, and Tunisia. Figures reported in Table 2 suggest that spreads are at rather high levels.

(2) There is of course some diversity within the OECD, and most new members of the OECD and Turkey, which are not high-income countries, have ratios comparable to those of Arab countries. Throughout the rest of this paper, the OECD averages refer to high-income OECD members.
(3) The speed of convergence is defined here with reference to convergence towards the level observed on the average in OECD countries 10 years ago. It is computed on an annualized basis. Results are not sensitive to the precise definition of this target.

Table 1. Ratio of Domestic Credit to Private Sector to GDP (%)

	1985	1990	1995	2000	2001	2002
High financial development	..	..	***52***	***52***	***56***	***59***
Bahrain	44	30	57	57	60	65
Jordan	66	72	74	76	75	74
Kuwait	81	..	39	53	66	74
Lebanon	..	79	58	92	91	91
Oman	20	23	29	37	39	39
Qatar	29	37	35	27	28	30
Saudi Arabia	62	55	56	52	56	58
United Arab Emirates	34	37	49	46	51	56
Medium financial development	..	..	***34***	***46***	***46***	..
Algeria	60	44	5	6	7	..
Djibouti	57	52	48	32	26	24
Egypt, Arab Rep.	36	31	37	59	62	61
Mauritania	32	43	23	27	28	32
Morocco	32	34	48	59	54	54
Tunisia	67	..	69	66	68	69
Low financial development	..	***18***	***21***	***14***	***14***	***10***
Comoros	10	15	14	12	10	9
Libya	25	31	33	24	25	18
Sudan	10	5	3	2	3	5
Syrian Arab Republic	8	7	11	8	8	8
Yemen, Rep.	..	6	5	5	6	6
Asian emerging market economies	..	..	***96***	***111***	***115***	***116***
Hong Kong, China	..	164	153	156	155	150
Korea, Rep.	59	66	65	101	107	116
Malaysia	87	..	124	140	149	146
Philippines	27	22	45	44	40	36
Singapore	106	97	106	111	130	115
Thailand	58	83	140	108	97	103
High income: OECD	***88***	***108***	***119***	***138***	***137***	***134***

Source: World Bank. 2004. World Development Indicators.
N.B. Countries without available data are not shown.

In countries such as Libya and Syria in the third group, interest rates are still controlled, and therefore not very informative of the actual cost of banking intermediation. In Algeria and Egypt, although interest rates have been liberalized, there is still a majority of state-owned banks, which still apply, notably for social reasons, distorted deposit and lending rate policies, thereby reducing their interest margins. In other countries where this information is available, interest rate spreads are still rather high by international standards, including in the first group of countries. In comparison, over the whole period under review (with the exception of the year 2002), the median Asian emerging market economy has enjoyed a spread below 4%, at levels similar to those observed in the OECD area.

Another aspect of the financial development concerns the emergence of capital markets. This aspect is perhaps less critical, given that capital markets usually develop only at a rather advanced stage of development of the financial system. Moreover, it should be kept in mind that bank-based financial systems, where equity markets play a relatively minor role, can still be fairly developed, such as in Germany. However, even in countries where equity market has existed for a long time (e.g. Egypt, Jordan, Kuwait, Lebanon and Morocco), the capital market has been rather limited until now (see Table 3).

Reforms implemented in recent years have gone in the right direction, within particular stock market liberalizations in Egypt, Morocco and Tunisia in the mid 1990s. However, only Egypt has a relatively large stock market, with more than 1100 companies listed. Also, ratios of market capitalization to GDP are typically low, as compared with Asian emerging market economies, with the only exception of Bahrain and Jordan, as illustrated in

Table 3. Privatizations (particularly in Egypt, Morocco and Tunisia) have led to some increase in market capitalization, but not enough to sustain a dynamic development of the stock markets, given the timid stance of privatization programs implemented in Arab countries.

One reason why market capitalization attains only modest levels in Arab countries is that usually, the owners of small and medium size enterprises are reluctant to issue shares on the equity market. Moreover, when such companies are listed, most of the shares remain family-owned, thereby reducing to a large extent the turnover in the market. This may also partly explain why data on capital market turnover show that the existing capital markets in Arab countries have a very small trading activity, as compared with capital market in developed countries. Generally, the turnover is below 20% (with the only exceptions of Saudi Arabia). On the other hand, the average turnover in Asian emerging market economies, as well as in OECD capital markets, is above 100% (see Table 4).

Although they provide a useful picture of the progress in financial intermediation activity achieved in Arab countries, the previous indicators do not demonstrate whether the financial sector supplies adequate sources of financing to private businesses. To answer this critical question, the focus is now shifted to microeconomic information, which is necessary. This information is available in the World Business Environment Survey (World Bank, 2000) for three economies in the region, namely Egypt, the Gaza Strip and Tunisia. We consider here the available information for Egypt and Tunisia.

Table 2. Interest Rate Spreads (percentage points)

	1985	1990	1995	2000	2001	2002
High financial development						
Bahrain	..	1.0	6.1	5.9	8.1	7.2
Jordan	..	2.2	3.0	4.8	5.1	5.8
Kuwait	1.5	0.0	1.8	3.0	3.4	3.3
Lebanon	4.0	23.1	8.4	6.9	6.3	5.5
Oman	1.2	1.4	2.8	2.4	4.7	5.7
Qatar	3.5	3.5	..	..	..	..
Medium financial development						
Algeria	..	..	3.0	2.5	3.3	3.3
Djibouti	..	..	..	..	8.7	10.1
Egypt, Arab Rep.	4.0	7.0	5.6	3.8	3.8	4.5
Mauritania	4.8	5.0	..	..	..	..
Morocco	-0.3	0.5	0.0	8.2	8.2	8.6
Tunisia	4.3	..	..	..	..	..
Low financial development						
Comoros	7.5	..	..	..	..	..
Libya	1.5	1.5	0.0	4.0	4.0	4.0
Syrian Arab Republic	5.0	5.0	5.0	5.0	5.0	5.0
Yemen, Rep.	..	..	..	5.5	4.5	4.7
Asian emerging market economies						
Hong Kong, China	..	3.3	3.1	4.7	2.7	4.7
Korea, Rep.	0.0	0.0	0.2	0.6	1.9	1.8
Malaysia	2.7	1.3	1.7	3.4	3.3	3.2
Philippines	9.7	4.6	6.3	2.6	3.7	4.5
Singapore	2.9	2.7	2.9	4.1	4.1	4.5
Thailand	3.1	2.2	1.7	4.5	4.7	4.9
OECD high income median country	***4.1***	***4.6***	***4.0***	***4.0***	***4.3***	***3.7***

Source: World Bank. 2004. World Development Indicators. N.B. Countries without available data are not shown.

Table 3. Ratio of Market Capitalization of Listed Companies to GDP (%)

	1985	1990	1995	2000	2001	2002
High financial development	..	**..**	***19***	***21***	***24***	***24***
Bahrain	..	..	..	87	88	89
Jordan	..	50	69	58	71	76
Kuwait	..	..	54	56	..	..
Lebanon	..	..	4	10	7	8
Oman	..	..	16	17	17	20
Qatar	..	..	..	29	..	..
Saudi Arabia	..	..	29	36	40	40
United Arab Emirates	..	..	..	8	11	..
Medium financial development	..	***4***	***16***	***28***	***23***	***25***
Egypt, Arab Rep.	..	4	13	29	25	29
Mauritania	..	..	..	..	113	..
Morocco	..	4	18	33	27	24
Tunisia	..	4	22	15	12	10
Asian emerging market economies	..	***57***	***101***	***114***	***109***	***100***
Hong Kong, China	..	111	214	377	311	287
Korea, Rep.	..	44	37	37	54	52
Malaysia	..	110	251	130	135	131
Philippines	..	13	79	68	30	50
Singapore	..	93	176	167	138	117
Thailand	..	28	85	24	31	36
OECD high income countries	..	***51***	***67***	***118***	***103***	***82***

Source: World Bank. 2004. World Development Indicators. N.B. Countries without available data are not shown.

Table 4. Turnover Ratio in Stock Markets (%)

	1985	1990	1995	2000	2001	2002
High financial development						
Bahrain	..	..	..	4	3	3
Jordan	..	20	11	8	17	15
Kuwait	..	..	53	21	..	..
Lebanon	..	..	..	7	4	5
Oman	..	12	11	14	15	13
Qatar	..	..	..	5	..	..
Saudi Arabia	..	..	16	27	32	30
United Arab Emirates	..	..	..	..	4	3
Medium financial development						
Egypt, Arab Rep.	..	..	11	35	14	16
Morocco	..	..	46	9	10	11
Tunisia	..	3	..	23	13	14
Asian emerging market economies	..		***48***	***82***	***114***	***105***
Hong Kong, China	..	43	37	61	35	43
Korea, Rep.	..	61	98	233	380	303
Malaysia	..	25	36	45	18	17
Philippines	..	14	26	16	7	15
Singapore	..	..	42	52	47	39
Thailand	..	93	41	53	109	98
OECD high income countries	**..**	***55***	***83***	***131***	***139***	***148***

Source: World Bank. 2004. World Development. N.B. Countries without available data are not shown.

In Egypt, the business environment of surveyed firms is still characterized by significant financing obstacles. The vast majority of these firms face major (9% of surveyed firms) or moderate (77%) financing obstacles, while only 2% face no obstacle, and 13% minor obstacles. Financing obstacles are encountered by large and small companies equally.

Conversely, in Tunisia, the vast majority of surveyed firms face no financing obstacle (33%) or minor obstacles (55%) and none of them face major obstacles. These ratios compare favorably with the average ratios observed in OECD countries, where 36% of surveyed firms do not face financing obstacle, and 25% face minor obstacles. These positive results are however lessened by the fact that, in Tunisia, only some large- and medium-sized enterprises face no financing obstacle, while small-sized companies, which play a major role in the economy, face such obstacles much more frequently.

A closer look at the principal financial issues encountered by enterprises in Egypt and Tunisia, provides revealing information on the main challenges that Arab countries still need to address regarding their financial sectors. In both countries, the issue most frequently mentioned by surveyed firms, is the cost of interest rates, as shown in Table 5. This suggests that reduced interest margins through reduced intermediation costs and/or increased competition among banks that would erode monopolistic rents, are absolutely necessary improvements in the credit markets of Egypt and Tunisia.

Heavy paperwork is also mentioned frequently suggesting that lending activity is still characterized by heavy regulations and that some further lessening of such regulations is needed. It is also characterized by significant involvement of public sector banks, which may explain the perception by borrowers of a heavy bureaucratic attitude of the lenders.

Table 5. Frequency of Problematic Financing Issues in the Business Environment

Egypt	%	Tunisia	%
High interest rates	74	High interest rates	54
Paperwork	71	Inadequate credit information on customers	51
Lack access to export finance	52	Paperwork	28
Need special connections with banks	48	Lack access to equity partners	27
Inadequate credit information on customers	47	Need special connections with banks	23
Collateral requirements	46	Collateral requirements	23
Lack access to lease finance	46	Lack access to foreign banks	19
Corruption of bank officials	44	Lack access to export finance	11
Banks lack money to lend	41	Lack access to lease finance	8
Lack access to foreign banks	39	Banks lack money to lend	5
Lack access to equity partners	39	Corruption of bank officials	3

Source: World Bank. 2000. World Business Environment Survey
N.B. Ratios reported are the percentages of surveyed firms for which the obstacle is major or moderate.

Another problem quoted rather frequently in both countries concerns the inadequacy of the available credit information on customers. It may be assumed that this issue is of course also critical for banks and other creditors, which may explain why a significant number of companies, particularly small businesses in the case of Tunisia, do not find adequate funding in the domestic financial market. This is to some extent confirmed by the fact, that a significant number of surveyed companies mention financing difficulties due to their lack of connections with banks and due to collateral requirements.

Finally, in Egypt, the lack of access to export finance is also mentioned relatively frequently by surveyed enterprises. This is consistent with the presence of significant rigidities in the Egyptian foreign exchange market, notably before the floating of the pound decided in January 2003.

There are obviously differences among Arab countries, as already illustrated by the differences between Egypt and Tunisia. Observations of these two countries should not be generalized for other countries. Nevertheless, these data are indicative of some major weaknesses of Arab country financial sectors to wit: high interest costs, heavy bureaucracy, uneasy relationships between lenders and borrowers and inadequate information systems.

Challenges Ahead

Deeper change in financial sectors is necessary if reforming Arab countries were to achieve more significant progress in their financial intermediation system in the years to come. Pro-market reforms should be strengthened in two main areas: (a) the reduction of remaining restrictive regulations in the financial sectors; and (b) the promoting of competition among the different financial intermediaries. Moreover, recent experiences with financial liberalization policies suggest that such policies need also to be supplemented with the provision of an adequate institutional and regulatory environment and the promotion of necessary financial market infrastructures. When this framework is absent, not only shock therapy policies may weaken the financial system, but also an efficient credit market cannot develop.

Regulatory Framework

According to Grais and Kantur (2003), restrictive regulations have been eased in a majority of Middle East and North African countries. However, these economies are still characterized by relatively restrictive controls and regulations in their banking and finance activities.

According to the Heritage Foundation (2004), which provides a qualitative index of restrictiveness of regulations in banking and finance, restrictiveness is high or very high in eight countries, i.e. Algeria, Egypt, Iraq, Saudi Arabia, Sudan, Syria and Yemen. This proportion is even higher than in the second half of the 1990 decade, when only six Arab countries had highly or very highly restrictive regulations. Table 6 shows that generally speaking, regulation restrictiveness in the banking and financial sector has not decreased in recent years, quite the contrary. Table 6 shows further that only three countries – Bahrain, Jordan and Mauritania – face low or very low restrictions.

In comparison, currently close to 70% of OECD countries have low or very low restrictions in their banking regulations. None has high or very high restrictions. Moreover, a large majority of OECD countries have reduced their regulation restrictiveness, contrary to the Arab countries. Also, all Asian emerging market economies have low or moderate restrictions, with the exception of Malaysia. Notwithstanding the reforms already implemented, this suggests that there exists significant room for further liberalization of banking sectors in Arab countries.

Table 6. Restrictiveness of Regulations in Banking and Finance Sector

		2003		
		Low or very low	Moderate	High or very high
Initially (mid to end 1990s)	Low or very low	Bahrain	Morocco Oman Tunisia	Algeria Libya Sudan Syria
	Moderate	Jordan	Djibouti Qatar	Iraq Saudi Arabia
	High or very high	Mauritania	Kuwait Lebanon UAE	Egypt Yemen

Source: Heritage Foundation. 2004. Index of Economic Freedom.

Liberalization and de-control of the banking sector do not imply the absence of regulations. Such financial reforms must be accompanied by the building of a strengthened prudential regulatory and supervisory framework. Otherwise, financial liberalization may only lead to financial fragility and crises. This is all the more important as banks have often inherited from the pre-reform period, heavy non-performing loans portfolios. A complete and speedy liberalization of the banking sectors would have been unadvisable unless prior measures are taken to clean portfolios and recapitalize banks, and to establish proper prudential regulations and monitoring of depository institutions.

Some progress has been gradually achieved by Arab countries since the early 1990s, sometimes in response to major bank crises. A few examples are the bankruptcy of the Petra Bank in Jordan in 1990 and the consequences of the collapse of the Bank of Credit and Commerce International in 1991, notably in Egypt and the UAE. However, partial available data on non-performing loans point to a significant financial fragility in a number of countries, as will be documented in the cases of Egypt, Jordan, Morocco and Tunisia.

Competition

As mentioned previously, banking intermediation is relatively costly in Arab countries. This is partly due to insufficient competition in the banking industry, insofar as monopolistic behaviors result in high intermediation margins. Bank competition may also improve firms' access to credit. The assumption of a positive relation between bank concentration and financing obstacles, which is consistent with the standard structure-performance hypothesis, is supported by empirical evidence provided recently by Beck *et al.* (2003). Using data from the World Business Environment Survey (2000), these authors find that firms face more financing obstacles in countries with high bank concentration.

Insufficient competition in the financial sector may constitute a handicap for Arab countries. Standard indicators suggest that the degree of concentration in the banking sector is high in Arab countries, where the share of the five largest banks in total bank assets varies generally between 65 and 80% (Table 7). These levels of concentration are significantly higher than in Asian emerging market economies, where the median country has a 5-bank concentration ratio equal to 47. The average concentration observed in OECD countries is equal to 48%. The only Arab county showing a lower concentration is Lebanon, where the bank concentration ratio is equal to 40%.

Recent research results on banking sector competition produced by Gelos and Roldós (2002) and by Claessens and Laeven (2003) suggest however, that standard concentration indicators do not measure accurately the degree of competition in the banking industry. They propose to use measures based on the Panzar and Rosse (1987) methodology, which relies on econometric estimates of the elasticity of total revenues of banks with respect to their input prices. This methodology cannot be applied to Arab countries, for lack of availability of the necessary micro-economic data, but results proposed by Claessens and Laeven (*op. cit*) suggest that competition in the banking sector is heavily influenced by barriers to entry, in particular those opposed to foreign banks.

In this account, Arab countries have implemented so far, very diverse policies. Jordan has a widely opened banking sector, with 68% of bank assets in banks that are 50% or more foreign-owned. Part of the high share of foreign banks' assets is due to the preference of migrants for deposits in foreign-owned banks. However, this does not explain all of it. Migration is a widespread phenomenon in Arab countries. Although smaller, the share of bank assets owned by foreign-controlled banks is also significant in Bahrain (28%), Lebanon (27%), Morocco (19%) and Tunisia (19%). All these countries have foreign ownership in the banking sector higher than in Asian emerging market economies, with the exception of Singapore (and possibly Hong Kong). On the other hand, in Egypt, foreign-controlled banks own only 4% of bank assets. In Egypt and in other countries with high or very high restrictions in banking regulations, (e.g. Algeria), a higher degree of openness to foreign banks could be beneficial to the economy. As shown by the experience of Saudi Arabia, this may be implemented through cooperation between local and foreign banks, without necessarily fully opening the market to foreign-controlled banks.

Another indicator of the degree of competition in the banking industry is the proportion of bank assets owned by private banks, or by banks with a majority of private shareholders. Again Bahrain, Jordan, Lebanon, Morocco and Tunisia enjoy, based on this indicator, a significant degree of competition, with more than two-third of bank assets owned by private-controlled banks. On the other hand, this ratio is only equal to one-third in Egypt. In comparison, in emerging market economies, the share of private-controlled banks is always high, with a minimum of 70%. Examples are Korea and Thailand where some banks have been nationalized after the 1997-98 financial crisis.

Table 7. Indicator of Competition in the Banking System

	5-bank concentration ratio (%)	Percentage of banking system's assets in banks that are 50% or more private-owned	Percentage of banking system's assets in banks that are 50% or more foreign-owned
High financial development			
Bahrain	71	96	28
Jordan	68	100	68
Lebanon	40	100	27
Oman	77	100	11
Qatar	76	57	15
Saudi Arabia	69	100	0
Medium financial development			
Egypt	65	33	4
Morocco	75	76	19
Tunisia	66	68	19
Asian emerging market economies			
Hong Kong, China	..	..	..
Korea, Rep.	48	70	0
Malaysia	30	100	18
Philippines	46	88	13
Singapore	..	100	50
Thailand	75	69	7
Median OECD high income country	65	97	7

Source: World Bank's Bank Supervision And Regulation Database, 2003; and authors' computation from data of the Association Professionnelle Tunisienne des Banques, Rapport Annuel 2002.

Finally, competition may be enforced with the development of a diversified financial sector, albeit currently, traditional bank loans are still the principal sources of financing. In this account, considerable work needs to be done in most Arab countries particularly concerning the development of instruments such as lease finance, and capital market segments such as secondary markets for government debt paper and bond markets. This may need not only private initiative, but also the development of proper regulations.

Legal Framework

Recent research papers (e.g. La Porta *et al*., 1998) show that adequate protection of creditor rights is necessary for the development of credit markets. This depends both on the design of laws and regulations, particularly well-designed collateral and bankruptcy laws, and on the actual implementation of such legislations. According to La Porta *et al* (*op. cit*), countries with civil law instead of common law, to which belong Arab countries, are handicapped by insufficient protection of creditors.

As shown in Table 8, theoretically speaking, creditor rights are sometimes well protected better protected in Arab countries than in the median OECD country [(4)] This is the case of Algeria, Mauritania and Syria. However, in other cases (Egypt, Jordan, Lebanon and Tunisia), they are worse protected. These observations may lead to the conclusion that the nature of the legal system does not seem to play a systematically adverse role in Arab countries. However, such observations are relevant only if legislations are actually enforced, or at least if they are equally enforced in the different countries. The "rule of law" indicator available in the governance dataset assembled at the World Bank by Kaufmann *et al*. (2003) shows doubtlessly that agents in Arab countries have significantly less confidence in the rules of society than agents in emerging market economies or in OECD countries.[(5)] This is true in particular of Algeria and Syria, which means that their supposedly high level of protection of creditor rights is to a large extent meaningless.

These observations imply that although in several Arab countries, improving the legislation on creditor rights would be advisable, the major challenge faced by the region goes beyond mere financial sector legislations. The greater concern is more generally the necessity to improve governance.

Similarly, only few Arab countries have set up depositor insurance schemes, which mean that they rely, in case of bank crises, on *ad hoc* measures including mandating rescue finance by other banks. Such institutional arrangements, in a context where prudential supervision is weak, may give the wrong incentives to banks and typically increase moral hazard problems.

[(4)] The Creditor Rights Index is based on the methodology of La Porta *et. al*. (1998). The indicator measures four powers of secured lenders in liquidation and reorganization: (a) whether there are restrictions, such as creditor consent, when a debtor files for reorganization; (b) whether secured creditors are able to seize their collateral after the decision for reorganization is approved; (c) whether secured creditors are paid first; and (d) whether an administrator is responsible for management of the business during the resolution of reorganization.

[(5)] The "Rule of Law" indicator summarises several indicators which measure the extent to which agents have confidence in and abide by the rules of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts. See Kaufmann *et al.* (2003) for further details.

Table 8. Legal Framework and Financial Infrastructure Indicators

	Creditor Rights Index	Rule of Law indicator	Quality of public credit registry information
Jordan	1	0.3	67
Lebanon	1	-0.3	..
Saudi Arabia	2	0.4	50
UAE	2	0.9	58
Medium financial development			
Algeria	3	-0.5	..
Egypt	1	0.1	50
Mauritania	3	-0.3	..
Morocco	2	0.1	17
Tunisia	0	0.3	36
Low financial development			
Comoros	..	-0.8	..
Somalia	..	-2.1	..
Sudan	..	-1.4	..
Syria	3	-0.4	..
Asian emerging market economies			
Hong Kong, China	4	1.5	..
Korea, Rep.	3	0.3	..
Malaysia	2	0.4	44
Philippines	1	-0.5	..
Singapore	3	2.3	..
Thailand	3	-0.2	..
Median OECD	***2***	***1.6***	
Europe			***78***

Source: World Bank. 2003. Governance Dataset; and World Bank. 2004. Doing Business Database N.B. The creditor right index is an integer index ranging from 0 to 4; the rule of law indicator is an index ranging from -2.5 to +2.5; the index of quality of public registry ranges from 0 to 100.

Financial Infrastructure

Another usual constraint to the development of credit markets is the absence of adequate and accurate information on the individual debtors' financial situation. The lack of such information is also responsible, to some extent, for poor risk management and the occurrence of high levels of non-performing loans. One way to solve the information asymmetry problem faced by lenders is to organize information sharing among them. This kind of institutional arrangement may be particularly helpful to improve credit access of small businesses. Such information exchange also reduces the informational rents that banks could otherwise extract from their customers (Jappelli and Pagano, 1999). In well developed financial systems, such information is provided by specialized agents, which may be public or private. In many of the most advanced countries, as well as in all Asian emerging market economies, private information services have emerged endogenously, through the creation of private credit bureaus. In some of these countries, there are both public and private credit registries (e.g. Germany and Malaysia) or, in a few instances (France, Slovak Republic), only a public credit registry.

Only countries with a rather large financial market can sustain an economically viable private financial information activity. In other countries, government intervention is probably necessary to initiate such an activity, which is of a public good nature. As shown by Jappelli and Pagano (*op. cit*), in either case, the availability of such services has a positive influence on the development of the credit market.

In Arab countries, there are no private credit bureaus, but public credit registries are available in Egypt, Jordan, Morocco, Saudi Arabia, Tunisia and the UAE. Such institutions are however, lacking in a number of other countries, including Algeria, Lebanon, Mauritania and Syria.

The impact of such services on the development of firms' access to credit may, however, depend critically on the quality of the information collected, which becomes totally useless if not fully reliable. On this account, Arab countries have poor performances. On the basis of the information available in the World Bank (Doing Business Database, 2004), the quality of information collected by the public credit registries may be considered as particularly poor in Morocco and Tunisia.(6) This suggests that, notably in Morocco and Tunisia, which otherwise, have achieved some progress in their financial sector reforms, more needs to be done in this area to promote a significant development of credit markets. In other Arab countries, only Jordan enjoys a quality of information provided by its public credit registry comparable to the quality standard available in more advanced economies.

Improving the quality of financial information would also require more general improvement in the business environment. In particular, improvements in this area would necessitate the enforcement of robust accounting and auditing systems, and better corporate governance.

Lessons Learned from Financial Liberalization in Egypt, Tunisia, Morocco and Jordan

Egypt

In Egypt, reforms started in 1991, with three principal objectives: (a) reducing inflation pressure created by monetary financing of the public deficit; (b) promoting private sector financing; and (c) restructuring the banking sector. This reform agenda was triggered by macroeconomic instability, insufficient results of the *Infitah*(7) open-door policy implemented in the 1980s and fragility of the financial sector, as exemplified by the consequences of the BCCI (Bank of Credit and Commerce International) bankruptcy.

A significant and rather rapid reform has been the liberalization of interest rates. Bank interest rates were fully liberalized in 1991. Real interest rates increased significantly, partly as a result of this measure and of reduced inflation. The prime rate which was below the inflation rate at the end of the 1980s, surged to 5.7% above inflation in 1992. Since then, with the exception of 1995 marked by an inflation peak, the difference between the prime rate and the inflation rate has continuously increased, to reach 11.1% in 2002. Although the initial upsurge of the interest rate was an inevitable and desirable consequence of the liberalization, its further rise indicated clear shortcomings in the financial liberalization policy, which did not succeed in improving the efficiency of financial intermediation.

As a consequence, nominal interest rates remained relatively high with positive real differential between interest rates on the Egyptian pound and the US dollar. This differential attracted capital inflows until 1997. The Central Bank intervened to buy excess foreign currency to avoid nominal appreciation. The associated sterilization measures, through the issuance of Treasury bills, were the most active monetary policy between the period 1991-1997.

The foreign exchange rate has been kept long under control. At the beginning of the reforms, there was a major issue regarding the foreign exchange market, leading to a significant dollarization of the economy, which was at the level of 51% in 1991. The foreign exchange market has been unified in 1991, and the pound was pegged to the US dollar in a managed floating system, stabilizing the exchange rate. This measure helped reduce the dollarization to 29% in 1992. However, the foreign exchange market was not liberalized, leaving on its wake a foreign exchange shortage, particularly affecting commercial banks. In January 2003, in response to continuing foreign currency shortage and a new rise in dollarization, the managed floating system was abandoned, supposedly in favor of a flexible exchange rate system, which led to a significant depreciation of the currency. However, the exchange rate has been kept under control

(6) The Public Credit Registry_quality of information index summarises scores on question regarding the process of data collection and verification. These concern the existence of legal penalties for reporting inaccuracies, the ability of consumers to inspect data, the legal requirement to respond to borrower complaints, the delay of submission of data, the actual submission of data on time by most financial institutions, the time allowed to correct reported errors, the delay of availability of data for distribution and the duration of existence of the registry. The maximum score is 100.

(7) *Infitah* means open door. It refers to President Sadat's policy after the October 1973 War of relaxing government controls on the economy so as to encourage the private sector and stimulate the inflow of foreign funds.

in an attempt to avoid disruptive consequences of depreciation on inflation and public finances, and insufficient foreign currency supply is still weakening the efficiency of the economy and of the financial sector.

This experience of Egypt among the four countries studied is unique, in the sense that, even though the foreign exchange market is not fully liberalized in Morocco and Tunisia, it has been kept close enough to equilibrium to avoid adverse consequences of foreign currency shortages on the real and the financial sectors, as well as dollarization.

Together with interest rate liberalization, the reform process has also concerned the credit ceilings previously used as a monetary policy instrument. Such measures, which were enforced on all banking credit, were removed in 1992 for the private sector and 1993 for the public sector.

Credit direction, which usually goes along with credit ceilings, and is characterized by the implementation of preferential treatment measures granted to the public sector and other priority sectors, has been also subject to some reforms. The Central Bank has suppressed in the early 1990s several regulations, such as administrative credit allocation, or the ban on business relations between a private bank and a state-owned company in the absence of a prior authorization by a state sector bank, which inhibited competition by private banks. These restrictions have been, however, replaced by the creation of credit ceilings on specific categories of loans, and public banks still have to comply with government objectives in setting their credit policies. Therefore, credit direction has not been fully abandoned.

At the beginning of the reforms, the banking sector was highly segmented. It was comprised of onshore banks and offshore commercial banks, business and investment banks, and specialized banks. The onshore commercial bank sub-sector was made of four state-owned banks and some 20 private banks, but state banks were predominant in size. Offshore banks specializing in foreign currency transactions, which emerged during the open-door policy period, were partly private and joint-venture banks, but were essentially controlled by the public sector commercial banks. Overall, the state controlled most of the banking sector through its public sector institutions. The four public sector commercial banks totaled 90% of bank assets, and moreover, were involved in the shareholding and management of private banks.

In the first phase of the reforms, there were several restructuring and liquidation operations. Fourteen branches of the National Development Bank were merged. The Bank of Commerce and Credit of Egypt (a subsidiary of BCCI) and Banque Misr were merged following the BCCI bankruptcy. However, the banking sector remained essentially state-controlled.

In the second phase of the reforms, the Egyptian government attempted a partial privatization. A public sector commercial bank was supposed to be privatized, together with offshore banks, where public sector bank had majority shareholding. However, no public sector commercial bank has yet been considered for privatization, and stakes held by the public sector in several offshore banks have been only partially and incompletely sold out.

Given this timid restructuring process, the sector has remained highly concentrated and segmented, and state-controlled. Competition is further weakened by significant entry barriers imposed by the Central Bank (El-Shazly, 2000).

The banking sector has also remained fragile, partly due to the poor quality of the portfolio of public sector banks. This is all the more a source of concern as there is no formal system of protection of deposits. After the BCCI bankruptcy, the government intervened on an *ad hoc* basis to protect depositors, forcing other banks to participate in a rescue package. In 1992, it approved a new legislation to create a deposit insurance fund, but this fund has actually never been created.

The systemic fragility had convinced the Central Bank to maintain or introduce rather severe prudential regulations regarding reserves, capital and liquidity requirements.

The reserve requirement ratio has been reduced in 1990 from 30 to 15% for local currency deposits, and in 1993 from 15 to 10% for foreign currency deposits. These reserves bear no interest, and therefore imply a significant implicit tax on banking activity, given the unusually high level of reserve requirements. On the other hand, the liquidity ratio regulation is rather loose. Liquidity requirements were further reduced in 1990, from 30 to 20% (25% for foreign currency).

The Central Bank has introduced a capital adequacy ratio along the lines of the Basle core principles (capital should account for at least 8% of the risk weighted assets), with gradual enforcement till December 1993. Public sector banks were recapitalized, through government bonds financing, to comply with this capital adequacy ratio. The required capital adequacy ratio was increased to 10% in 1996, in an attempt to improve the stability of the financial system.

The Central Bank has also been enforcing since April 1993, a regulation regarding credit concentration (with only gradual enforcement initially). Credit to a single customer, public or private, should stay below 30% of a bank capital (as defined by the Basle Committee). This regulation was applied initially to commercial banks, but it has been extended to business and investment banks, which since September 1995, could not have a participation in the capital of a company exceeding 40% of the paid-up capital.

Finally, loan classification and provisioning of non performing loans (NPL) were introduced in September 1991. The regulation defines three categories of NPLs: (a) Substandard debt (with a delay of debt servicing between 3 and 6 months); (b) Doubtful debt (with a delay of servicing between 6 and 12 months); and (c) Bad debt with a delay of servicing over one year. Compulsory provisioning on this NPLs are respectively 20, 50 and 100%. Cases of fraud and liquidity problems faced by the banking sector in recent years suggest however, that this regulatory system needs to be enhanced. Moreover, there is a lack of adequate tax incentive for taking loan-loss provisions. Although such data are not published regularly, it seems that NPLs are not only at high levels, but are also growing. According to estimates released by the Central Bank, NPLs accounted for 14% of total credit exposure in 2001, but other independent estimates put this ratio at 20-30%. This issue is to be related to insufficient monitoring of individual banks, and lack of market transparency.

All in all, the banking sector reforms in Egypt have, so far, introduced some progress in the regulatory environment. However, the sector restructuring has been incomplete, with a remaining heavy weight of the public sector, which hinders efficiency and competition within the banking sector, with consequently, a relatively modest improvement in the price and quality of services offered by the sector. Also, supervision by the Central Bank has shortcomings, resulting in a significant fragility of the banking sector, as suggested by NPLs estimates. In addition, a peculiarity of Egypt is the fact that the management of the foreign exchange market by the Central Bank has led continuously to foreign currency shortages and dollarization, which have directly and negatively affected the banking sector.

Tunisia

Tunisia started reforming its financial sector relatively early, in1987, in the context of its overall structural adjustment policy. However, reforms were implemented only very gradually, with some of the major reform measures concerning bank prudential supervision particularly, taken only as late as 2001.

Interest rates were controlled until January 1987. At that time, debtor interest rates were partially liberalized, within a margin of 3 percentage point of difference with the money market rate. Debtor rates for non-priority sectors were fully liberalized in June 1994, together with bank margins. Debtor rates on loans granted to priority sectors (agriculture, exportation and small and medium size enterprises) were liberalized only in November 1996. Most creditor rates were liberalized in January 1987 as well, with the exception of sight deposits, the remuneration of which is subject to a ceiling of 2 percentage points since 1990, and earnings on special savings accounts, which is indexed on the money market rate. This liberalization process, over a 10-year period, has been one of the slowest in the region.

As in other countries, modern monetary policy instrument were introduced together with interest rate liberalization, with the suppression of credit ceiling and creation of the money market in 1987. Subsequently, new debt instruments in the money market (Certificate of Deposits and Treasury Bills) were introduced in 1991. As a logical consequence, credit direction was also gradually abandoned, but at a slow pace. Mandatory holdings were suppressed only in 1996. Until this date, banks were still required to hold at least the equivalent of 10% of their deposits on loans to priority sectors.

The financial sector is concentrated and is characterized by low competition, as suggested by its current high profitability, achieved in spite of high levels of non-performing loans. The state still plays a major role in the sector, insofar as it controls three of the largest commercial banks (among a total number of 14 commercial banks) and it directly or indirectly controls more than half of the banking system's assets. In addition, the state is involved, together with other Arab governments, in the development bank sector, albeit this sector does not play a significant role in the financial sector, given that development banks today hold only 4% of total financial assets. Furthermore, the distinction between commercial and development banks was suppressed in 2001. The state also controls financial institutions outside the supervision of the Central Bank such as the CCP (Centre de Chèques Postaux) and the CENT (Caisse d'Epargne Nationale Tunisienne), which together, account for close to 8% of total financial assets, as well as pension funds. On the positive side, the range of financial services has expanded in recent years with the creation of several non-bank financial institutions in the sectors of leasing and factoring. There are also two merchant banks, and a limited offshore banking activity.

There has been some recent restructuring in the public banking sector. This led in December 2000 to the merger of two former development banks, BNDT (Banque Nationale de Développement Touristique) and BDET (Banque de Développement Economique de Tunisie) with the STB (Société Tunisienne de Banque), one of the major state-controlled commercial banks. There were also two privatizations of medium-sized banks, accounting each for around 7.5% of total commercial bank assets, i.e. the BS (Banque du Sud) in 1997 and UIB (Union Internationale de Banque), in which the French bank Société Générale has acquired a majority shareholding in November 2002.

The main fragility in the Tunisian financial sector lies in its public-controlled segment. It is likely that the state would intervene to protect depositors in case of difficulties, but there is no deposit insurance system. The Central Bank has authority to appeal to "market solidarity" in the event of a banking crisis. However, such procedure may be difficult to enforce, and may prove costly to the state budget, given its heavy involvement in the weakest segments of the financial sector.

On paper, a complete modern regulatory framework has been put in place by the Central Bank since 1991. However, the regulations remained rather weak and insufficient for quite some time. To some extent, the relatively slow process of reform of the banking sector and the lasting dominant role of the state, have been due to the lack of sufficient progress in bank supervision until recent years.

Firstly, reserve requirement are quite minimal. Today, commercial are only requested to keep the equivalent of 2% of their sight deposits and 1% of their term deposits and Certificates of Deposits in non-bearing interest reserves with the Central Bank. In addition, liquidity requirements have been put in place only recently, i.e. in February 2001, by the Central Bank. They are defined by a 100% liquidity ratio (ratio of achievable assets to current liabilities).

Secondly, the Central Bank was unable, until recently, to enforce a capital adequacy ratio requirement comparable to international standards defined by the Basle core principles. This is for the simple reason that bank balance sheets were not sound enough to sustain such requirements. Initially, the banking system inherited large amounts of non performing loans from the pre-reform period of directed credit policies. In 1993, the ratio of gross NPLs on total assets of commercial banks was equal to 34% with 82% of these NPLs owned by state-controlled banks. Although these ratios slightly declined in the following years, they remained at unmanageable level, all the more that the level of provisioning of these NPLs was minimal, due to shortcomings in the regulation on NPLs provisioning. These NPLs were particularly high in the development bank sector until the merger of BDET, BNDT and STB.

Only in 1997 did the government take comprehensive measures to tackle this issue, including the creation of private asset management companies, a government guarantee granted on NPLs owed by active public enterprises, and substitution of NPLs owed by privatized or liquidated enterprises with 25-year government bonds bearing no interest. Primarily due to this treatment of a major part of NPLs, in December 1999, the Central Bank was able to align its regulation on international standards, through increasing the required capital adequacy ratio from 5% (according to the 1991 regulation) to 8%.

The Central Bank has also been enforcing since 1991, a regulation regarding credit concentration, which was however not very severe until December 1999. From 1991 to 1999, credits to a single customer were supposed to stay below 40% of a bank's net capital. This ratio was reduced to 25% in 1999, a level more comparable to international standards. In addition, the total debt of the biggest clients of a bank (defined as clients with debt above 5% of the bank's net capital) should not exceed 10 times that bank's net capital. In spite of this regulation, presently, it seems that bank exposure to large individual debtors is alarming. According to unofficial and controversial information circulated in the press in early 2004, some 127 individual customers could have a total debt equivalent to 5.3 billion dollars (27% of total domestic credit).

Finally, the Central Bank has introduced loan classification and provisioning of non performing loans in 1991. The regulation defines three categories of NPLs consistent with international standards: (a) Substandard debt with a delay of debt servicing between 3 and 6 months; (b) Doubtful debt with a delay of servicing between 6 and 12 months; and (c) Bad debt with a delay of servicing over one year. In 2001, NPLs of commercial banks were as high as 19.5% of total gross claims, but were much higher in state-controlled banks (close to 25%) than in private banks (close to 11%). Mandatory provisioning of NPLs is on paper, consistent with international standards, with respectively 20, 50 and 100%. However, the regulation does not require that loans backed by real estate collaterals be provisioned. As a consequence, provisioning is low, because of the large size of debt backed by such collaterals. In 2001, net NPLs accounted for 12.3% of total net claims. The main risk exposure, and NPLs, of the Tunisian banking sector is on the tourism sector, which has heavily borrowed funds to build hotels and resorts. Due to cumbersome judicial procedures, recovering such assets is a very long and uncertain process for banks. This phenomenon may imply that the current regulation does not provide for enough provisioning of NPLs. In addition, tax rules limit deductible provisions, and therefore, do not create adequate provisioning incentive.

All in all, the Tunisian financial sector, although today highly profitable, is exposed to major risks, due to long delayed reforms of its regulatory framework. If this does not imply any major risk for private banks, the state-controlled financial sector is considered as vulnerable. Its recapitalization needs could represent a significant cost for the state budget, as concluded by the IMF and World Bank in their Financial System Stability Assessment completed in 2002. This low-performing public financial sector certainly hinders the capacity of the banking sector to develop dynamically, given its size and the systemic risk it inevitably creates. Moreover, its poor financial situation has played a major role in delaying the implementation of a solid regulatory framework.

Morocco

Morocco's structural adjustment program was one of the earliest in the region, starting as early as 1983. However, the Moroccan financial sector stayed highly regulated and controlled by the public authorities for a long time, and the financial reforms were implemented only in the 1990s. Moreover, the state still plays a significant role in the financial system, and the weak functioning of the public institutions remains a major shortcoming in the Moroccan financial system, although at a lower level than in Egypt and Tunisia.

Like in other countries, financial liberalization started with a deregulation of interest rates. The deregulation process has been somewhat faster than in Tunisia, but slower than in Egypt. It took more than a five-year period, from July 1990 to February 1996. Creditor interest rates were liberalized first, in July 1990. Medium-term and short-term debtor rates were partially liberalized in October 1990 and January 1991 respectively, but they were still subject to a ceiling based on a reference rate determined by the Central Bank. In spite of this ceiling, debtor rates surged to 14.5% in the first half of 1991 and 15.8% in the first half of 1993. Further measures constrained the debtor rate below 12% in March 1994 for short-term and medium-term loans and 13% for long-term loans. At the same time, some preferential rates were maintained. This policy weakened the credibility of the financial liberalization policy, and prevented banks from properly managing their risk portfolios. It was dismantled only in February 1996, when interest rates have been almost fully liberalized, although limited controls on some deposit rates remain in force.

Before the reforms, the monetary policy was characterized by credit ceilings, which were used by the Central Bank, together with reserve requirements, to control the volume of credit. This system implied rigidities in the credit system, detrimental to economic activity. From 1991, this policy has been reformed, and the Central Bank, as in other reforming countries, has turned to open market instruments, together with changes in reserve requirements, to control the liquidity expansion. Until the reforms, as in Egypt and Tunisia, the Moroccan Central Bank also applied a directed credit policy. Banks were required to lend to the Treasury as well as to priority sectors. From July 1991, the Central Bank has started reluctantly, to reduce these distortions. However, Morocco has been slower than the other countries in this move. Until June 1998, banks were still required to hold a minimum proportion of their short-term liabilities in Treasury securities bearing interest rates below the market rate. Such requirement, which concerned 35% of bank portfolio in 1990, was phased out only slowly (it was still at the level of 20% until September 1996).

Most, but not all, other mandatory holdings were eliminated in April 1994. Banks still have to hold a minimum of 2% of their liabilities in CNCA (Caisse Nationale de Crédit Agricole) notes. In addition, the Central Bank still requires that funds lent to banks through repurchase agreements be met for 50% by loans to exporters, SMEs and new businesses, and for the other 50% by Treasury Bills.

The banking sector was initially highly concentrated, and has remained so. There are 14 commercial banks and four specialized banks, together with some offshore banks in Tangiers. The state involvement in this banking sector is significant. It has a strong participation in the CPM (Crédit Populaire du Maroc), which accounts for some 29% of the deposits in the banking system, as well as in three other commercial banks. Moreover, it controls the four specialized banks, which account for around one third of the lending market, and operate outside the regulatory framework of the banking sector, although they have a role similar to commercial banks. The role of the state in the banking sector has been only reduced by the privatization of the BMCE (Banque Marocaine du Commerce Extérieur) in 1995. All in all, government-controlled institutions still held around 43% of all banking system assets at the end of December 2001. Moreover, most important non-bank financial institutions are parastatals such as the CDG (Caisse des Dépôts et de

Gestion), an institution with dominant position in the management of institutional savings, or the Post Office, which offers financial services through its network but is not subject to banking regulations. Given its concentration and the role still played by the state, the financial sector is still characterized today by limited competition and transparency.

Due to moderate competition and relatively comfortable interest margins, the commercial banking sector is profitable, and consequently relatively robust, according to the Financial System Stability Assessment performed by the IMF and the World Bank (International Monetary Fund and the World Bank, 2003). However, stress tests conducted for this assessment have shown that several major commercial banks, principally foreign-owned, were exposed to significant fragility *vis-à-vis* credit risks. On the other hand, the large public-owned specialized banks are already in a very difficult financial situation, due to their accumulated losses and non-performing loans.

To protect depositors against risk of bank failures, a deposit insurance fund has been created by the Bank Law in July 1993. According to the law, this mechanism may be supplemented by *ad hoc* financial interventions organized by the Central Bank, which may ask other financial institutions to participate in a rescue operation when one of them faces difficulties, like in Egypt and Tunisia, with the same adverse consequences in terms of incentives and of risk for the government budget.

The Central Bank introduced reserve requirements in the pre-reform period in 1966. It has since then used mandatory reserves as a monetary policy instrument, with in particular a rise in mandatory reserves up to 25% in October 1992, to reduce them back to 10% in 1993. Liquidity ratios were introduced in 1982, and have stayed at 60% since then.

The Central Bank has introduced only very late a capital adequacy ratio along the lines of the Basle core principles. Although the 1993 Bank Law provided for such a regulation, it has been put definitively in place by decree only in January 1997. However, once implemented, the capital adequacy ratio required by the authorities has been, in fact, relatively restrictive. Firstly, the risk weighting factors are relatively strict. Secondly, until January 2001, the capital considered in this ratio took account of only the own funds and assets (tier-one capital), while the Basle capital adequacy ratio definition takes also into account tier-two capital (such as subordinated debt). Nevertheless, commercial banks have always had statutory capital much higher than the amount required to cover their risk-weighted assets. Their capital adequacy ratio was on the average above 15% in 2001 and 2002. The main issue in the Moroccan banking sector lies with the specialized banks sector, particularly BNDE (Banque Nationale de Développement Economique), CNCA and CIH (Crédit Immobilier et Hôtelier), which have been exempted on an *ad hoc* basis from the solvency regulation, and have in fact statutory capital much lower than their risk-weighted assets. Apart from creating a competitive distortion, this situation puts at risk the whole public financial sector, and requires urgent corrective measures.

Regarding credit concentration, the Moroccan regulation initiated in 1977, has been rather restrictive. Until 2000, credit to a single customer (weighted by its risk factor) could not exceed 10% of a bank net capital. This risk concentration ratio has been increased to 20% in October 2000, which is still restrictive by international standards.

Loan classification and provisioning of non performing loans have been introduced in December 1995 and modified in December 2002. Overall, they provide for an adequate representation of asset quality. NPLs are classified in three categories, defined principally by the delay of servicing, but also by the financial situation of the debtor: (a) Pre-doubtful debt with a length of arrear between 3 and 6 months; (b) Doubtful debt with a length of arrear between 6 and 12 months; and (c) unrecoverable debt with a length of arrear above 1 year. Provisioning rates for these NPLs are respectively 20, 50 and 100%, after deduction of agios and collaterals. At present, NPLs of commercial banks are reasonably low and well provisioned. Their gross NPLs amounted to 11% of their total assets, and their net NPLs 2% in September 2002. However, NPLs of specialized banks are very high, 36% of their assets (in gross terms) in September 2002 and are inadequately provisioned. The NPL problem is aggravated, like in Tunisia, by a weak functioning of the judicial system, which implies long delays in the recovery of claims through the courts.

All in all, the Moroccan performances in banking sector reforms have been similar to those of Tunisia, with a significant not-too-efficient public sector. However, implementation of a modern regulatory framework has been apparently somewhat easier, due to a better viability of public sector commercial banks, which have relatively smaller and better provisioned non performing loans.

Jordan

In Jordan, the banking sector, which is essentially private and open to foreign competition, had been booming in the 1980s, fuelled by growing worker remittances in the wake of the second oil shock. The number of financial institutions increased dramatically, in an essentially unregulated framework, introducing stiff competition in the sector. As a consequence, banks took unbearable liquidity and foreign exchange risk exposure, and NPLs mounted at high levels. This led to a banking crisis in 1989, triggered by a 21% depreciation of the Jordanian Dinar (JD), which led to the formation of a speculative foreign exchange black market. There was also corruption and managerial failure in several institutions. The Central Bank attempted to rescue ailing banks through the injection of the equivalent of 10% of GDP in overdraft facilities. However, this did not prevent the bankruptcy of three major banks (Petra Bank, Syria Jordan Bank and Jordan Gulf Bank), together with emerging difficulties in six other financial institutions. In response to this crisis situation, the Central Bank launched a major reform of the financial sector.

Creditor interest rates were liberalized without delay, in 1989, and debtor rates a year after, apart from relatively minor subsidized credit schemes. This, however, did not lead to any increase in real interest rates during the first years of the reforms. Quite the contrary, real interest rates declined, due to the inflation in 1989 and 1990 created by the large quantity of money injected by the Central Bank in the economy. Inflation and real interest rates went back to normal levels in 1992.

The main thrust of the reforms has been initially an attempt at restructuring the banking sector. Four bankrupt banks were liquidated in 1990 and 1991: Al Batra Bank, Syria Jordan Bank, National Islamic Bank and Jordan Credit Bank. Moreover, a number of other institutions were restructured and merged. However, this restructuring process was uneasy, due in particular, to the family ownership of banks.

In spite of these liquidations and restructurings, Jordan is still considered as over-banked. It has 21 banks and 479 bank branches for a total population of 5.3 million, which is two to three times the average banking coverage of Egypt, Morocco and Tunisia. This large bank coverage is favorable to competition in the banking industry. Moreover, competition is reinforced by the facts that there is no state-owned bank and that foreign controlled banks play a major role in the sector, with foreign participation accounting for around 40% of bank ownership. As a consequence, by regional standards, the Jordan banking sector may be considered as relatively competitive (Khamis, 2003), although being highly concentrated, given that the Arab Bank Plc. accounts alone for 60% of all assets (and the three largest banks for 90%). This competition is reflected in the interest margin of no more than 5% in the banking sector (Mahdi, 2001), which does not leave significant profit after payment of administrative costs, legal reserves costs (equivalent to more than 1 percentage point of interest) and income tax (Hashemite Kingdom of Jordan, Ministry of Planning, 2000). Nevertheless, it should be noted that entry costs have been increased by the Central Bank, since the minimum capital requirement, which was before the reforms of only JD5 million has been increased in several steps to JD20 million (around US$30 million). Such entry barriers have not barred, however, the recent licensing of two new foreign banks, the National Bank of Kuwait and the Banque d'Affaire du Liban et d'Outre-Mer.

To prevent financial fragility, several measures were taken over time to improve the regulatory framework of the banking sector. Such reform measures culminated in the introduction in 2000 of a new Bank Law (amended in 2003), strengthening the supervisory power of the Central Bank, and the creation of a Deposit Insurance Corporation, in 2000 as well.

Reserve requirements, which were equal to 9% of deposits in 1988, were increased by the Central Bank to 15% in the early 1990s. However, such reserve requirements have been reduced since then in several steps, to levels similar to the pre-reform period (10% in 2000). These reserves bear no interest. The Central Bank also introduced in 1992 a liquidity ratio of 30%, which was increased to 53% in 1996.

Prudential regulations were strengthened from the early 1990s in response to the systemic fragility of the banking sector. The Central Bank introduced in 1992 a capital adequacy ratio regulation compatible with the Basle committed rules. In order to further improve bank solvency, this ratio which constitutes the principal prudential regulation instrument used by the Central Bank, was raised to 10% in 1996 and 12% in 1997.

In addition, the Central Bank introduced in 1992 a regulation regarding credit concentration, according to which any exposure on a single customer above 10% of the paid-up capital of bank must be authorized by the Central Bank, and such exposure cannot rise above 25%.

Finally, loan classification and provisioning of non-performing loans had been already introduced in the pre-reform period. The regulation defines three categories of NPLs: (a) Substandard debt with a delay of debt servicing between 6 months and a year; (b) Doubtful debt with a delay of servicing above 12 months; and (c) Lost debt (whenever the bank obtains evidence that the loan is not recoverable). Mandatory provisioning on these NPLs are respectively 50%, 100% of the portion of the loan which is not covered by collaterals, and 100% of the total loan. This regulation is less stringent than international standards, which usually classify debt as doubtful after three months of delay in servicing, instead of 6 months. On the other hand, recoverable loans should be covered by a provision of 1 to 2%, which is restrictive by international standards. Until recently, however, these rules were not strictly applied. This situation has been remedied by the introduction of the new Bank Law, which strengthens supervisory powers of the Central Bank, and also provides for tax-deductibility of provisions for NPLs. A private evaluation estimated NPLs at close to 11% of total loans of the 21 licensed banks in 2001, which is much lower than in Egypt, Tunisia and Morocco, and reports of individual banks suggest that such NPLs are decreasing.

All in all, the Jordan banking sector appears, by regional standards, relatively well developed. Regulatory reforms, although relatively late, have contributed to reducing its fragility. Several ingredients played a role in the relative success of the banking sector reforms. Due to worker remittances, the sector has already been quite large and buoyant in the pre-reform period. This sector has been essentially private. Bank restructurings have been implemented early, and the Central Bank has been able to inject large amounts of money to help the bank restructuring process; thanks to this restructuring, the Central Bank is able to impose strict regulatory standards (stricter than those defined by the Basle core principle), which now guarantee the soundness of the financial sector.

Synthesis

This survey of country experiences provides some significant observations. Banking sector reforms in all four countries have had shortcomings.

- Reform introduction and implementation was lengthy; even in Jordan, where reforms were comparatively faster and deeper and a new Bank Law passed only in 2000, more than ten years after the start of the reforms.
- All four country experiences share in common the difficulties faced by the authorities in promoting bank sector restructuring, which may explain some delays in reform implementation. Certainly, such restructurings have been more difficult in Egypt, Tunisia and Morocco, where the state sector still plays a significant role, than in Jordan.
- Non-restructured public sector banks are the least efficient and also the least viable, given their high NPLs ratios and insufficient provisioning, and sometime their exemption from standard prudential regulations.
- Reforms in all countries have attempted to introduce modern prudential regulations, inspired by the Basle core principles, but the pace of introduction of such regulations has been uneven. Moreover, they have not been fully implemented due to the inadequate supervisory power of the Central Bank and the heavy weight of public sector banks, particularly in Egypt.
- Shortcomings in the legal systems, which create in particular, cumbersome obstacles to the collection of collaterals, hinder improvements in the financial soundness of commercial banks.
- In this context of long-lasting fragility of the banking sector, ways and means utilized by the Central Banks to prevent systemic crises and protect depositors, lead to incentive issues such as moral hazard. At this point, the recent introduction of the Depositor Insurance Corporation in Jordan suggests a possible direction to improve the situation.

Conclusion

Overall, Arab countries have implemented cautious and gradual financial sector reforms over the past 10 to 15 years. Their financial systems are still dominated by relatively concentrated and highly oligopolistic commercial bank sectors. Very often, they are still controlled by the State, even in countries which have adopted market-economy reforms such as Tunisia and Morocco. Although restrictive regulations in the banking sectors have been softened, there are still a number of impediments to competition, diversification and innovation, such as those concerning the involvement of foreign banks. A counterfactual example is Jordan, where the financial sector is essentially private and open to foreign competition, and where reforms would have been more productive.

Capital markets are generally recent, with the notable exceptions of Morocco, Egypt and Jordan. The numbers of listed companies, the capitalization of stock markets and their trading activity are limited. Capital market segments such as bond markets are still underdeveloped. In general, both because of the lack of competition and innovation in the banking sector and of the limited development of capital markets, the access of private companies to finance is uneasy. In particular, small- and medium-sized businesses face significant financing obstacles.

To some extent, this picture may be related to the cautiousness and slowness of financial reforms, which have not been able to stimulate a critical mass of change, although it has also minimized so far, the risks of emergence of financial sector crises. Clearly, there has been a trade-off between the speed and coverage of reforms on one hand and the avoidance of bank crises on the other hand. This has delayed and lessened reforms in many countries, particularly those which inherited an ailing public financial sector from the pre-reform period. However, the absence of critical change in the financial sector must be also related to broader issues such as the need to strengthen property rights protection and the rule of law and to improve corporate governance, which are critical for the development of a credit market.

Not all Arab countries face the same shortcomings. Jordan and Lebanon, as well as GCC countries such as Saudi Arabia, already have a significant bank intermediation activity. This is also true also to some extent, to Egypt, Tunisia and Morocco. However, in these three countries, the banking sector needs further pro-market reforms, including privatization of state-owned banks and diversification of financial services, and the further development of financial market infrastructure. On the other hand, Algeria, Iraq, Libya, Sudan and Syria, where public authorities are still very much directly involved in the financial sector, still need more basic pro-market reforms.

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