ERF WORKING PAPER SERIES

THE CHANGING FINANCIAL LANDSCAPE: OPPORTUNITIES AND CHALLENGES FOR THE MIDDLE EAST AND NORTH AFRICA

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Working Paper 0208

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As of August 1998, financial support towards the ERF Working Papers Series from the Commission of the European Communities (through the FEMISE Program) is gratefully acknowledged. The views expressed in the Working Papers are those of the authors and do not necessarily reflect the views of the European Commission.

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Abstract[1]

Economists have come to acknowledge that finance matters for development in more ways than had been previously recognized. Changes in the financial services industry are providing immense possibilities for economic development. This paper introduces a framework to help understand the changes occurring in the financial landscape. At the same time it attempts to lay out the opportunities as well as the challenges that the Middle East and Northern Africa region face in light of these changes. The framework views financial development as a two-way, continuous and dynamic interaction between, on the one hand, three "driving forces" shaping the industry (financial liberalization, technological changes and market innovation), and on the other hand four stylized dimensions of financial services (disintermediation, institutionalization, modernization and globalization). This paper provides a strategic perspective on the opportunities, and challenges the profound changes in the financial industry bring to the MENA region, its policy makers and market participants.

[1] The World Bank – March 2002. The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to members of its Board of Executive Directors or the countries they represent. The World Bank does not guarantee the accuracy of the data included in this publication and accepts no responsibility whatsoever for any consequence of their use.

1. Introduction

Finance matters for development. This has become increasingly clear with the major changes the financial services industry is undergoing as well as both the welfare gains and intensity of economic and social dramas they have been associated with. While traditional economics and finance had lived separate conceptual lives in the past, this is no longer possible. The changed paradigm pauses challenges to the Middle East and North Africa region (MENA)[1] in its strive for development. This paper provides a strategic perspective on the opportunities and challenges introduced by the profound changes that the world financial industry is experiencing and draws out the questions these changes pose to the MENA region, policy makers, and market participants.

Deep changes have transformed the nature of many financial services. The boundaries between banking and non-banking activities are blurring, and so are the boundaries between sovereign states. Financial deregulation and the recognition of the benefits of consolidation and size have launched an era of mergers and acquisitions, leading to the formation of multinational universal banks. Authorities face the challenges of regulation without stifling market initiative, a difficult trade off.

New products are being created to meet the changing needs of customers, relying increasingly on the use of technology. Global financial institutions are taking the lead in spreading the new products and technologies. As a result not only a dramatically altered financial intermediation landscape is providing huge opportunities for development but also challenges for policy makers and the markets. Worldwide recent corporate scandals, weakened market confidence and uncertainty are a sober reminder.

While the changes provide immense opportunities for development for the MENA countries, they also raise daunting challenges for them. First, there is the ability to monitor and understand the ongoing developments and anticipate further ones. In essence organizational, management and information capacities are core to hopes of reaping the benefits while often downplayed or overlooked. Another challenge is the ability and readiness of MENA authorities to promote an enabling environment that would allow the region's population to benefit from the changes occurring and to lead some of them. The trade off between unshackling the genius and energies of a resourceful population while limiting excesses and drift cannot be solved on one end of the spectrum. The third challenge is the ability of domestic market participants to seize the opportunities, innovate, create and gain in a corporate and socially responsible way.

[1] In general, references to the MENA region would cover the following group of countries: Bahrain, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Morocco, Oman, Saudi Arabia, Syrian Arab Republic, Tunisia, United Arab Emirates, Yemen (See Appendix 1).

This paper tries to pull together various conceptual developments that would suggest a framework to improve the monitoring and understanding of these challenges and shed light on strategic public policy choices for the MENA region.

The framework views and simplifies financial development in a continuous dynamic interaction between two sets of factor. For conceptual convenience and ease of presentation, these factors are defined as three driving forces and four major trends. They do interact with numerous cross-feedback interactions. Abstracting for a moment, factors jointly modify the financial landscape while it is understood that the dynamic interaction allows for feedback from the major trends to the driving forces. The three driving forces are: financial liberalization, technological changes, and market innovation in response to demands for financial services.[2] The four trends along which financial services are altered in response to the forces at play are identified as: disintermediation, institutionalization, modernization, and globalization. Both sets of "instruments" and "outcomes" are inter-related in some dynamic and complex process with feedback loops from the latter to the former. One example of such a feedback process would be from liberalization to bank portfolio deterioration, to regulatory reforms and strengthened prudential regulations. Another would go from liberalization to globalization, contagion and international standardization of norms and codes. Figure 1 suggests the elements of the framework.

The paper provides an overview of the changing landscape of financial intermediation on the backdrop of the foregoing framework. It focuses, first, on the major factors behind the changes in the international financial services industry and the extent to which they are present in MENA economies. It, then, turns to the changes experienced by the sector worldwide and in MENA as a result. Reference to a feedback loop is made without further elaboration but without underestimating its importance.

Liberalization of financial sectors remains uneven in MENA and is largely a reflection of the "affordability" of capital mobility, which is highlighted by its further advance in the Gulf region. It is also highly affected by a direct ownership presence of the state in financial institutions generally combined with a heavy call on national savings through notably a large control on contractual savings. The foregoing features are not always essentially an adamant opposition to market freedom, but often a fundamental caution that abhors crises and errs on the side of conservatism in managing the difficult policy trade offs between liberalization and stability. MENA countries and financial institutions are becoming generally enthusiastic with technological change and *information*

[2] This perspective emphasizes the roles of public policy makers, the research and technology community, and market participants.

technology. There are pools of highly skilled and innovative young emerging technology talents that is promising if the institutional environment is put in place and telecommunications infrastructure improves rapidly. Besides the UAE where 30 % of the population had access to an Internet connection, most countries in the region are well below 5%, with a regional average equivalent to that of Africa. *Market participants'* creativity in product innovation is not likely to be constrained to the region, as are many examples in Islamic financial innovations as well as the extent of street-smart abilities, but creativity needs harnessing and an inductive environment that adapt and enforces intrinsic existing deontology codes to business practices. Misunderstood importation rules do have their costs. Finally disintermediation, institutionalization, modernization and globalization remain lagging in comparison to other regions of the world in spite of progress. They are a gain mostly that reflection of states that find it difficult to reach a breakthrough in the policy trade off between development and stability and err on the latter side generally for expediency.

The paper includes two chapters and conclusion. The first chapter reviews the penetration of liberalization, technological developments, and market innovation in MENA financial services industries. The second chapter considers the extent to which the MENA financial services industry is actually experiencing the international trends of disintermediation, institutionalization, modernization, and globalization. The conclusion reviews how the observed changes in the financial services industry can contribute to growth, stability, and equity.

2. The Driving Forces Shaping the Industry

"Liberalization" paradigm, technological changes, and market participants' drive for innovation appear to be the main driving forces in the transformation of financial intermediation. The MENA region is engaged in all three forces though it does not seem yet to have become the prevailing "rule of the land" internalized by both public authorities and market participants.

2. 1. Financial Liberalization

The policy and institutional reforms ride the liberalization paradigm. For at least three decades after the Second World War, the world experimented with "financial repression" even within certain developed market economies. Credit ceilings, directed credit to certain sectors, interest rate controls on deposits and lending, subsidized credits, compulsory sale to banks of government paper at below market rates, liquidity requirements among other interventions were widely used and may remain still in certain countries. All these were generally associated with controls on capital flows and politically determined exchange rates. These controls reflected the then prevailing view about development policies and responded to directives of development plans, public finance requirements or rough risk management practices. The outcome of this type of "financial repression" regime was a misallocation of resources, inflationary pressures, and low or unsustainable growth.

The failure of repressed financial systems to deliver on growth and stability[3] found its way in the late 70s and 80s in strong debates on the usefulness of financial liberalization and on how to achieve it, whether using "shock therapy" or "gradualism", and if the latter, in what sequence. The debate in the late 80s about the performance and the collapse of Central and Eastern Europe and Soviet Union models had been changed from whether to liberalize to how to implement liberalization. By the early 90s, most countries engaged in a financial liberalization process (see Table 1). However, the scope and pace varied greatly with the strength of entrenched and vulnerable vested interests, external pressure, availability of human capital, as well as the management style, prudential and credit cultures of each country.

The liberalization measures let markets determine interest rates; allowed competition through the feedom of entry and less regulatory segmentation, tolerating failures and exits; removed government control over banks' operations and lending practices; decreased government ownership of financial institutions or their privatization; removed constraints on foreign ownership of financial institutions and cross-border borrowing or lending; and abandoned the distorting exchange rate regimes inconsistent with market liberalization.

While many countries pursued market liberalization, much less attention was given to the required supporting institutional infrastructure.[4] The full steam liberalization drive of the mid-90s has been tempered notably by the East Asia crisis. It brought to the front the critical need for an appropriate institutional infrastructure and confirmed once more the essential pre-requisite of macroeconomic stability. More caution is now exerted when recommending the opening of the capital account, and the consideration of taxation of capital inflows is no longer rejected as a heresy.[5] A significant effort is deployed to create and implement a diversity of standards and codes to strengthen the institutional infrastructure.

Where, then, does the MENA region stand in the "Liberalization Saga"? The perception of observers outside the region is that it has been mainly an interested spectator, sometimes a reluctant participant, but never really in the mainstream of

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[3] This was not limited to the financial sector as the overall static planning development model was increasingly put in question. In fact, the financial sector is more of a latecomer to the liberalization agenda.

[4] Williamson, Mahar, 1998.

[5] John Williamson. (2000) "Modernizing the International Financial Architecture: Big Outstanding Issues." Presentation at the inaugural session of the Centro Brasileiro de Relacoes Internacionais, Rio de Janeiro, Brazil, September 15, 2000.

the process. In fact, it is a perception of a region being hesitant and slow to engage in financial liberalization. However, one could safely argue that many countries of the region have achieved macro-economic stability and fulfill the prerequisite for financial liberalization, and that, in addition, a number of them are engaged in various financial liberalization tracks. There remains the need for a strong reform drive encompassing liberalization and institutional infrastructure to anchor noticeably the region on the world financial map.

This "view from outside" masks a diversity of experiences. A broad brush could distinguish in the region emerging markets with Egypt, Jordan, Lebanon, Morocco, Tunisia, and Turkey; transitional markets with Algeria, Syria, and Iran; early-development markets with Yemen or Djibouti; closed markets with Libya and Iraq; and perceived more mature markets in the Golf Council countries (GCC). But diversity is there even within these groups. Table 2 provides a broad view of liberalization of financial sub-sectors within MENA, using the distinction between its emerging transitional, early development, closed and perceived more mature markets.

Public ownership of banks and financial intermediaries varies significantly across the region. Emerging markets in the region, such as Egypt or Tunisia, are still coping with high levels of public ownership in their banking systems. In Egypt, four state-owned commercial banks own 70% of total assets held by commercial banks, 60% of deposits, and 68% of loans although these shares may be decreasing. In Tunisia, 50% of total assets are in the hands of public institutions. Both countries are seriously considering the privatization of banking assets as well as the liquidation or restructuring of banks with poorly performing portfolios. In Jordan and Lebanon, state ownership of banks is almost absent. The state presence in banking in Morocco stands at about 27% of the capital of the total banking system. State ownership is mostly concentrated in the specialized banks after the 1995 privatization of the BMCE.[6] The privatization of the three state-owned banks, including the country's largest bank Banque Centrale Populaire (BCP), is within the reform agenda of the government.[7] In Oman, all commercial banks are privately owned with the government with minority stakes in a few, while two of the four specialized banks are public. Syria nationalized the financial sector in 1963, and its banking sector remains essentially publicly owned. Although the government gave green light to the private sector banks at the beginning of 2001 under strict conditions, no private banks have yet began operating in Syria. In Libya, in 1993, the government issued a law permitting private banks to operate under strict restraints, and one bank—the country's first private bank since 1969—opened in December 1996 to promote regional economic development.

The presence of foreign banks and foreign ownership in domestic banks varies considerably. Foreign banks were allowed to enter the Egyptian market in 1992, and currently there are 21 foreign banks in the country. In 2000, Citibank acquired 20% of EFG-Hermes (Egypt), as a result of which EFG-Hermes used the additional capital to expand its activities within the region, and Citibank strengthened its presence in the region. Jordan's government has allowed foreign banks entry since 1997. Tunisia has been gradually opening up its banking sector to foreign competition under the agreements with WTO.[8] This increased competition in the industry also encourages mergers in the industry and a move towards universal banking. In Morocco, commercial banks are required to have at least 51% Moroccan ownership, but some of the 14 commercial banks in Morocco are partially owned by foreign banks, including the country's largest private bank, Banque Commerciale du Maroc (BCM).[9] The Algerian government has authorized foreign banks to operate in local markets in 1999. However, foreign bank presence in the country remains low, with Citibank being the only 100% owned foreign bank to open a branch so far. Whereas in the UAE, foreign banks accounted for one-forth of the industry by the end of 2000.[10] All GC countries are members of WTO, with the exception of Saudi Arabia currently negotiating access. These countries will gradually have to adapt their regulatory environment[11] accordingly.

Stock exchanges have mushroomed across the region but are characterized by a limited number of listed companies often dominated by banks or telecom businesses, and even more limited number of ones regularly traded. The stock exchange in Egypt was among the first in the world, having been established in the early 1900s. After the 50s, for a long period of time when it was dormant, the Cairo-Alexandria Stock Exchange reopened in 1993 with the enactment of the new Capital Market Law that removed restrictions on foreign investments, organized primary and secondary markets, introduced mutual funds, and enforced listing and trading rules. In 1999, Cairo-Alexandria Stock Exchange

[6] Morocco's Bank of Foreign Trade.

[7] EIU reports that privatization of these banks, although previously scheduled for 2002, may be delayed up to two years in order to restructure banks and make them profitable investment targets.

[8] Leading foreign banks that have presence in Tunisia are Citibank and Link; however, more foreign banks are expected to establish presence in Tunisia with increased relationships with the European Union.

[9] Other banks with substantial foreign ownership are BMCI, Crédit du Maroc, SGMB, BMCE, and Wafabank.

[10] Moody's Special Report: Banking Sector Outlook in UAE, 2001.

[11] Egypt, Jordan, Lebanon, Morocco, Turkey, Israel allow 100% foreign ownership. Tunisia has a limit of 49.9% as well as Bahrain and Oman (49%) for non GCC nationals and 100% for GCC nationals. Saudi Arabia has a limit of 25% for GCC nationals while non-GCC nationals can access the market only through mutual funds. See Standard and Poor (2000) "Emerging Stock Markets Fact book 2000".

signed an agreement with a Canadian company (EFA) to start electronic trading activities. Since 1995, the Casablanca Stock Exchange of Morocco is a limited liability company, owned in equal shares by stockbroker firms; and foreign investment is allowed in the exchange. The current government in Syria welcomed the notion of establishment of a stock exchange though the country still needs to establish a regulatory framework in line with international standards with the associated supervisory agencies. The GCC financial markets are fairly developed and liquid though they may feature the same limited number of listed companies. The UAE has the youngest stock exchange in the region, established in 1999. Saudi Arabia has no official exchange, but the Saudi Arabia Monetary Agency (SAMA) sponsors a sophisticated computer-based stock-trading system, the Electronic Securities Information System (ESIS). Qatar has recently established DSM (Doha Securities Market), while the Bahrain and Oman exchanges have been in operation for a few years. These exchanges are either government run or semi-government run.

Financial liberalization movements in the region have not yet contributed to the development of vibrant debt markets. Both public and corporate bond markets remain limited with secondary markets almost absent. Money markets continue to rely heavily on central banks interventions. Other non-bank financial intermediaries have emerged with some of them operating in the absence of a clear legal and regulatory framework. They are often subsidiaries of banks.

2.1 Technological Changes

Technological development, in particular in information processing, has been the last decade's main force of change, not only in financial services, but in all sectors, ranging from education to entertainment through manufacturing and even agriculture. As a result many sectors have changed and are changing their strategies to adapt to the "new economy," and policy makers are facing the challenge to create an enabling environment for newly created business models.

The penetration of new information technology and the advances of the new economy across the world remain significantly uneven. Figure 2A presents a few connectivity indicators across a number of countries providing a sense of the degree of penetration of the new technologies: internet hosts per 10,000 people, mobile phones per 1,000 people, and personal computers per 1,000 people. These figures suggest that many developing countries are striving to build the infrastructure to improve connectivity.

The emerging picture, however, is that most of the MENA region appears to be lagging behind in terms of technology penetration, even compared with South Africa or Mexico. This limited penetration may become a serious hurdle in the transformation of the financial services industry in the region and a constraint to its potential to support overall development. The region is also the most unconnected region of the world in terms of number of people on-line (Figure 2B).[12] UAE, Israel, Lebanon, and Kuwait have the most people on-line as % of population (Figure 2C).

The internet usage in the region, especially in GC countries has been growing at high rates, exceeding 60% per year.[13] However, the investments in technological infrastructure and application of these technologies in the financial services industry have been considerably slow, partially due to public information policies in the region that restrict access to certain sites.[14] In the UAE, government extents full support to e-initiatives or e-ventures.

The lagging liberalization of the telecom industry raises deeper concerns as to the penetration of information technology in MENA countries. Indeed, the liberalization of the telecom industry has been a driving force behind developments in the information technology. Worldwide many governments have long resisted privatizing or breaking the monopoly of the state telecom industries for various reasons but, in particular, because these companies provide a major source of income for state budgets. The trend has reversed. Increasingly, countries recognize that to catch up with the technological developments supporting the new economy they need to have developed, liberalized, and efficient telecom industries as well as to allow competition and foreign entry in the sector. As a result, more and more state-owned telecom monopolies are being dismantled.

Many MENA countries are perfectly tuned to the importance of the development of the information technology industry. A tradition of extreme caution made them embrace more slowly the critical role of private leadership in the sector. One can mention the gradual opening in Morocco and Egypt, more gradual in Tunisia, successful in Jordan, and potentially bold in Algeria. The Gulf countries are increasingly encouraging foreign service providers and equipment suppliers to set up in the region through joint ventures.15 Table 3 provides a broad overview of the climate governing the development of the non-mobile telecom sector in selected MENA countries, the UK, and the US.

Figure 3 provides the most striking evidence to the fact that the MENA region has only marginally benefited from the great feast produced by the information

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[12] Nua Internet Surveys, August 2001.

[13] Moody's report. (2002) Internet Banking in the Gulf, drawing on estimates by Internet Arab World (IAW) magazine. IAW estimates the growth rate to be 80%-100% per year for the next two years.

[14] In some of the MENA countries access to the internet has been restricted as an attempt to avoid access to some other material disapproved by the governments of these countries. However, this should not constitute a barrier to higher penetration as the new improvements in the technology allows on-line financial services providers to restrict access to the other sites in the Internet. (Moody's special comment on Islamic banking, January 2002.)

[15] Lucent Technologies, Motorola Inc., and Nokia Telecommunications are currently in the region.

revolution of the second part of the nineties. As a share of GDP private investments in the telecom sector have remained the lowest in the world. In addition, while South Asia and Sub-Saharan Africa have managed to bring this share to around 2% percent of GDP in 1999, MENA at best reached 0.75% of GDP.

2.3 Creative Drive of Market Participants

The worldwide liberalization drive and progress in technology provided an enabling environment for an explosion in creativity in the design and supply of financial services responding to the demands of businesses and investors, consumers, traders, and micro and small enterprises. Risk management became more affordable and accessible to larger groups. This has allowed easier still rigorous access to finance, more competition in its provision, and enhanced welfare for the beneficiaries. In many economies, opportunities provided by liberalization and technology were seized by the immense number of decentralized, independently driven market participants working within a set of credible and transparent rules.

The advantages provided by liberalization and technology may be compounded for developing countries as they have the opportunity to engage in "leapfrogging" and lock themselves on a superior growth path.[16] Through the "technology catch-up effect" (Madden, Savage 1999), emerging countries can enjoy higher productivity increases due to leapfrogging in technologies that lower costs, increase market access and permit the development of new and efficient industries.

The MENA region does not seem to have yet unleashed the immense energies its population and market participants can deploy in a liberalized, technologically penetrated environment. The latent demand for diversified financial services is immense including micro and small scale business financing, housing mortgages, sustainable old age schemes, diversified and flexible insurance products, other risk hedging products or large project finance to quote a few. At face value the MENA financial systems appear to have in place many of these products. They do not seem, however, to be able to contribute to the vibrant activity that can be observed in other parts of the world. For example, the acknowledged micro and small business financing needs remain largely unmet. Access to housing finance remains a serious thorn notably in societies like Algeria or Egypt,[17] but not only there. Derivatives and other risk management products are virtually absent from the menu of the region's financial products. The ability of the financial systems to provide products adapted to the various degrees of risk appetite of financiers is still fledgling in the region.

There is no single reason behind this apparently stifled domestic large-scale drive of private initiatives. This may be puzzling given the widespread adoption of new legislation and regulation, supposedly putting in place a liberalized enabling environment during the 90s. An explanation may be found in North's (1990)[18] distinction between formal and informal norms. The newly introduced legislation and regulation is becoming a new formal rule in an environment that continues to behave according to the old formal rules and practices, which now become the informal ones and are still prevailing in daily life. Practically, the status of state intervention changes from that of being the formal norm to becoming the informal one in an environment where the formal legislation and regulation is very much a liberalized one. One reflection of the foregoing is the prevalence of foreign initiatives or ones taken by the state or at its best in the development of new financial products.

3. The Changing Nature of the Industry

The driving forces liberalization, technological penetration and creative drive of market participants have led to profound changes in the financial intermediation industry and contributed to its ability to offer more diverse products. Across the world, financial services have experienced four major trends: disintermediation, institutional adaptation, modernization, and globalization. In turn, the major trends have affected the driving forces influencing liberalization and institutional reforms, adapting new technologies, and inducing more creativity. These changes have unevenly permeated the MENA region.

3.1 Disintermediation

Finance is essentially an information processing industry. A rationale often given for the existence of banks is the ability to reduce information asymmetries. Liberalization, technological penetration, and market creativity have provided opportunities to bypass banks in the management of information asymmetries. But more generally and beyond banks, the value added of many intermediaries has been eroded in an environment where market participants are free to innovate and create with advanced technologies.

Disintermediation is not a new phenomenon in the US financial system. Between 1960 and the early 90s, commercial banks' share of total financial intermediaries assets fell from around 40% to less than 30%.[19] Even within banking, transaction costs have drastically changed the way business is done and the banks' business

[16] The complementary input of a supporting human capital base is critical however.

[17] In 2001, the Egyptian Parliament adopted a mortgage law that should help the development of mortgage markets.

[18] Douglas North. (1990) "Institutions, Institutional Change and Economic Performance." (Cambridge: Cambridge University Press)

[19] See Franklin R. Edwards. (1996) "The New Finance: Regulation and Financial Stability." The AEI press, Washington, DC.

of intermediation. The same transaction can cost through the internet less than 1% of its cost when done through a branch. In the same way, the role of traditional insurance agents has significantly diminished with agent-based insurance fees being more than double the fees required with internet-based transactions. The emergence of bank-assurance[20] industry, although not that widespread in the developing world yet, has features of disintermediation by allowing dissemination of several financial products through the same financial institution.

Disintermediation seems to be in its early stages in the MENA region. Stock exchanges are now established in many MENA economies but are still marginal in terms of financial intermediation (Figure 4). Stock market capitalization and banking assets as a share of GDP range between 10% and 125% and 60% and 272% respectively[21] (Table 4), well below what is observed in more advanced regions of the world.[22]

Secondary trading in debt markets and sometimes primary markets for both corporate and government paper seem to be slow to emerge (Figure 5). The virtual absence of secondary markets for government debt paper has several negative consequences: (1) It reduces the opportunities for the government to issue new debt by making new issues less attractive investments as liquidity is limited; (2) The hampered liquidity also constrains banks in their use of these securities for liquidity management purposes, by limiting their access to liquidity to Central Bank's repo activities; (3) Again, as a result of decreased liquidity, investor demand shifts from longer term securities to shorter term, more liquid securities.

The shallow state of secondary markets does not allow for the development of benchmark rates for longer-term securities and a yield curve, necessary for pricing long-term assets and diversification of institutional investors portfolios. These consequences often hinder the development of corporate debt markets and securitization. However, increased interest by international rating agencies and the dynamism of securities companies are encouraging a number of corporations to issue bonds as an alternative funding for their longer term financing needs.

Another aspect of disintermediation is the explosion of securitization. It allowed the transformation of illiquid financial assets into liquid capital market securities. An example to that effect is the development of mortgage-backed securities, which has given a tremendous impulse to the housing sector, access to housing ownership and easing labor mobility in the United States. Securitization allows one to transform a 30-year mortgage loan into, for example, tranches of mortgage backed securities that can be bought and sold in the secondary markets. There is even an expanding practice of securitizing future cash flows including credit card and auto loan receivables. An enabling regulatory environment needs to support this activity.

[20] The distribution of banking and insurance services by banks or financial institutions.

[21] Saudi banking assets, at about $150 billion in the end of 1999, are more than double the $60 billion market capitalization.

[22] Stock markets capitalization and banking sector assets as percentage of GDP respectively are 203% and 728% for United Kingdom, 68% and 271% for Germany.

Equally, money markets continue to be limited and to heavily involve central banks. Their weakness limits the ability of central banks to conduct monetary policies better adapted to liberalized market economies. In addition, domestic banks appear to want to remain in the center stage in terms of sponsorship of less intermediated activities constraining competition and limiting to some extent the potential that liberalization, technological penetration, and market participants' creativity could unleash.

3.2 Institutional Adaptation

Different institutions have assumed the role of market players. Pension funds, mutual funds, insurance companies, venture capital funds, micro-finance institutions, leasing and factoring companies, inter alia, channel the flow of funds. The regulatory and disclosure arrangements applying to them provide for more transparency and market efficiency.

The well-known example of disintermediation and institutional adaptation is the explosion of the mutual funds industry in the US, between 1982 and 1994, which captured 35.8% of the net growth of households' liquid financial assets[23] while accelerating its growth. The spout of reforms of pension systems from pure distribution to often multi pillar systems with a capitalization component contributed to the fast development of the pension funds industry in the 90s. It is now one of the biggest intermediary of funds, channeling huge resources; more than 100% of GDP in countries like the Netherlands and Switzerland. More globally, contractual savings mobilized through institutional investors amounted to more than 400% of GDP in the Netherlands, the UK, and Switzerland in 1997. (See Box 1 for Innovative examples from the MENA region.)

[23] Franklin R. Edwards (1996) "The New Finance. Regulation and Financial Stability" AEI press, Washington DC.

Box 1. Innovative examples from the MENA region

- Microfinance industry has only recently emerged in the MENA region. Although 60 programs are active in the region, Egypt's National Bank for Development has been the only commercial bank active in the microfinance industry. Its microfinance lending program has emerged as a model for the region and a best practice in the overall microfinance literature for commercial banks' microlending operations. The program reaches its target clients through a network of 44 branches. In 2000, there were 269,000 of disbursed loans, with an increase of 15% over 1999 and the value of loans increased by 20%. Twenty percent of the borrowers in year 2000 were women.[24]
- The region has been slow to increase penetration of financial services on the web; some ***e-finance initiatives*** are worth mentioning. In Fall 2001, the Union of Arab Stock Exchanges launched an Internet-based network that transmits live prices in 11 Arab bourses and allows brokers to place on-line orders across borders. Arab Financial Markets Network has made a significant step towards integrating the small exchanges of the region, hence bringing in liquidity and transparency to the sector. The network includes the Gulf countries, Egypt, Jordan, Palestine, Lebanon, Morocco, and Tunisia and enables cross-border trading between the financial markets within the Arab World.[25]
- iHilal Financial Services is a UAE-based on-line network specializing in ***Islamic financial products and services***. It offers a range of financial services that includes an on-line Islamic stock trading service and an Internet platform to invest in Islamic mutual funds provided by leading financial institutions. In October 2001, iHilal launched iHilal Portfolio Management System, a web-based management system developed to provide independent financial advisors in the Middle East with the ability to access Shari'ah compliant US equities and off-shore mutual funds.
- UAE is also a pioneer in the region in terms of ***internet banking***. The UAE government supports the innovations in the industry, and the Central Bank just recently allocated resources for creation of an internet banking platform for small banks in the country. Mashreqbank and Emirates Bank are two examples from the industry that were the first to offer customers on-line access to a variety of transactions including account information, transfers, payment of credit card bills, etc.

Venture Capital financing has been underdeveloped in most of the developing countries and even more so in the MENA region. However, the real issue does not seem to be lack of supply, but more a lack of demand due to family-based corporate culture in the region. Some examples of private equity funds that have emerged are "Ebticar", an e-venture funding program set up by Hewlett Packard and Chescor Capital, the "Injazat Technology Fund" created by Gulf Finance House and Islamic Corporation for the Development of the Private Sector, and the "Rasmala Fund" set up to invest in the financial sector of GCC countries. Access Capital Atlantique SA (ACASA), a US$ 30 Million Moroccan-Canadian venture capital fund, launched by Morocco's Caisse de Depot et de Gestion (CDG), and Canada's Caisse de Depot et Placement (CDP), invests in Moroccan manufacturing- sector SMEs.[26]

The MENA region pension and social security systems mobilize significant resources and could provide significant mentoring for the development of the region's capital markets (Figure 6). The challenge is to manage their transition to arrangements effective in their purpose of social old-age protection, but dynamic in the way they contribute to financial and economic development. They remain, however, mostly mono-pillar public pension schemes.[27]

Many regional pension schemes do not obtain significant returns. A dearth of liquid financial assets, the prohibition or limits on investing abroad, as well as availability of fund management skills constrain the performance of many pension funds in the region. A high pension contribution rate of 26% in Egypt has helped accumulate significant reserves that account for the total insurance system for 36% of GDP. These are placed with the NIB[28] that uses to fund national projects whose returns are often mixed. Negative real rates of return on pensions' assets prevailed for a long time but have become positive after interest rate adjustments in the late 90s. In Jordan, the Social Security Corporation has diversified more of its assets though bank deposits still remain at 52%. Saudi Arabia has two large pension funds with assets in excess of one and a half times GDP and significant returns. Asset allocation is diversified with about a quarter placed in foreign bonds and equities.

The MENA region remains the most under-insured in the world with a share of insurance premiums in GDP around 1.1 % in 1999, half the premiums mobilized by the next region, less than one eighth of what obtains in the North America and Western Europe and less than a third from Sub-Saharan Africa (Figure 7). This is still the case when one considers premiums per capita, though in this case the

[24] NBD web-page.
[25] Arab Financial Markets Network web-page : http://www.alshabaca.com/mefn/home/aboutprofile.jhtml.
[26] Venture Economics news: www.ventureeconomics.com/vec/ZZZJMZQ4IWC.html.
[27] Dmitri Vittas. Public Pension Fund Management in MENA. (2001) World Bank, mimeo.
[28] In June 2000, 92% of assets were placed with the NIB (the state-owned National Investment Bank), 1% in equities, and 6% in other bank deposits.

differentiation between regions other than Western Europe and North America is much less pronounced.[29]

Credit reporting and scoring is one of the most significant developments in allowing for increased outreach to small businesses and consumers. They contribute to reducing the cost of processing loan applications, in commoditizing financial products, unbundling financial services, and reshaping the intermediation process. Indeed, one of the rationales for the existence of banks is their ability to manage the asymmetric information between lenders and borrowers. This advantage is being eroded by the information gathering and processing provided by the development of credit registries.[30]

Box 2. Advantages of Credit Information Systems (CIS)

- The use of CIS allows the reduction of the transaction costs of lending.
- The quantification of the risk of applicants allows banks to choose appropriate terms for loans and increase their lending to the small firms, which in turn increases the banks' profitability and reduces the rate of bad loans.
- The use of these automated systems reduces the human bias toward lending to a minimum. The personal relationships of the bigger firms with the banks are no longer an advantage.
- The use of credit information and scoring systems allows banks to focus their attention only on problem loans.

The question that naturally arises is whether such systems are applicable in other contexts other than developed countries. There are a number of pre-requisites that need to be in place, though the effectiveness of these systems builds up through time and, therefore, requires early engagement. Important issues to address in considering the development of credit information systems are the availability of a basic information infrastructure, regulations notably related to eligibility and method of access to the information stored, the nature of the information (negative, positive or both) to be collected. One particular issue is whether the development of such facilities should be public or private, or both. Allowing private initiative may attract foreign participants who could bring with them advanced technologies and systems and possibly help "leapfrogging" in the industry.

[29] SIGMA. (2001) World Insurance in 2000.

[30] Especially for the small transactions associated with small businesses and consumers.

A number of MENA countries are contemplating or are in the process of establishing credit reporting systems[31] and are facing decisions related to the foregoing questions. The current initiatives seem for the most part pursued either by public entities alone or in association with the private sector, often through banks associations. It is important to weigh the advantages and drawbacks of such an approach. It may be expedient as it puts existing domestic institutional capacity behind the initiatives, it may, however, tend to limit the potential for competition.[32]

Box 3. Examples of Credit Information Bureaus serving MENA

- Arabcredit.com delivers on-line credit reports on companies and businesses operating in the Arab World.
- Arab Business Information is an internationally recognized agency providing credit reports and corporate information in the Arab countries.
- Arab Research and Information Company, Ltd. provides commercial credit reports on companies operating in the Middle East and Arabian Gulf Region.
- Overseas Data Services is a leading supplier of credit reports on Middle East businesses.

Another important institutional reform relates to the development of micro-finance institutions. *Micro-finance* provides access to finance, and not only credits but also a full variety of financial services, to micro-entrepreneurs who would otherwise be deprived of it and would most likely not pursue their efforts. Most successful micro-finance institutions emerged in response to unmet financing needs of the entrepreneurial poor. Examples from around the world show that micro-finance can be profitable for financial institutions specialized notably in retail or consumer business. Moreover, there is increasing recognition that micro-finance activities should not depend on government programs or donors to be able to achieve sustainability and should be privately run. Grameen Bank of Bangladesh, widely considered as one of the world's most successful micro-finance institutions, provides short-term credit to the poor with

[31] Some central banks have in place public registries dealing with large amounts focusing on negative information without keeping a history record when the affected assets are cleared. Their fundamental rationale relates more to supervision than to credit processing. (See Margaret Miller 2000)

[32] The World Bank group is currently developing a product that would provide support and advice to clients interested in developing credit information systems. A number of international credit information companies have established a presence in or advised developing countries. Some examples are Equifax in Latin America, Experian Credit Expert in Europe, and Trans Union in Mexico and South Africa.

differentiated loan products tailored to different levels of risk and costs. Grameen bank was emulated by a number of other institutions around the world and the model extended to reach out to micro businesses in rural areas.[33]

Micro-finance programs are in operation in MENA, however there remains a serious gap between supply and demand. Table 5 gives a snapshot of the outreach gap (the share of potential borrowers not being served) and micro-financing gap (the dollar value of the gap between supply and demand) for selected MENA countries. Egypt contains 66% of the regions potential borrowers and an outreach gap of 95% among the highest in the region. According to a survey of 60 microfinance institutions in the region by Brandsma and Chaouali (2001), only 10 were sustainable and achieved some profitability. Most of the micro-finance institutions are government owned. One private initiative in the region is the micro-finance program of the National Bank for Development of Egypt, which is considered to have one of the best performances the region.[34]

Beyond microfinance, in the more advanced markets of the world, financing gaps are financed through innovative products such as venture capital, securitization of future cash flows, leasing and factoring services. These are supported by both financial and non-financial institutions such as GE Capital or Sun Microsystems. Although the trend may be less evident in emerging markets, it is wide spread. Policy makers are increasingly considering the required framework to ease the introduction of these products in their markets.

Asian emerging countries have been leading the rest of the developing world in the area of *private equity financing*. According to the 1996 Guide to Venture Capital in Asia, the growth of new venture funds within the period 1990-95 have been 800%. The industry is slowly emerging in the region, including Morocco, Tunisia, Egypt, and the Gulf.[35] The industry is facing the issue of tax implications, which may be more of a difficulty in countries with legal systems not grounded in common law principles. In addition, financial markets remain shallow and may not facilitate exit through IPOs. Anticipated lengthy and costly dispute resolution mechanisms may also be discouraging. Finally, the slow shift of entrepreneurial culture from closed family-owned businesses to open corporate entities is also contributing to the slow emergence of the industry.

Leasing provides an important financing alternative to traditional funding sources especially for micro- and small businesses where capital markets are relatively underdeveloped and the banking sector is reluctant to provide term financing. It has funded a significant share of investments in a number of countries (Table 6). Leasing draws on the assumption that generation of profit is through the use of capital assets, not ownership. Leasing companies provide investment funding to small businesses while retaining the ownership rights of the assets. Leasing contribution to investment releases resources for working capital purposes allowing small businesses to be better focused on their activity and less on their financing needs.

The MENA region has a limited leasing industry. Tunisia, Morocco, Egypt, Lebanon, and more recently Oman (2000) have introduced leasing regulations in an attempt to beef up supply. The International Finance Corporation (IFC) provides financing and technical assistance to private leasing companies. See Figure 8 for penetration of leasing for some MENA countries versus the rest of the world.

3.3 Modernization

Two main developments characterize the modernization of financial systems: (i) the increased use of information technology for more efficient financial intermediation, in terms of delivery channels, information processing and information disseminations; and (ii) institutional reforms to ensure financial stability in the form of adoption of prudential regulations in line with international practice.

3.3.1 Information Technology

One way in which information technology has altered financial institutions is in the use of the internet as a delivery channel for financial services. This has led to lower costs and greater competition. The marginal costs of providing on-line financial services are lower than those of traditional delivery channels due to the advent of personal computers and cheap data transmission. A study by Tower Group [36] shows how on-line banking has significantly reduced costs in Latin America and the US (Figure 0). Similar evidence is provided in Table 8 for the US.

Technological advances have increased competition and market contestability by lowering barriers to entry. This competitive pressure on banks is forcing them to reduce the prices of services and costs for the ultimate benefit of consumers. Glaessner, Klingebiel, and Claessens (2001) show an erosion in banking margins. They anticipate a decline in banking margins of 13 percent from 1997 to 2005 in industrialized countries and 11 percent in emerging economies.[37] Similarly in

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[33] For a more comprehensive discussion on the promise of Microfinance to be able to lend profitably to low-income households. (See Jonathan Morduch 1999)

[34] Brandsma & Chaouali. (2001) "Making Microfinance Work in the Middle East and North Africa."

[35] See Box 1.

[36] Tower Group Research. (1999) Overview of Retail Banking and IT Spending Trends in Latin America.

[37] Their forecasts were based on observations on selected industrialized countries (Australia, Austria, Belgium, Luxemburg, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands,

brokerage and asset management related services, brokerage revenues could drop by half in industrialized countries and by one-third in the emerging markets.

Brown and Goolsbee (2000)[38] analyzed the impact of information technology on the life insurance industry. They show that the use of the internet as a delivery channel for insurance policies reduces search costs for consumers, therefore made markets more competitive and lead to a reduction in insurance premiums. The structure of most on-line insurance portals are such that the customer would answer a medical questionnaire on-line and the portal will list a number of insurance policies offered by various companies and their quotes. According to Brown and Goolsbee, once the on-line insurance sites began, the faster a group adopted the Internet, the faster prices of term life insurance fell. Though the study was based on US insurance industry data, and country conditions vary,[39] a similar trend is likely to occur in other markets.

Emerging markets face the challenge of international competition on their domestic markets. Information technology and deregulation of financial sectors has made it possible for international on-line financial services providers to enter more easily a larger number of domestic markets. This added factor compounds the challenge of adapting to the new technical-liberal environment and maintaining competitiveness and profitability, the challenge of being absorbed, merged, or pushed to exit the market.

The MENA region remains behind in terms of penetration of on-line banking. Even in the Gulf where significant efforts were made, the share of on-line banking customers is less than half of what is observed in emerging markets on average[40] (Figure 10). Only 18 of the top 100 Arab banks currently offer e-banking services, and the internet is rather seen as a marketing and information dissemination tool[41] (Figure 11).

On-line trading has been introduced in many of the region's stock exchanges. SAMA,[42] Casablanca Stock Exchange, Dubai Stock Exchange and Muscat Securities Market have modernized their systems and introduced electronic trading of securities. There was another interesting initiative during the year 2000. The US Internet brokerage DLJ Direct Inc. has launched a Dubai-based joint venture to provide on-line trading in US stocks for investors in the Middle East and North Africa. The pace of introduction of e-finance in the region appears somewhat slower in comparison to other regions. Mostly triggered by the entrance of major on-line trading firms of industrialized countries, emerging countries of Asia, Europe and Latin America seem well advanced in terms of using information technologies in the modernization of their financial systems (Box 4).

Box 4. Some examples of on-line stock trading initiatives in the developing world.

Eastern Europe:

- Electronic System for Trading Securities on the Stock Exchange and OTC-Market (Bulgaria, Romania, Croatia, Bosnia and Herzegovina, Macedonia, Albania)
- Economic Construction and Development in Southeast Europe (a joint World Bank-European Commission web-site that aims to coordinate assistance to the countries in the region) posted a project datasheet proposal to establish an electronic system for trading securities on the Stock Exchange and OTC market.
- **Sati On-line Brokerage**, the first broker in the *Czech Republic*, has developed a system of stock handling via Internet that is used by clients from the Czech Republic as well as by clients from abroad.

Asia:

- **Karachi Stock.com** (*Pakistan*) offers its members and visitors on-line and off-line stock trading in KSE (Karachi Stock Exchange) and processes the orders to buy or sell stocks in Karachi stock exchange.
- **DFNN.com** is a *Philippine*-based application services provider, financial e-commerce solutions provider, financial portal, and on-line stock trading firm. The portal provides free access to updated stock quotes, research reports, technical analysis charts, news headlines, market commentaries and product information on various financial products and services, all of which helps the user to decide what financial transaction to make on-line trading, on-line banking, etc.
- **Asian Capital Equities, Inc** is a Philippines based on-line stock broker, a joint venture partnership between the *Hong Kong*-based Bank of East Asia Ltd., the *Philippine* investment banking pioneer East Asia (AEA) Capital Corporation, the Malaysian conglomerate affiliate MUI Philippines Inc., and individual Filipino investors. Incorporated in 1989, the company was the first Philippine brokerage house to go on-line and currently averages one billion Philippine Pesos in annual value transactions.

Norway, Portugal, Singapore, Spain, Sweden, Switzerland, UK,USA) and emerging countries (Argentina, Brazil, China, Czech Republic, Egypt, Hong Kong, Hungary, India, Korean, Mexico, Poland, Russia, South Africa, Thailand, Turkey).

[38] Jeffrey R. Brown and Austan Goolsbee. "Does the Internet Make Markets More Competitive?" NBER Working Paper, November 2000.

[39] Both culturally and in terms of available infrastructure.

[40] The leading banks offering on-line banking in the emerging markets are Bradesco in Brazil, Bancomer in Mexico, Hanvit Bank in Korea, Bank Pekao in Poland. The major on-line banks in the MENA region are the National Bank of Kuwait, Riyadh Bank in Saudi Arabia, Banque Libane-Francaise in Lebanon, Abu Dhabi Islamic Bank in Dubai, and Egyptian Gulf Bank in Egypt.

[41] EIU Pyramid Research. (2001) "Arab Middle East: E-Banking Opportunities."

[42] The recent introduction of the "Tadawul" system is another significant advance.

Latin America:

- **Patagon.com** is *Latin America*'s premier on-line brokerage site for stock trading and personal financial management.
- **Rava Sociedad de Bolsa**: Argentina's on-line stock trading firm.

3.3.2 Governance Modernization

The other aspect of modernization is the reform of the legal and regulatory environment governing the financial system. The effectiveness of a financial system in mobilizing and allocating resources in a stable and efficient way, promoting investments and economic growth is highly dependent on confidence. Domestic and international investors will be more inclined to rely on the system when there is significant transparency and accountability. International code and standard setting bodies are actively working to develop standards and codes to improve accounting and auditing rules, regulation and supervision of financial systems, and good governance in the corporate and financial sector. Currently, a set of 12 standards and codes have been developed.[43]

The region has shown interest in complying with some of these standards. In May 2001, GCC senior supervisors attended a workshop organized by the Financial Stability Forum on consolidated supervision, Core Principles for Effective Banking Supervision, and Corporate Governance. The region has also taken initiatives to improve money laundering legislation.

Also a program to systematically assess vulnerabilities and development potential of financial systems across the world has been put in place. This Financial Sector Assessment Program (FSAP) is co-led by the World Bank and the International Monetary Fund. It helps assessing compliance with international best practices and principles as well as undertaking stress tests. One objective of FSAP activities is also to assess how well a financial system is positioned to support the development of the economy. Five countries from the region have already participated in the program and three to four are scheduled for the next twelve months.

Anti-money laundering is another emerging issue that has been a major concern globally. In the wake of current events,[44] Financial Action Task Force (FATF) has taken the leading role in assessing anti-money laundering practices of countries globally. However, more and more international organizations, including the World Bank and the IMF, are increasingly focusing on these issues to be able to advise their client countries on how to "*modernize*" systems to effectively fight money-laundering practices. MENA region has been responsive to developments in this context. GCC countries are members of the Financial Action Task Force (FATF). Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates have all completed self-assessment surveys, and all but Saudi Arabia have undergone mutual evaluations. Israel and Lebanon are the two countries in the region in FATF's non-cooperative list, but have been acknowledged to have made progress in terms of addressing some deficiencies in their systems. Financial Intelligence Units (FIUs) created databases that are established to capture suspicious monetary transactions and alert the legal authority on the matter.[45] None of the countries in the MENA region have established FIUs, but the growing trend is such that more and more countries will set up such systems.

Finally, it is important to note the challenge posed for supervision by the tremendous changes the industry is experiencing. One aspect of it is whether or not there is a need for integrated supervision across the various parts of the financial sector. For instance, rules applied to a banking entity may fail to capture transactions in a wider conglomerate[46] involved in several segments of the financial system, raising notably the possibility of regulatory arbitrage.[47] This may require better coordination between supervisors of banking, securities markets and insurance companies. Furthermore, these services[48] include new products and financial services that may require adapted prudential guidelines. To deal with the foregoing some argue for an integrated approach to regulating the various segments of the financial system and propose a consolidated

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[43] Among these are the Basel Core Principles for Effective Banking Supervision developed by Bank for International Settlements, Core Principles for Securities Supervision developed by International Association of Securities Supervisors, and Core Principles for Insurance Supervision by the International Association of Insurance Supervisors.

[44] September 11, 2001: Attack on the World Trade Center and the Pentagon.

[45] See FATF web-site for a full list of countries with operational FIUs: http://www1.oecd.org/fatf/Ctry-orgpages/org-egmont_en.htm

[46] The issue is increasingly relevant in the MENA region where a number of consolidations are taking place mostly in anticipation of increased competition from large foreign banks following WTO accessions. Although the region is characterized by less foreign involvement in its financial systems compared to other emerging regions, international banks including Deutsche Bank and Citibank have interest in increasing their presence in the region. Local financial companies are merging to be better positioned to face more intense competition. Some examples are the strategic alliance between EFG-Hermes and CIIC (Commercial International Investment Co) in Egypt, mergers in Oman and in Saudi Arabia inter alia. In its own self-assessment of the BCP, the Central Bank of Oman notes that it has to establish the necessary regulations for the supervision, on a consolidated basis, of banking organizations in which a bank has been formed as a holding company or a subsidiary.

[47] For example, an entity providing loans with a sister institution providing equity and a third providing guarantees or insurance may lead to ineffective prudential exposure ratios.

[48] These services may include financial products targeting small and micro businesses (e.g., leasing, factoring, private equity), foreign trade participants (foreign exchange risk hedging), the housing, and consumer sectors (securitization).

supervision putting all supervisory activities under the umbrella of one agency. Others propose improved coordination between the various concerned agencies. The approach taken to address the issue of integration of financial supervision should reflect the specific conditions prevailing in each country. The existence of large financial groups involved in several sub-sectors of financial services, or blurred boundaries between different financial services are often situations that call for increased integration of financial supervisors, or even one consolidated supervisory agency. If, on the other hand, such financial conglomerates do not exist and financial services are provided by segmented markets, the upside potential for consolidating supervisory functions is limited. Furthermore, in order to be able to create an integrated or consolidated supervisory system; the separate supervisory agents need to be strong in terms of professional and technical capacities. Table 8 provides a synopsis of the practice regarding regulatory structures across the world. SAMA in Saudi Arabia appears to be the only institution in MENA practicing consolidated supervision.[49]

3.4 Globalization

Globalization is both a natural consequence of financial liberalization, technological penetration and creativity of market participants, and a contribution to this evaluation. It has also become a dominant fact by enlarging to the level of the world the playing field where competition takes place. It is contributing *de facto* to further shaping the financial services industry.

The most visible aspect of globalization is the increased ease of cross border capital flows and their explosion. Indeed the world has witnessed an increase in capital flows and a shift from public flows to private flows in the form of direct investments and portfolio investments. However, mostly in emerging countries, capital flows have been volatile, following and causing economic crises, even falling occasionally to negative levels. (Figures 12A, B, C). This volatility masks, however, stability of FDI flows which while beneficial are not free from possible drawbacks. [50]

Another dimension brought about by globalization is the increased size of financial intermediaries, in other words, consolidation with a view that size matters for competition in globalized financial markets. Developing countries have hardly caught up with the fact that their banking sectors remain almost minute in the face not only of industrialized countries, but also vis-à-vis large world conglomerates (Figure 13). This point is made even clearer when comparing the size of the largest 20 banks in various regions of the world with the size of one bank HSBC (Figure 14). Only East Asia and the Pacific region dominates HSBC in terms of assets, deposits, and loans but not so much in terms of equity.

In response to globalization, consolidation in developed markets, and in anticipation of more competition from both banks and non-bank financial institutions, many banks in the emerging and industrialized countries have sought to merge. This widespread trend is reflected in the reduction of the number of banks across the world as illustrated in Figure 15.

A number of mergers and consolidations have already taken place in MENA. For example, the Omani banking system went through a series of mergers during the 90s: six commercial banks merged during 1993-94, followed at the end of 2000 by the merger of the country's two biggest banks, Bank Muscat and Commercial Bank of Oman. EFG-Hermes and CIIC, the two biggest investment banks in Egypt, have recently agreed to merge and hope to become a significant force in the local and possibly regional markets as well as be better positioned to compete with the major foreign players in the industry.[51] Investment banking is a relatively new industry in the Middle East, with small players in the field, which makes mergers inevitable for the local players to be able to compete with their foreign rivals.

The relative sizes of the financial systems, as illustrated in figure 4 and 5, raises for the MENA region, as well as for other regions, strategic questions in terms of financial development.[52] One question often raised is whether sufficient liquidity can be achieved in each of numerous stock markets, operating independently, for them to be efficient intermediaries, allowing to raise the needed capital for the development of their own economies. Embedded in the question is whether consolidation of exchanges or alliances between them and others in the world is the road to follow. In some regions with smaller economies, it has been observed that stock markets can contribute to financial development and economic growth more effectively by merging into one regional exchange or integrating into larger exchanges. The larger size and higher turnover will bring in benefits of decreased costs of trading and increased investor attraction.[53]

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[49] Though it seems that SAMA is both the organizer and supervisor of the stock market, in addition to its other mandates.

[50] For a more comprehensive discussion, see IMF's Finance & Development June 2001, How Beneficial is Foreign Direct Investment for Developing Countries, Prakash Loungani and Assaf Razin

[51] Salomon Brothers, Merrill Lynch, Goldman Sachs, and Morgan Stanley. "The merged entity will only have 10-20% of the capabilities of a Merrill Lynch, but at least there will be a respected Egyptian entity with the same power of placement, financial assets, human resources, management, strong backing" says Abdel Aziz, chairman of CIB.

[52] Biagio Bossone, Patrick Honohan, and Millard Long. (2001) "Policy for Small Financial Systems, Financial Sector Discussion Paper." The World Bank.

[53] The dynamics and potential benefits observed through the regional exchanges of Southern and Eastern Africa was discussed by Kenneth Mwenda, "The Dynamics of Market Integration: African Stock Exchanges in the New Millennium," Brown Walker Press, 2000.

Either route poses the question of the consistency of the institutional infrastructures in which they operate, in terms of rules and regulations (e.g., accounting, disclosure, listing and trading requirements and other securities, corporate governance and judicial aspects).

4. Conclusion

Developments in the financial services industry are providing immense possibilities for economic development. This sense is gradually becoming part of the general awareness of the role of finance in promoting growth and equity. But more importantly the evidence pointing in this direction is accumulating. There are macro studies linking financial deepening with growth and more structural views outlining how financial services are instrumental in supporting competitiveness. There are also views on the potential of financial services to stabilize expectations contributing to an environment more conducive to investment and growth. Finally, there are views on the positive role of financial services in promoting social equity by providing access to opportunities that would otherwise never materialize.

The MENA region is facing the opportunity of adapting its financial services to allow the various channels from finance to growth and equity to take place. It is well engaged in the changes taking place though it appears to be somehow lagging behind most other regions of the world. The region does not lack in either finance or human resources and skills. Where it may be wanting is in daring and managing the ensuing process. One particular area where radical change is needed is in the authorities' and the population's perception of the role of the state. A dynamic private financial sector cannot emerge at the behest of the state and creativity needs decentralization. The role of the state needs to be limited to that of a facilitator in matters of financial services. In particular, it needs to constantly monitor and upgrade the legal and regulatory environment in which the industry operates without stifling independent initiatives or disorienting it through frequent, poorly transparent changes. The state needs to refrain from becoming directly or indirectly the promoter of financial activities where its presence is not essential for the public good. Similarly, the population and businesses need to refrain from looking at the state as the benevolent father, supplier of applause for success, and compensation for failure.[54]

[54] A related issue not mentioned in the text is that of inappropriately designed deposit insurance which may create a moral hazard and encourage risky behavior on the part of the banks.

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Figure 1:

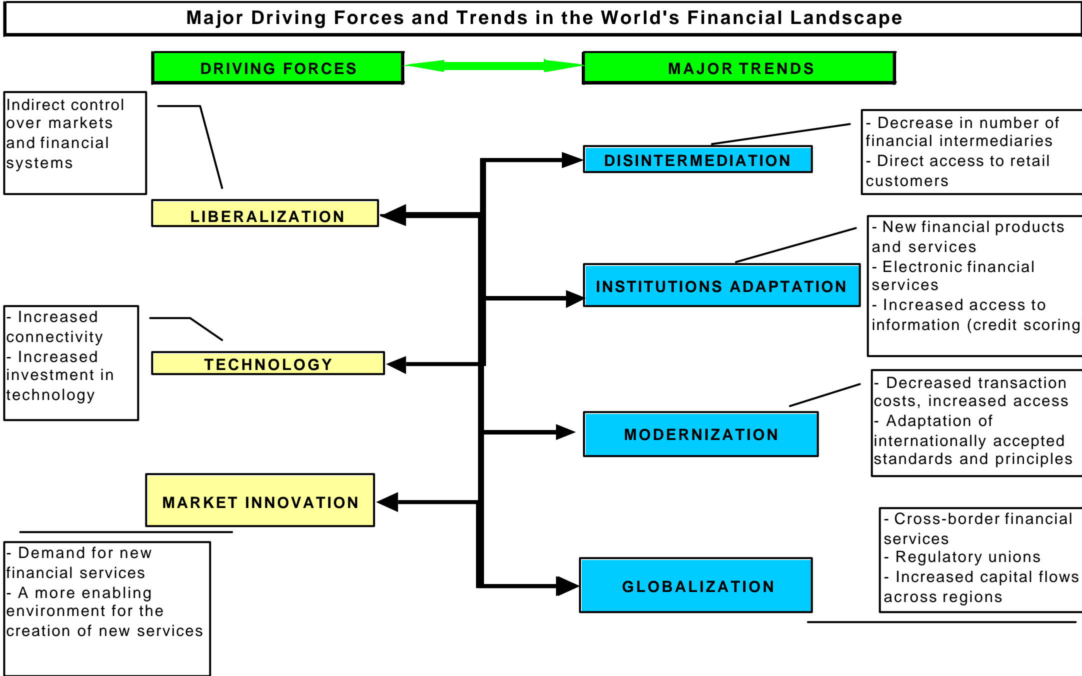


Figure 2a Connectivity Indicators 1999

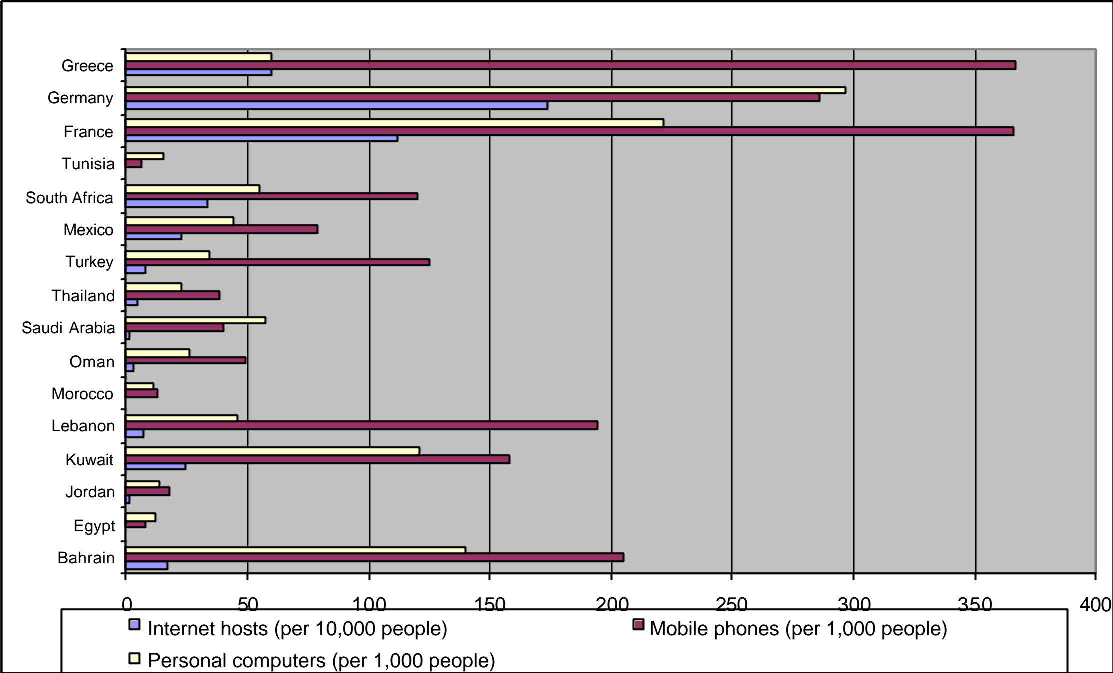
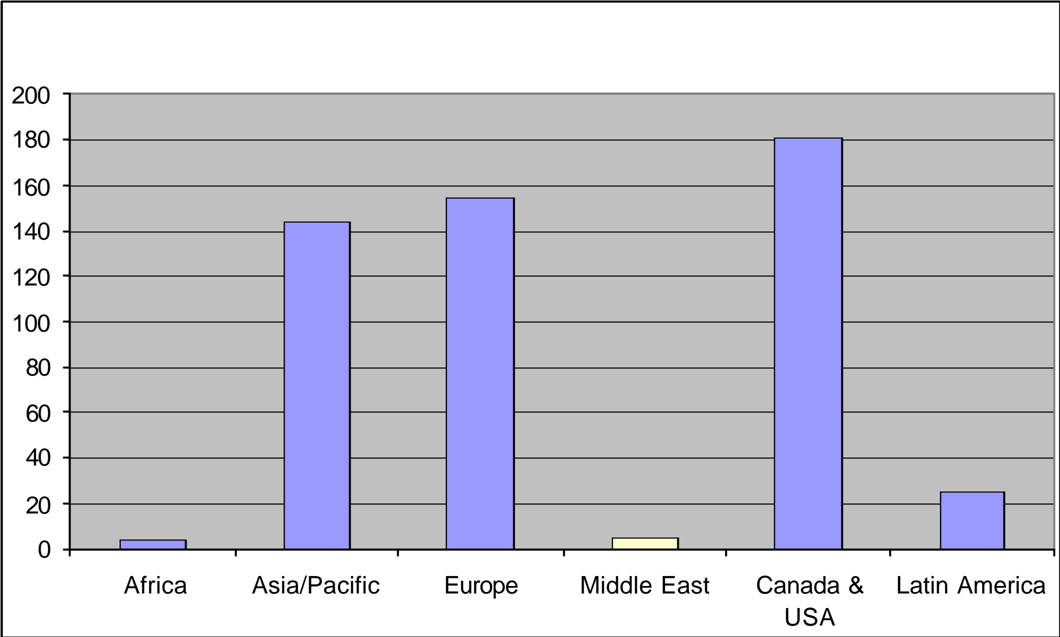
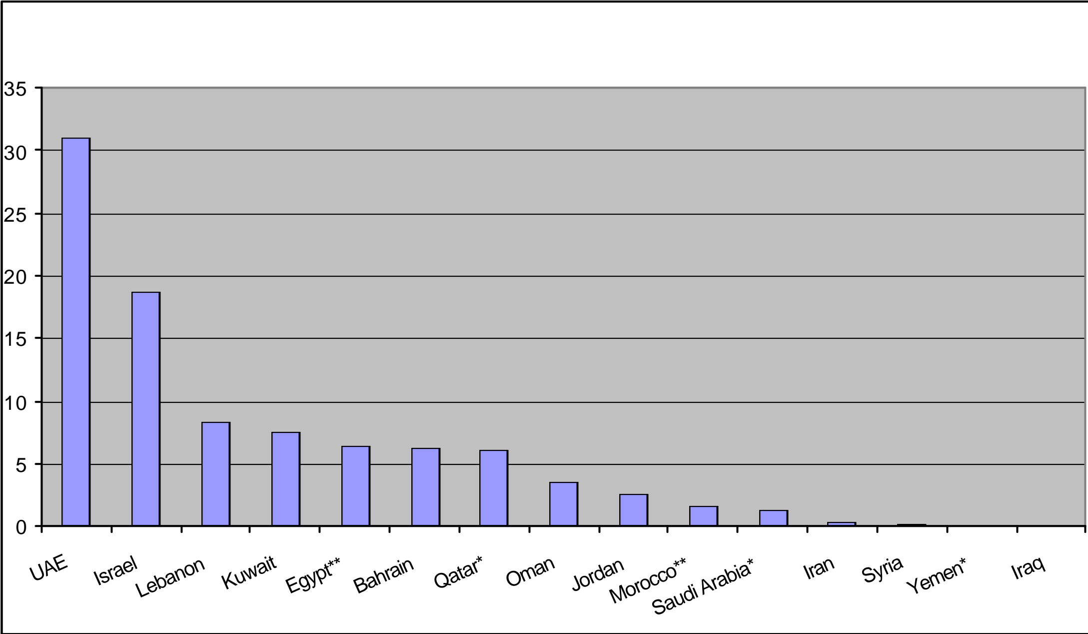


Figure 2B: Number of online people (millions)



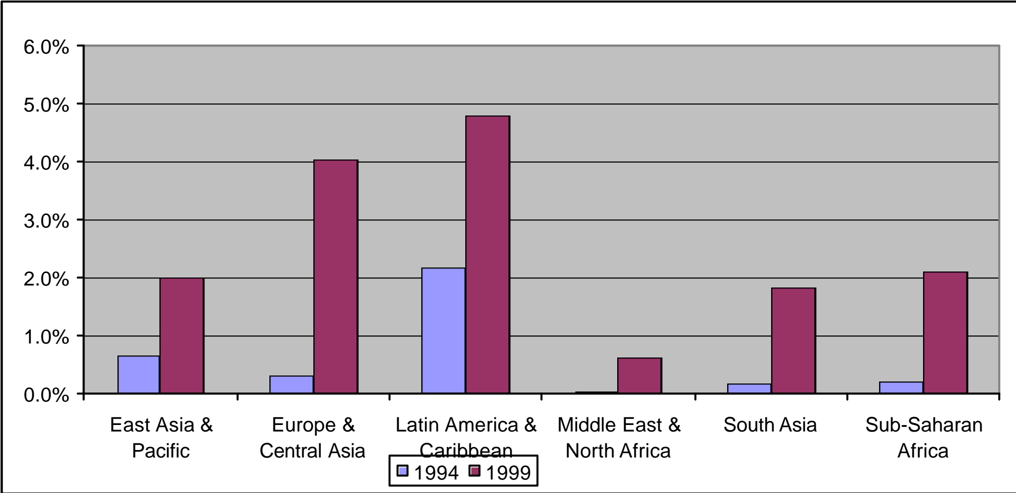
Source: Nua Internet Surveys, as of August 2001

Figure 2C: How Many Online (% of Population) end of 2000



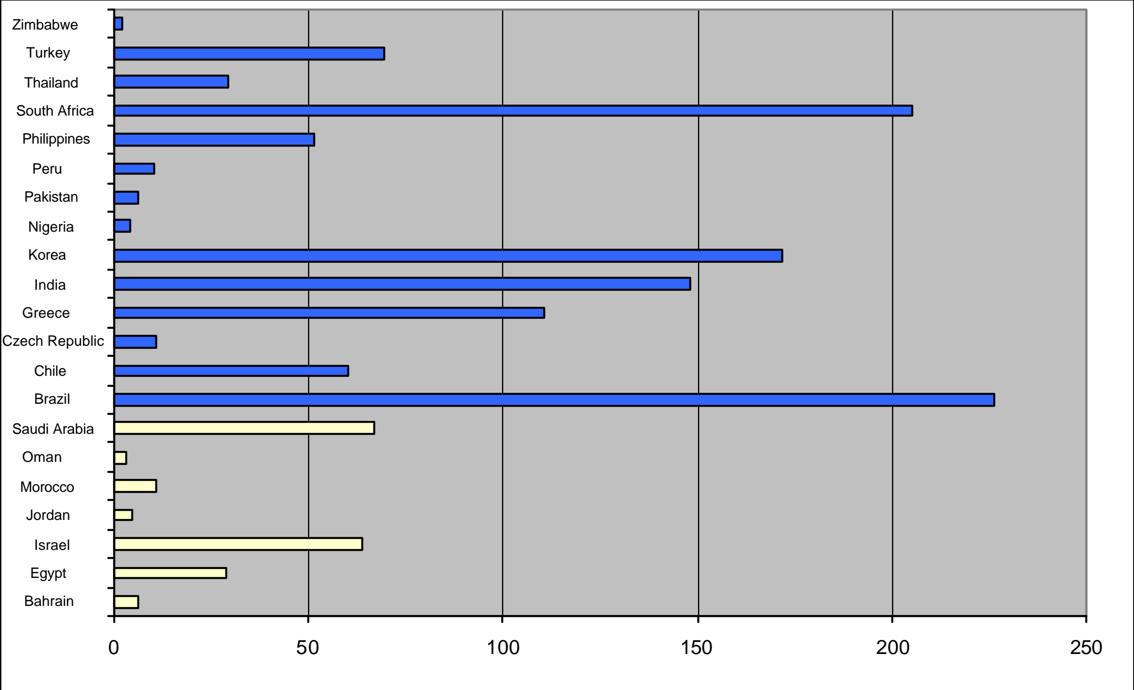
Source: ITU, Nua Internet Banking Surveys; *end of March 2000, ** end of February 2000

Figure 3: Private Investment in Telecom 94-99 (% of GDP)



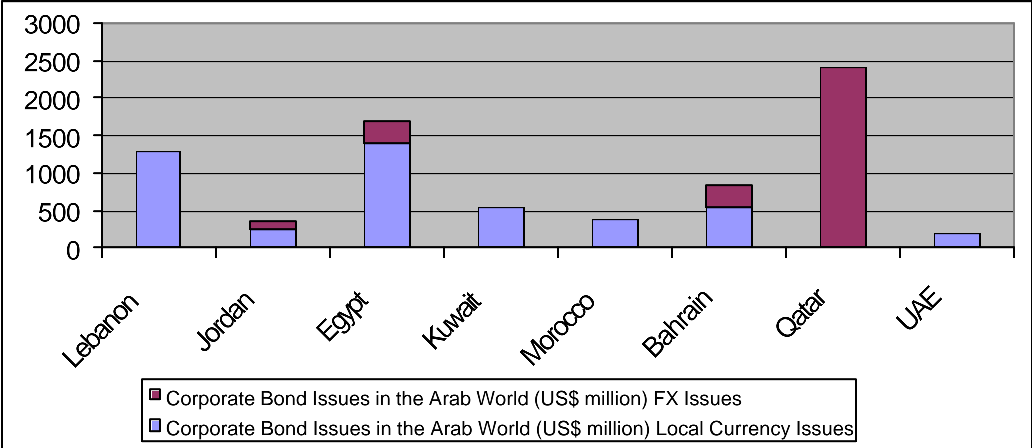
Source: World Development Indicators

Figure 4: Market Cap (billions $s) (end of 2000)



Source: S&P's Emerging Markets Database

Figure 5: Corporate Bond Issues in the Arab World (1999 - US$ million)



Source: Middle East Capital Group, 2000[1]

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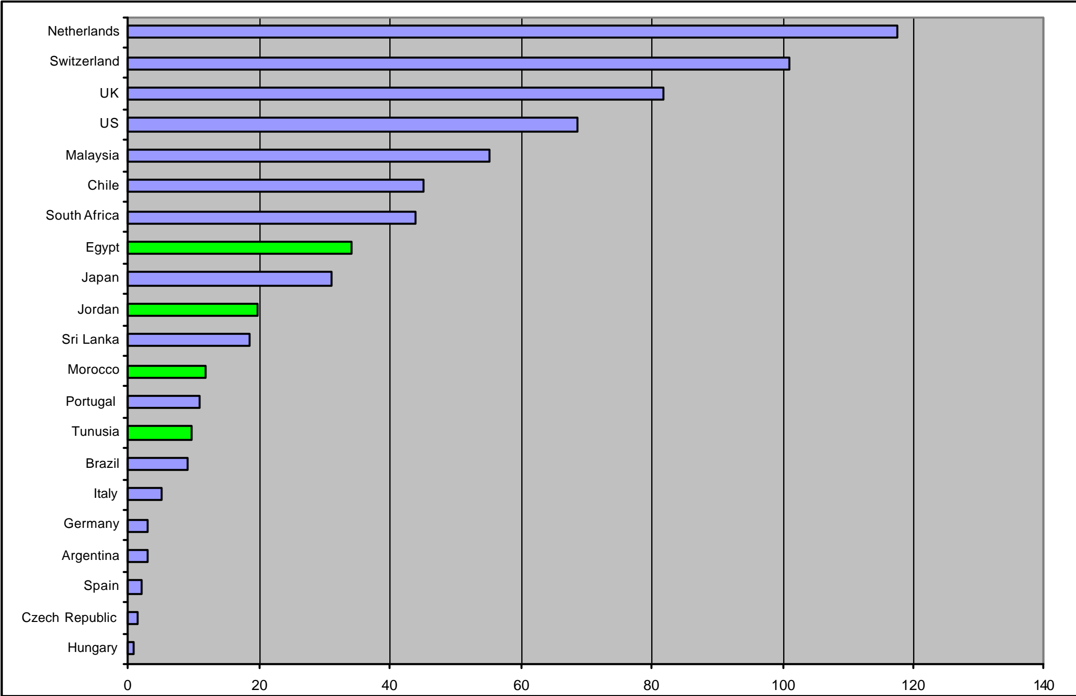
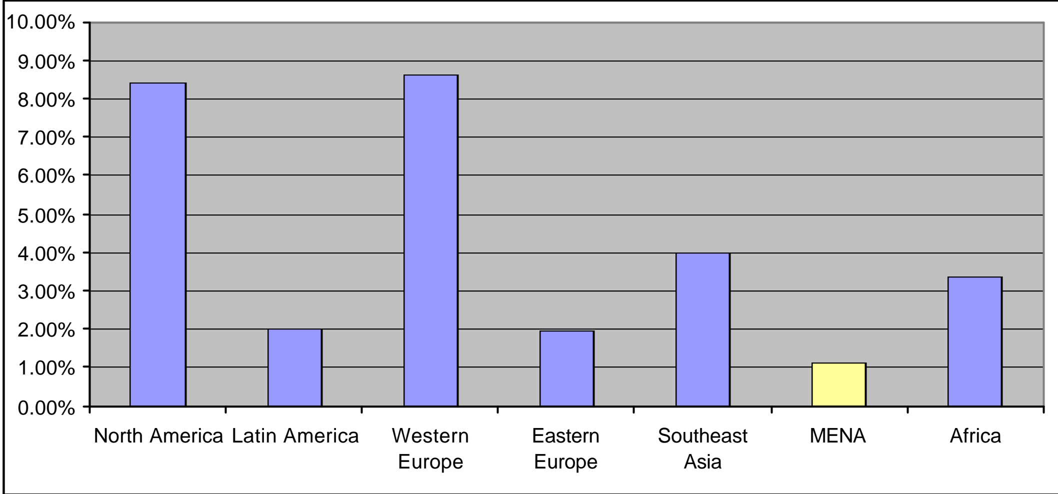
1 "Arab Bond Markets: Moving from the Embryonic Stage to the Take Off Stage." Middle East Capital Group, December 2000.

Figure 6: Pension Institutions Assets % of GDP (Selected Countries - 1997)



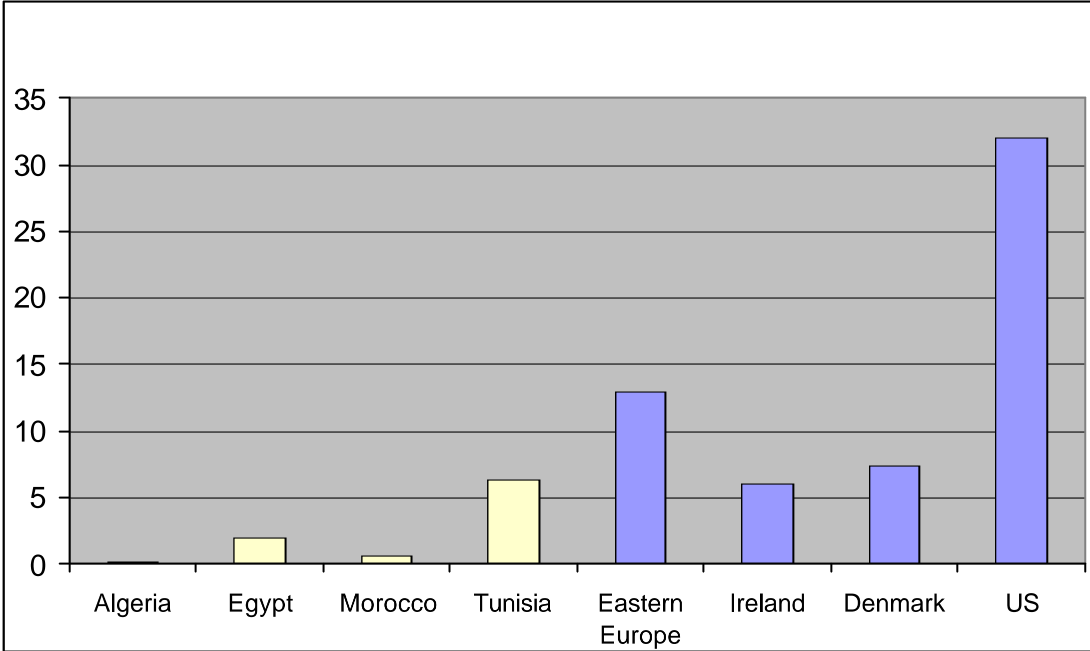
Source: Grais, Vittas 2000.

Figure 7: Total Insurance Premiums in 2000 (% of GDP)



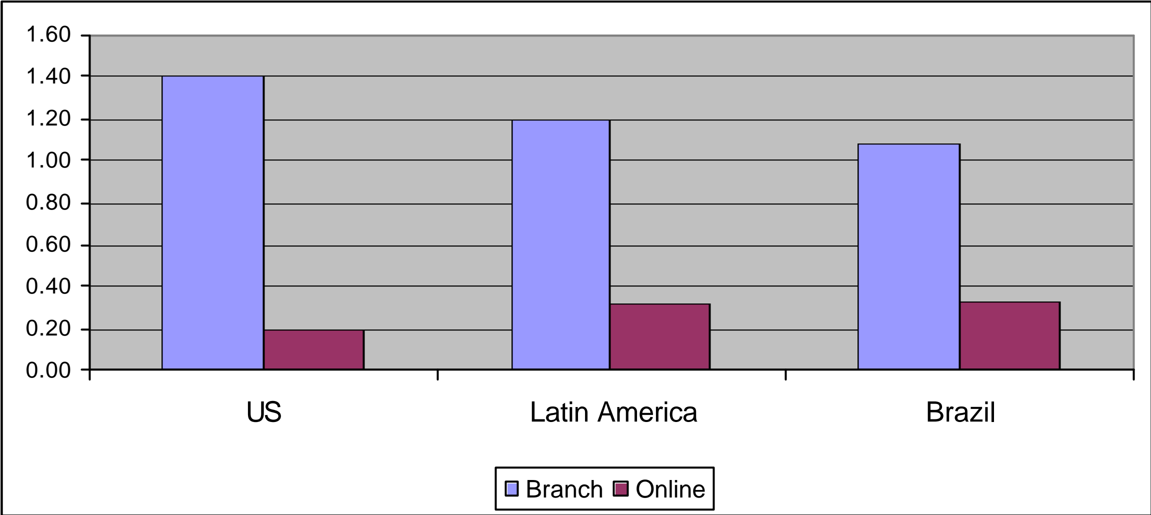
Source: SIGMA, World Insurance in 2000.

Figure 8: Leasing % of Gross Fixed Investments



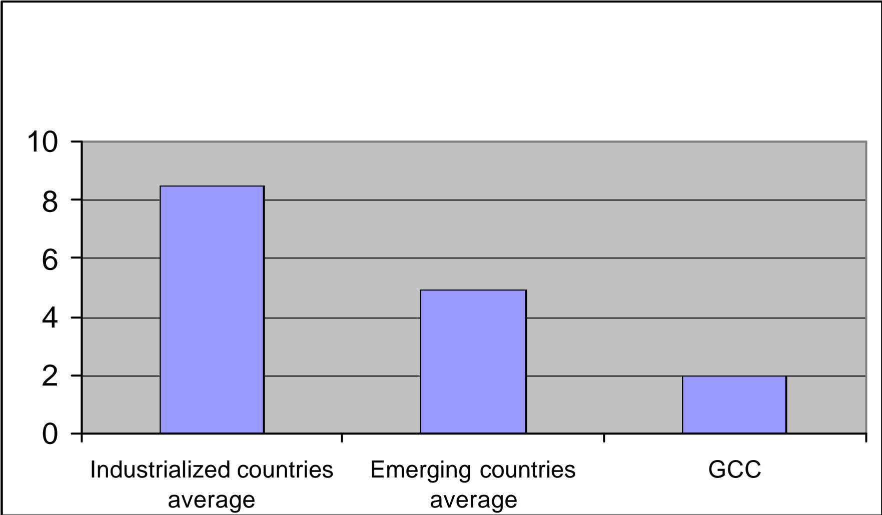
Sources: Egypt, Morocco, Eastern Europe, Denmark, Ireland, and US: World Leasing Yearbook, 2002.
Algeria: estimated and should be used with some caution. Tunisia: Central Bank of Tunisia.

Figure 9: Banking Industry Channel Cost Profile



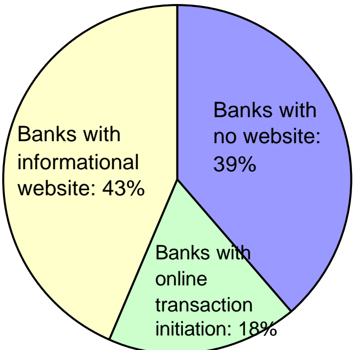
Source: Tower Group estimates, 1999

Figure 10: Online Banking Customers (% of total bank customers)



Source: Pyramid Research, March 2001

Figure 11: E-Banking status of the Top 100 Arab Banks (Asset sizes, year 2000)



Source: Pyramid Research, March 2001

Figure 12A: Net Private Flows in 2000 (% of GDP)

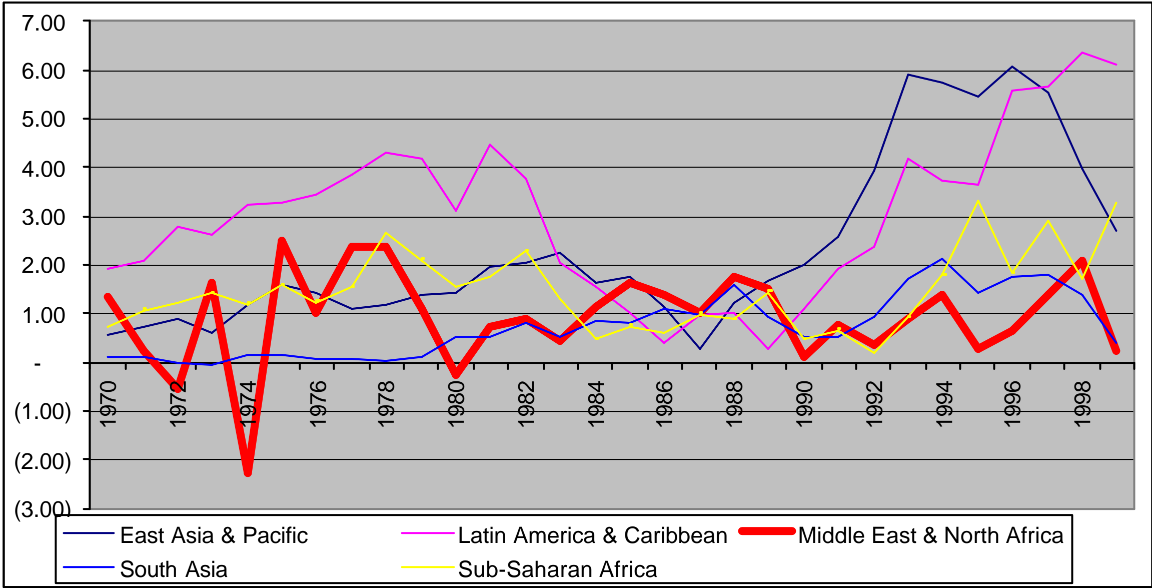


Figure 12B:Official Development Aid in 2000 (% of GDP)

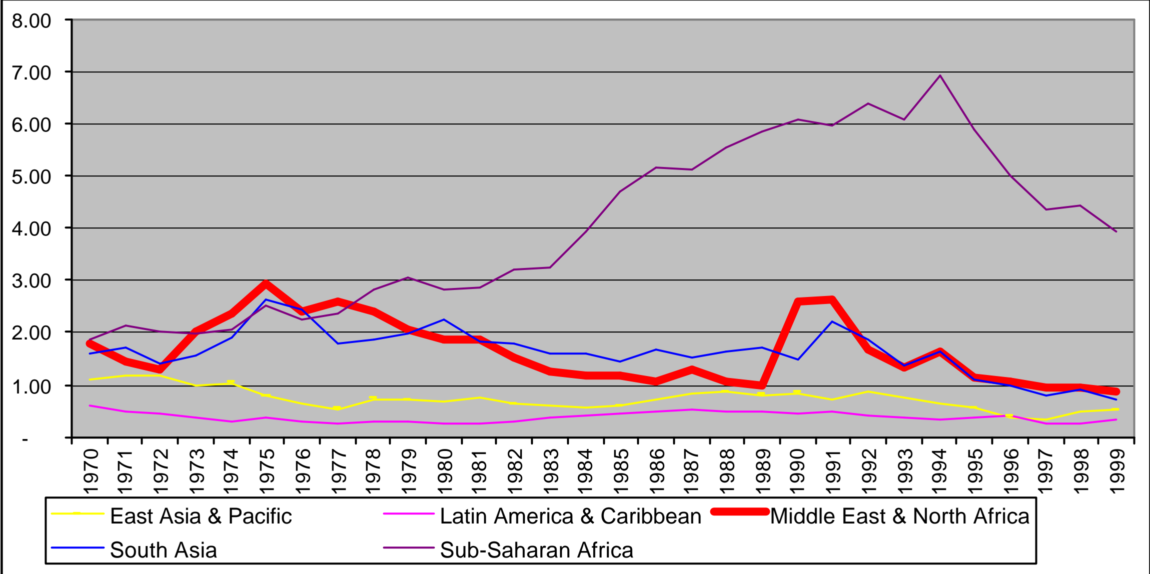
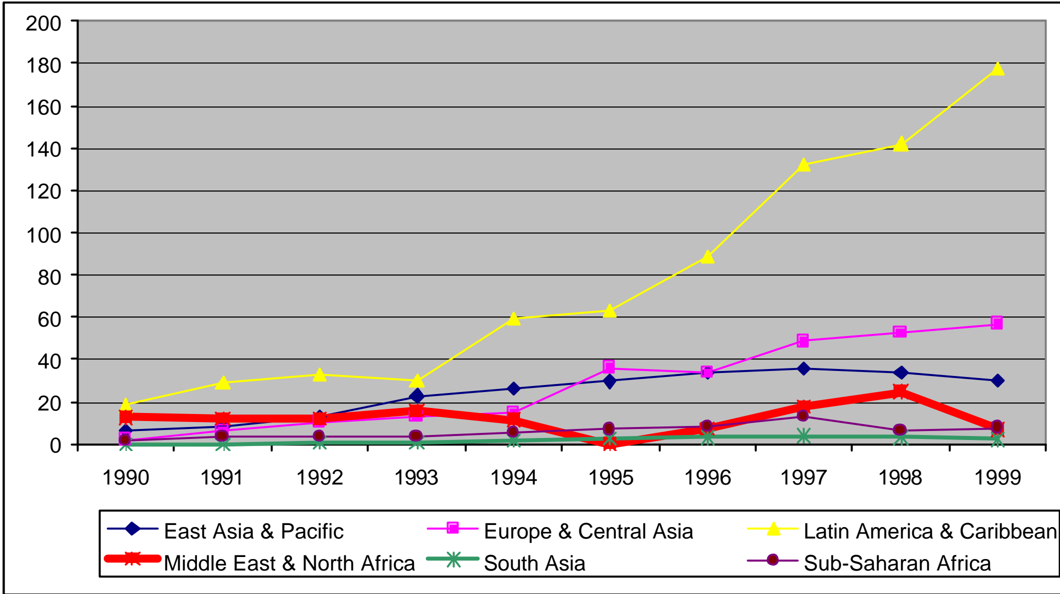
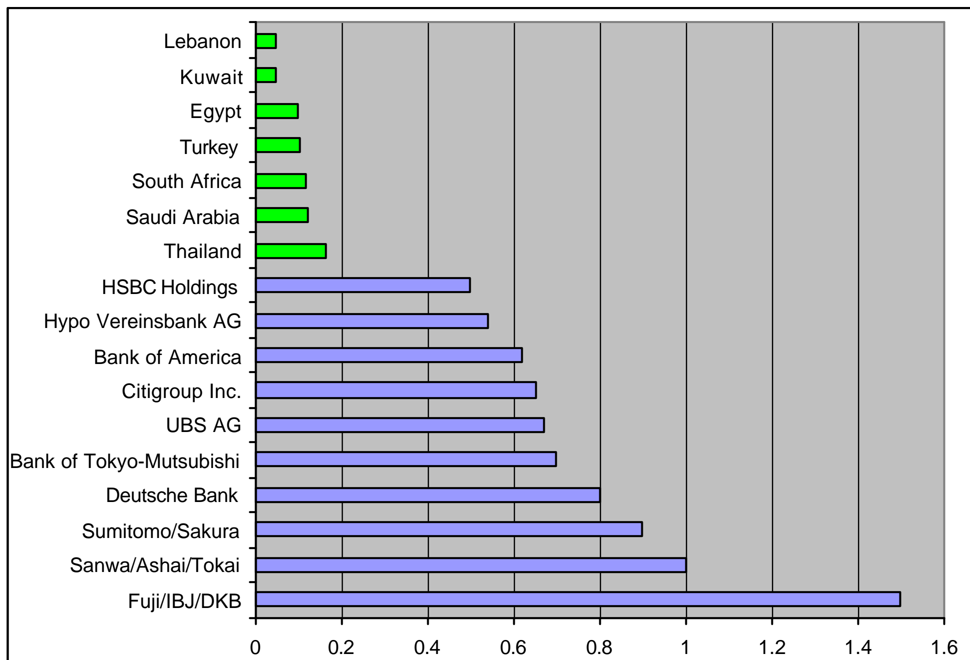


Figure 12C. FDI Net Flows Per Capita in 2000 (USD)



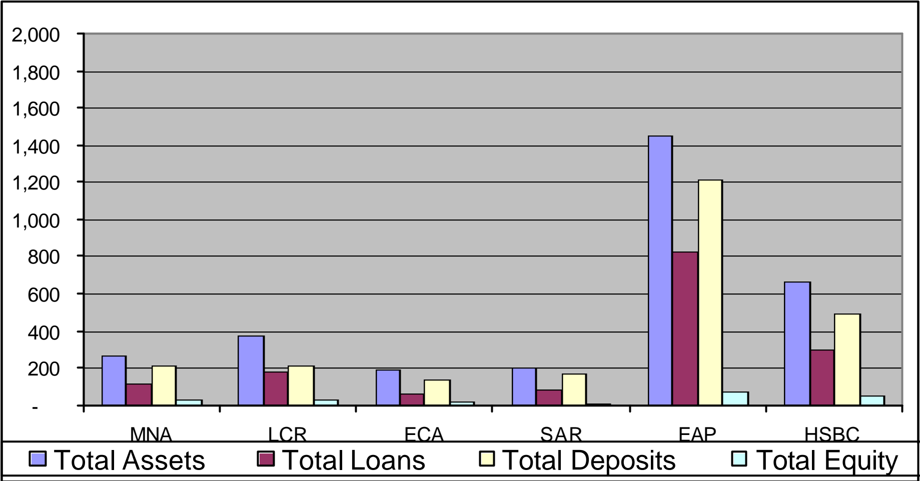
Source: World Development Indicators

FI 13: World Largest Banks Total Assets compared to Total Banking Assets of Selected Developing Countries (end of 1999, USD trillions)



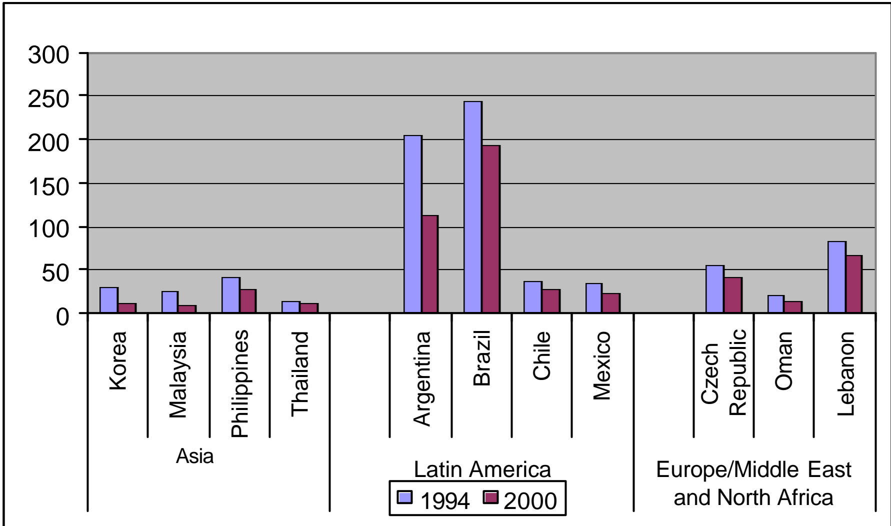
Source: Central Bank web pages, Banks' scope for individual banks.

Figure 14: Size of 20 Largest Banks (billions of USDs)



Source: Bankscope.

Figure 15: Number of Banks



Source: IMF, 2001, Central banks.

Table 1: Dates of Financial Liberalization

Country	Start of Liberalization	Interest Rate Liberalization	Stock Exchange Liberalization	Financial sector largely liberalized
United States	1982	1982-95		1973-96
Canada	1980	1980-95		1973-96
Japan	1979	1985-95	1980	1993-96
UK	1981			1973-96
France	1984	1984-95		1985-96
Germany	1980	1980-95		1973-96
Italy	1983	1980-95		1988-96
Australia	1980	1981-95		1986-96
New Zealand	1984	1984-95		1985-96
Indonesia	1983	1992-94	1989	1989-96
Korea	1983	1984-88, 1991-95	1992	-
Malaysia	1978	1980-95	1988	
Philippines	1981	1981-95	1991	
Thailand	mid-1980s	1989-95	1987	
Argentina 1	1977			
Argentina 2	1987		1989	
Brazil	1989		1991	
Chile	1974	1980-95	1992	
Colombia	1980	1980-95	1991	
Mexico 1	1974			
Mexico 2	1989	1989-95	1989	
Peru	1991	1980-84, 1990-95	1991	
Venezuela	1991	1991-95	1990	
Algeria	1990	1990-95		
Egypt	1991	1991-95	1993	
Israel	1987	1990-95		
Morocco	1991	1991-1996	1994	
Tunisia	1987	1990-1994*	1995	
South Africa	1980		1995	
Turkey 1	1980	1980-82		
Turkey 2	1988	1988-95	1989	
Bangladesh	1989		1994	-
India	1992	1992-95	1992	-
Nepal	1989			-
Pakistan	1991			-
Sri Lanka	1978	1980-95		-

Sources: Demirguc-Kunt (World Bank, 1998), IMF 2001.

Table 2: Financial Liberalization in MENA (2000)

	Emerging Markets	Transitional Markets	Closed Markets	Lagging Markets	Perceived More Mature Markets (GCC)
Public Ownership of Banks	25% - 70%	75 % - 100%	100%		20% - 40%
Foreign Ownership of Banks		0% - 10%	0%		Only GCC members
Established Stock Exchange	Early to mid 90s. Egypt –1903	Syria –In process Algeria – Jul 1999		None	Oman, Bahrain, Kuwait, Qatar, UAE late 1990s, Electronic exchange in Saudi Arabia under SAMA's supervision
Foreign Ownership of Shares	Allowed	Not allowed			Restriction
Active Money Market with limited Central Bank Intervention	Money market frequently a liquidity instrument for the CB				
Secondary Market of Treasury Bills					
Market Determined Yield Curve		No	No		

Table 3: Middle East Telecom Climate*

	State -dominant Telecom	Public-Private Ventures	Private Telecom
Bahrain	Yes	Yes	no
Egypt	Yes	Yes	no
Israel	Yes	Yes	yes
Jordan	Yes	Yes	no
Lebanon	yes	Yes	yes
Morocco	yes	Yes	yes
Saudi Arabia	yes	Yes	no
UAE	yes	Yes	no
UK	no	Yes	yes
USA	no	No	yes

Source: Booz, Allen and Hamilton
** non-mobile*

Table 4: Size of Banking and Stock Markets in Selected MENA and other Emerging Countries (% of GDP) (end of 2000 unless otherwise specified)

	Banking		Stock Markets	
	Total Assets (million USD)	% of GDP	Market Capitalization (million USD)	% of GDP
Bahrain *	9,900	150%	7,180	125%
Jordan *	18,214	209%	5,783	72%
Kuwait	46,020	124%	15,749	43%
Lebanon	45,034	272%	1,700	10%
Oman	10,309	60%	5,066	29%
Egypt	100,396	102%	35,516	36%
Saudi Arabia	121,034	74%	68,091	42%
Morocco	29,694	92%	10,899	33%
Tunisia	15,337	79%	2,828	15%
Turkey	101,029	51%	69,507	35%
South Africa	118,309	94%	204,952	163%
Mexico	158,832	27%	127,228	22%
Thailand	162,486	133%	31,891	26%

Sources: S&P Emerging Markets Database, Central bank websites, World Development Indicators
end of 1999

Table 5: Outreach and Microfinancing Gap for Middle East Countries

Country	Outreach Gap (number of bonowers)	Microfinancing Gap (millions of US dollars)
Egypt	1,475,000	371
Jordan	145,000	54
Lebanon	36,000	37
Morocco	485,000	194
West Bank & Gaza	33,000	17
Morocco	485,000	194

Source: World Bank Survey of Microfinance institutions, figures end of 1998

Table 6: Leasing (% of Private Investment)

	1988	1990	2000
United States	32	32	32
United Kingdom	20	20	15
Australia	33	25	20
Spain	26	28	6
Sweden	27	15	14
Ireland	19	28	22
Portugal	10	10	13
Korea	13	16	23
Indonesia	6	9	12
Hungary	..	8	12

Source: Lease Europe Annual Report, 2001

Table 7: Equipment leasing companies for selected countries, 2000

Country	Independent leasing companies	Captive leasing companies*	Leasing companies owned by banks	Leasing companies with banking status or banks	Total
Austria	4	2	2	2	10
Belgium	2	1	1	4	8
Denmark	3	2	1	-	6
Italy	2	1	2	2	7
Norway	3	2	1	4	10
UK	2	4	1	3	10
Czech Rep	3	2	1	4	10
Estonia	4	3	1	1	9
Finland	1	3	4	0	8
Hungary	2	4	2	2	10
Morocco	4	-	1	-	5
Poland	0	3	1	2	6
Slovakia	4	2	1	-	7

Source: Lease Europe Statistics, 2000.
* Leasing companies owned by non-financial conglomerates mainly to finance their own customers' purchases.

Table 8: Banking Costs per Transaction

	Branch	Telephone	ATM	Proprietary On-line System	Internet
Costs per transaction	$1.07	$0.52	$0.27	$0.015	$0.01

Source: B. Gates (1999) "Business at the Speed of Thought" Warner Books, New York. From "The Emerging Digital Economy", US Department of Commerce, 1998.

Table 9

Comparison of MENA to the Regulatory Structures around the World		World Outlook		MENA		Emerging Countries		Industrialized Countries	
			%		%		%		%
Separate agencies for each		46	53%	9	69%	40	55%	6	43%
Combined securities and insurance		3	3%	0	0%	3	4%	0	0%
Combined banks and securities		7	8%	3	23%	6	8%	1	7%
Combined banks and insurance		17	20%	0	0%	16	22%	1	7%
Single agency	Central Bank	9	10%	1	8%	8	11%	1	7%
Other		5	6%	0	0%	0	0%	5	36%
Total		**87**	**100%**	**13**	**100%**	**73**	**100%**	**14**	**100%**

Regional Summaries		MENA	Latin America	Eastern Europe	Africa	Asia	Industrialized Countries
		%	%	%	%	%	%
Separate agencies for each		69%	38%	52%	46%	69%	43%
Combined securities and insurance		0%	8%	0%	8%	8%	0%
Combined banks and securities		23%	8%	5%	0%	8%	7%
Combined banks and insurance		0%	46%	29%	23%	8%	7%
Single agency	Central Bank	8%	0%	14%	23%	8%	7%
Other		0%	0%	0%	0%	0%	36%
Total		**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: How countries supervise their Banks, Insurers and Securities Markets, Central Bank Publications, London, University of Toledo, College of Law, Financial Regulators Gateway.