Quantitative Measures of Financial Sector Reform in the Arab Countries

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Abstract

Arab countries like other developing countries have embarked since the early 1990s on financial sector reforms. The purpose of this study is to review and analyze the financial reform experience of the Arab countries after more than ten year of the implementation of these reforms.

Financial reforms have already brought about significant improvement in monetary and credit aggregates in many Arab countries. Financial sector reform has certainly had a noticeable impact on the cost of intermediation: real interest rates and gross interest margins. However, there is scope for even more improvements over the next years as competition enhancing measures and administrative costs reduction interventions are adopted. Moreover, the financial sector in Arab countries caters mainly to the public sector. There is a need for the monetary authorities to strengthen and promote private sector activities and ensure that the public sector does not crowd it out. Furthermore, Arab capital markets remain relatively small and face various constraints.

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I. Introduction

In the last decade, Arab countries, especially those of the Gulf, made significant progress in building a modern financial sector. Arab countries have embarked on economic and financial reforms in recognition that economic growth and stability are often associated with increasing financial deepening and in response to the need to quickly adopt to rapid globalization. For the most part, the financial and monetary authorities have implemented financial sector liberalization programs. These programs have included deregulating, interest rates liberalization and the gradual opening up of the financial sector for foreign participation, privatization of banks and other financial institutions and increasing competition.

The purpose of this paper is to review and analyze the financial sector reform experience of the Arab countries during the last decade. However, it has been recognized that the Gulf Co-operation Council (GCC) countries are faced with a different set of challenges than the rest of the Arab countries and thus the analysis here distinguishes between two main groups of Arab countries. These groups are the diversified Arab economies, i.e., Algeria, Egypt, Jordan, Lebanon, Morocco, Syria, Tunisia and Yemen and the oil-based economies, i.e. Bahrain, Qatar, Kuwait, Oman, Saudi Arabia and the UAE.

The paper starts by presenting a framework through which the financial reform experience of Arab counties can be reviewed and analyzed.

The framework's focus is on the design and sequencing of specific measures that, together, constitute the optimal financial reform package. To set the stage for a discussion of reform in the Arab countries, section III presents the quantitative indicators of these countries' financial sectors while providing a comparison with a selected group of reforming developing countries (Chile, Indonesia, Korea, and Philippines). The final section concludes by highlighting areas in the Arab countries where additional reforms are still needed.

II. The Financial Reform Experience of Developing Countries

Since the mid-1970s, many developing countries have been implementing financial liberalization programs. A study conducted by Bisat, Johnston, and sundararajan (1992) examined in detail the experience of five countries with financial sector reform and liberalization: Argentina (1976-81), Chile (1974-80), Indonesia (1983-88), Korea 1980-88) and the Philippines (1980-84). Furthermore, Fry (1988) presented a general review of issues of financial reform. The interaction between economic growth and financial sector reform is presented by Sundararajan (1985 and 1987), and Gertler (1988). This section attempts to summarize the main lessons from these developing countries' experience, focusing on six topics: intermediation approach; monetary and credit directions; monetary policy; prudential supervision measures; status of competition; and the role of stock markets.

1. Intermediation Approach

Real interest rates are likely to become a more important policy instrument in the post-reform period than in the pre-reform period. For the

most part, credit expansion that continues for a long period after reform could threaten macroeconomic stability through putting pressure on price levels and the external accounts imbalance. This would occur if real interest rates were negative in the post-reform period, as this would encourage a more rapid growth of credit and slower growth of deposits. While negative real interest rates are common in pre-reform periods, their impact on credit tends to be limited by application of direct credit controls.

In contrast, if positive real interest rates were maintained, the growth of credit would slow down compared to the initial post-reform period. This would be emphasized by a rise in the growth rate of deposits that would also react favorably to the development of financial instruments and institutions, and to banks becoming more efficient deposit users following the reduction in the central bank role as liquidity provider. The above analysis strongly suggests that a necessary prerequisite for successful reform is the adoption of prudent macroeconomic policies that would result in positive real interest rates.

Financial liberalization tends to affect the cost of funds in complicated ways. First, the removal of interest rate controls allows banks to price credits and risks more appropriately and this may cause an increase in interest rate margins since controlled lending rates were usually set too low in the pre-reform period. Second, risk premiums tend to rise in the post-reform period as banks significantly expand their loan portfolio to new borrowers with unconventional risks. Thirdly, upward pressure is placed on the gross interest margin since competition in credit markets increases only slowly relative to that in the deposit markets. Against those factors, financial liberalization also tends to put downward pressure on the cost of funds. First, reserve requirements are normally lowered as part of the reform package that

reduces the cost differences between deposit and lending rates. Second, competition is increased through the reduction of barriers to entry.

In conclusion, evidence from the experience of developing countries suggests that reforms tend to expand banks' gross lending margins. However, this can be corrected by a strengthening of bank supervision, by further reducing the reserve requirements, and by a rapid implementation of competition-enhancing measures.

2. Monetary and credit Directions

Financial reform is usually associated with increases in the ratios of money, financial assets and credit to the private sector, to GDP, while the ratio of currency to deposits fall following the reforms. Thus, the effect of financial liberalization on the behavior of the key monetary and credit aggregates needs to be taken into account in setting monetary targets in the post-reform period.

Financial liberalization also tends to be followed by a period in which credit growth exceeds the growth of deposits with financial institutions. This phenomenon can be explained as follows. In the pre-reform period, both deposits and credit tend to fall. The decline in the former reflects a voluntary portfolio response to financial repression. In the post-reform-period there is a gradual portfolio adjustment by depositors to the new liberal financial situation. In contrast, credit growth in the pre-reform period is constrained by direct controls with an excess demand for credit. Once the direct controls are removed, financial institutions respond by meeting the excess demand for credit and credit expands rapidly. This has the impact of increasing imbalances, and putting pressure on prices and the country's external accounts. The credit boom can pose a threat to economic stability; its

appropriate management is a crucial element of successful financial liberalization.

3. Monetary policy

Financial liberalization requires the ability to manage interest rates and liquidity and credit aggregates through market-oriented instruments of monetary policy, i.e., indirect instruments, rather than through direct administrative fixing of various interest rates. However, in the immediate post-reform period, there is a space for using direct controls which would line up credit growth with the otherwise lagging growth of bank deposits. Therefore, while there is a need for an early implementation of indirect monetary instruments, credit ceilings may be used on a temporary basis, and so long as they are supported by positive real interest rates.

Money markets require an active involvement of the central bank in order to ensure the existence of a reciprocal market in bank reserves. In doing so, the central bank should switch gradually from being the principal market maker to creating and supporting the financial deepening of the market. In this capacity, the central bank should withdraw (or inject) reserves at own initiative in anticipation of surpluses (and deficits) emerging in the market while leaving market participants to make their own decisions. Thus, indirect momentary instruments are essential for the development of money markets and the deepening of financial markets.

4. Prudential Supervision Measures

The soundness of the banking system has implications on how to manage the reform process. This is because a system that is burdened with rolling over of loans of weak firms or large nonperforming loans cannot

easily change lending priorities to new venues and investments. In addition, higher interest rates on deposits will compound the cash flow problems, and higher lending rates only deteriorate the bad debt problem. Weak institutions tend to also become a greater source of pressure on central bank resources thereby affecting monetary policy.

More importantly, financial reforms themselves may weaken the banking sector. For instance, the removal of credit restrictions before proper credit approval processes are put in place may result in an increase in lending to more risky projects and to new activities. This is particularly critical if, as in the developing countries, (implicit or explicit) deposit guarantees exist which leave investors largely indifferent as to where they place their deposits.

Thus, financial liberalization in some developing countries implementing financial reforms was followed by a financial crisis. It should therefore be emphasized that financial sector and monetary authorities face difficult constraints and may lose their effectiveness if a significant part of financial institutions have sizeable nonperfoming loans and face constant cash flow problems. Therefore, measures to deal with banking sector problems would need to be put in place before financial reform starts. In addition, banks need to be encouraged to improve their internal credit assessment, risk appraisal systems and strengthen their accounting and disclosure practices.

5. Status of Competition

The banking systems in countries embarking upon financial reform are usually characterized by oligopoly market structures. As a result, the speed of adjustment of deposit and lending rates to changes in monetary

policy conduct is often slow, and the margin between deposit and lending rates also tends to adjust slowly. While enhancing competition and interest rate liberalization have a positive impact on financial competition, the impact tends to happen with a lag.

6. The Role of Stock Markets

A key question that always arises during the financial reform process concerns what sequence to pursue when developing non-banking financial markets. The international experience appears to suggest that money markets and the markets for short-term instruments such as treasury bills and bankers' acceptances should be developed prior to long-term markets. This is because the development of well-capitalized dealers in securities is easier in short-term instruments than in long-term instruments such as shares and other stocks. The capital markets sophistication and exchange skills developed through short-term instruments can then be translated into long-term instruments over time.

The development of capital markets, within a sound regulatory framework, requires a number of structural reforms including; an effective privatization plan; a macroeconomic environment that is conducive to increasing the private sector share in the economy; and the strengthening of market forces through improving information flows, accounting standards, property rights, pricing efficiency, and tax reform. Finally, political stability is vital for the development of sound capital markets.

III. Quantitative Assessment of Financial Sector Reform in Arab Countries

Prior to examining the financial sector policies of the Arab countries, this section provides a quantitative assessment for these countries during the 1991-2000 period. The section considers four sets of indicators relating to interest rates; monetary aggregates; credit aggregates; the capital market and other related aspects of the financial sector. Furthermore, the analysis examines how the indicators behaved following liberalization and how they compare to levels prevailing in a set of developing countries that are advanced in the process of financial liberalization: Argentina, Chile, Thailand and the Philippines.

This section adopts a two-tier classification of the Arab countries surveyed in this paper. The first category includes the diversified Arab economies such as Lebanon which has historically possessed a liberal and open financial sector and countries that are, to varying degrees, advanced in the process of financial sector reform such as Jordan, Egypt, Morocco, and Tunisia. In addition, it also includes Algeria, Syria and Yemen--countries where the financial sector is, or until recently was heavily administratively controlled and/or was part of a planning apparatus that mobilized financial resources and centrally allocated them to prescribed projects. While Algeria and Yemen have recently embarked on a financial sector reform effort, Syria is currently in the process of initiating its own financial reform program.

The second group includes all the GCC countries as these countries have already completed most of the crucial stages of liberalization and financial reform, and unlike the other Arab counties, their financial systems are not encumbered with distortions.

A) Diversified Arab Economies

1. Interest Rates

Two indicators related to interest rates and the intermediation aspects of the financial sector operations are considered (see Bisat, 1996). The level of real interest rates demonstrates the allocative efficiency of financial resource use. Gross interest rate margins (i.e. the difference between deposit and lending rates) point to the level of financial sector competition.

In general, real interest rates in most of the diversified Arab economies were negative before embarking on financial reform, by the mid-1990s all of the Arab countries showed positive signs (see Table 1A&B). In Algeria, Egypt, Morocco, Jordan and Lebanon interest rate liberalization was followed by relatively high real interest rates; however, these rates have been falling over the last few years. In Syria and Yemen, banks are still adjusting to the recently liberalized financial environment and therefore, temporarily showed a negative sign for Yemen or high real interest rate as the case for Syria. Furthermore, real interest rates in diversified Arab economies are slightly higher than those prevailing in other developing counties.

Gross interest rate margins in diversified Arab economies have been declining over time indicating an increase in competition within the financial market. Only two countries are exception namely, Lebanon and Morocco were the gross interest rate margins are higher than those prevailing in other Arab countries and even those prevailing in other developing countries. This may suggest that financial sector competition remains limited.

Table 1A. Interest Rate Indicators; 1992-2000
(In percent)

	1992	1995	1996	1997	1998	1999	2000
	Real Deposit Rates						
Algeria	-15.8	-6.6	-3	-4.2	-0.3	5.5	4
Egypt	-3.6	0.5	-2.2	6	8.2	8.4	7.4
Jordan	-0.7	0.2	2	5.9	4.8	7.6	6.2
Lebanon	-46.8	5.0	-2.1	3.3	7.3	2.5	5.5
Morocco	3.5	2.4	2.0	2.3	4.5	5.6	3.3
Syria	-2.7	-6.1	-3.2	-3.2	2.9	5.9	7.1
Tunisia	3.6	0.5	4.9	3.2	3.5	3.0	2.6
Yemen	-25.6	-23.1	-6.3	8	0.3	7.3	-1
Argentina	-6.5	3.7				1.9	0.7
Chile	2.5	5.1				3.3	4.9
Philippines	4.9	0.3				1.4	1.9

Source: International Financial Statistics, IMF.

Table 1B. Interest Rate Indicators; 1992-2000
(In percent)

	1992	1995	1996	1997	1998	1999	2000
	Gross Interest Rate Margin						
Algeria	10.0	7.5	4.5	2.8	3.5	3	2.8
Egypt	3.6	4.6	5	4	3.7	3.8	3.8
Jordan	6.5	5.8	2.8	0.8	1.6	4.0	4.8
Lebanon	23.1	8.4	9.7	7.0	7.0	7.0	6.9
Morocco	10	8.2	7	9	10	10	9.8
Syria	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Tunisia	6.9	6.9	5.4	6.0	4.9	3.5	4.5
Yemen	5.0	8.0	7.7	7.6	3.4	3.8	5
Argentina	8.6	6.1				6.0	4.4
Chile	5.7	4.4				5.3	5.7
Philippines	5.2	6.3				5.1	4.5

Source: International Financial Statistics, IMF.

2- Monetary Aggregates

The traditional measures of financial deepening are the ratio of currency to deposits, the ratio of M2 to GDP and the ratio of M1 to M2. While the first two ratios are intended to demonstrate the depth of the market; the third ratio provides an indicator of the importance of long-term banking and the degree of sophistication in the financial market. (See Table 2A,B & C).

The currency to deposit ratios are lowest in Lebanon, Egypt, Tunisia, Jordan, and to a leaser degree in Morocco indicating fairly sophisticated financial markets and public confidence in the banks. The ratios for Egypt and

Lebanon are in line with those of the developed countries but for Tunisia; Jordan and Morocco, ratios are slightly higher than other developing countries. Nevertheless, these levels represent a significant improvement from the level prevailing at the beginning of the decade and suggest a post-liberalization improvement in financial intermediation. In Algeria, Syria and Yemen the currency to deposit ratios are high which is common in many developing counties in economic transition in the periods before and immediately after implementing financial reform measures. In the case of Algeria and Yemen, the higher ratios are indicative of the presence of the monetary overhang phenomenon in the financial market as both price and import controls are applied combined with expansionary financial policies. For Syria, however, the ratio predominantly reflects a cash-based society and a lack of sophistication in the financial market.

The monetization ratio, M2 to GDP, is higher in Jordan and Lebanon than the rest of both other developing countries and other diversified Arab economies and clearly demonstrates a deepened financial sector. Egypt, Morocco and Syria's monetization ratios are relatively lower but remain quite high when compared with the levels prevailing in other developing countries. This is mainly indicative of an advanced deposit banking system in these countries. Moreover, the monetization ratios for Tunisia, Algeria and Yemen are generally lower than both other developing countries and other diversified Arab countries, which is also a trend common in many developing counties in economic transition in the periods before and/or immediately after implementing financial reform measures and it also reflects the lack of new and innovative forms of financial savings.

Furthermore, the M2 to GDP ratio in Algeria has been declining steadily during the period reflective of the unstable political environment. The

long-run mobilization ratio, M1 to M2, is very low in Lebanon and Egypt and to a lesser extent in Jordan. In these countries this is clearly indicative of a well-developed banking sector and illustrates the depth of the financial sector in each of these countries. In all other reforming Arab countries, the M1 to M2 ratios are relatively higher than those prevailing in other developing countries which indicates less developed financial sector even though these ratios are generally declining over the time period. This suggests that these countries need to further develop their banking sector as they realize the full impact of interest rate liberalization including the effect of maturity differentiation among depositors.

Table 2A. Monetary Indicators; 1992-2000 (%)

	1992	1995	1996	1997	1998	1999	2000
	Currency to Deposit Ratio						
Algeria	41.2	35.8	52.0	50.8	48.3	47.3	46.2
Egypt	10.8	11.4	16.2	16.6	17.3	18.1	17.2
Jordan	31.5	25.6	25.1	24.1	21.7	22.7	22.9
Lebanon	7.2	4.8	4.2	3.6	3.2	3.1	3.0
Morocco	34.7	32.0	32.7	27.0	26.4	48.3	25.0
Syria	60.0	73.3	81.2	92.5	87.7	64.6	73.3
Tunisia	35.7	22.4	20.7	18.7	18.9	18.9	18.3
Yemen	97.7	94.5	103.9	93.9	86.1	89.9	80.4
Argentina	32.9	28.4				23.4	22.9
Chile	9.0	8.8				9.1	9.0
Philippines	17.9	14.1				11.1	11.7

Source: International Financial Statistics, IMF.

Table 2B. Monetary Indicators; 1992-2000 (%)

	1992	1995	1996	1997	1998	1999	2000
			M2 to GDP Ratio				
Algeria	53	40.5	35.6	39.2	46.1	42.7	40.9
Egypt	75.2	74.2	79.0	77.9	78.9	77.4	77.6
Jordan	120	111.7	95.3	98.4	96.2	110	112
Lebanon	125	126.9	125.6	119.5	125.4	122.3	127
Morocco	60.4	63.2	62.2	72.5	71.5	51.6	58.9
Syria	59.2	62.4	64.1	65.1	62.3	59.7	60.2
Tunisia	43.1	38.9	40.1	42.7	43.6	45.1	45.7
Yemen	32.4	33.8	31.7	34.6	41.3	35.8	37.5
Argentina	13.7	10.6				17.6	19.6
Chile	37.7	39.0				39.4	41.5
Philippines	36.2	45.6				52.1	55.8

Source: International Financial Statistics, IMF.

Table 2C. Monetary Indicators; 1992-2000 (%)

	1992	1995	1996	1997	1998	1999	2000
	M1 to M2 Ratio						
Algeria	78.4	64.9	64.4	62.2	63.8	60.6	60.2
Egypt	25.7	22.9	24.7	24.4	26.5	25.3	23.8
Jordan	41.5	33.8	32.3	31.8	29.7	28.2	29.9
Lebanon	12.5	6.8	6.1	5.6	5.1	5.0	4.9
Morocco	77.3	72.9	72.4	72.2	73.4	60.8	73.9
Syria	79.9	78.2	64.3	69.1	67.5	66.1	65.5
Tunisia	47.9	48.2	46.5	45.1	45.9	44.9	43.2
Yemen	68.7	61.8	59.0	56.4	54.6	55.2	52.6
Argentina	36.6	33.3				41.2	42.1
Chile	16.1	13.9				12.9	12.4
Philippines	24.0	20.7				17.3	16.8

Source: International Financial Statistics, IMF.

3- Credit Aggregates

The credit aggregates indicators utilized here are the private sector's credit as a percent of GDP, Credit to the public sector to GDP and the monetary authority credit to the financial sector as a percent of total financial sector credit (see Table 3A, B & C). The first indicator shows the banking system's orientation to the private sector and the extent to which domestic regulations constrain credit and thus the level of activities in the private sector. It also reflects the importance of the private sector in the economy and degree of success of obtaining its credit needs.

Credit to private sector ratio in Tunisia is the highest among the eight Arab countries followed by Jordan and Morocco. Those countries' ratios are in line with those prevailing in other developing countries. In Lebanon and

Egypt, the ratio is about 50 to 60 percent but points still to the impact of crowding out of the private sector by the public sector despite the well-developed banking sector and the liberalization of credit policies. In particular in Egypt, this ratio improved dramatically in the last decade but there is still plenty of room for improvement. In Algeria, Syria and Yemen, the credit to private sector ratios are extremely low indicating a weak private sector role in the economy and low reliance on credit provided by the banking sector.

The credit to public sector ratio mainly tells the other side of the story of the first indicator, credit to private sector. However, it essentially point out the dominance of the public sector in the economic activities. In Tunisia the credit to public sector is the lowest, followed by Jordan and to lesser extent Morocco, which suggests an advanced privatization process and a more conservative fiscal perspective in these countries. In Lebanon, the credit to public sector amounted to about half of all the credit provided by the banking system despite the near absence of the public sector in the Lebanese economy. This is mainly associated with the persistence of large public debt due to a chronic budget deficit. In the remainder of the diversified Arab economies, the ratios have fallen dramatically in the last decade but there is large room for improvement, especially in countries like Egypt, Morocco and Syria.

The degree of reliance on monetary authorities by the financial sector is assessed by the ratio of credit provided by the central bank to local financial institutions to total credit. Egypt, Lebanon, Jordan, Morocco and Tunisia show a low and decreasing ratios that is indicative of a low level of reliance on central bank for their operations. These ratios are a bit higher in Algeria and very high in Syria. In Syria it was increasing over the time period, indicating that more than two thirds of Syria's financial sector credit is financed by the central bank.

Table 3A. Credit Indicators; 1992-2000 (%)

	1992	1995	1996	1997	1998	1999	2000
Credit to Private/Total Credit							
Algeria	9.1	10.7	13	9.3	10.1	10.9	-
Egypt	24	45.3	49.8	53.6	56.9	59.8	59.2
Jordan	58	78.3	81.7	84.5	79.8	82.5	84.6
Lebanon	51	66.3	61.2	56.8	54.8	54.5	50.2
Morocco	22.3	54.5	56.4	58.1	60.1	63.8	64.2
Syria	9.6	23.2	24.8	26.5	27.3	29.6	33.7
Tunisia	49.5	96.1	96.9	95.2	95.4	93.4	90.3
Yemen	7.4	11.0	11.5	11.8	17.6	17.5	26.9
Argentina	15.2	16.5				18.9	20.2
Chile	45.4	48.5				49.3	50.7
Philippines	20.6	29.1				38.7	39.4

Source: International Financial Statistics, IMF.

Table 3B. Credit Indicators; 1992-2000 (%)

	1992	1995	1996	1997	1998	1999	2000
Credit to Public/Total Credit							
Algeria	60.8	89.3	87	90.7	89.9	89.1	-
Egypt	70.4	54.7	50.2	46.4	43.1	40.2	40.8
Jordan	35	21.7	18.3	15.5	20.2	17.5	15.4
Lebanon	29.6	33.7	38.8	43.2	45.2	45.5	49.8
Morocco	27.7	45.5	44.6	41.9	39.9	36.2	35.8
Syria	48.7	76.8	75.2	73.5	72.7	70.4	66.3
Tunisia	7.1	3.9	3.1	4.8	4.6	6.6	9.7
Yemen	87.2	89.0	88.5	88.2	82.4	82.5	73.1
Argentina	7.0	7.1				9.3	10.9
Chile	13.4	7.8				6.5	7.2
Philippines	0.5	15.8				20.1	22.3

Source: International Financial Statistics, IMF.

Table 3C. Credit Indicators; 1992-2000 (%)

	1992	1995	1996	1997	1998	1999	2000
	Credit from Central Bank/Total Credit						
Algeria	12.5	19.6	24.4	18.8	17.8	19.5	-
Egypt	5.4	1.3	1.1	1.0	0.9	1.2	1.0
Jordan	12.6	3.2	2.8	3.0	2.6	2.4	2.3
Lebanon	2.3	1.8	0.5	0.3	0.9	1.0	1.6
Morocco	2.0	0.7	.41	0.4	1.2	0.4	2.2
Syria	24.1	38.1	44.6	49.5	50.8	58.8	68.8
Tunisia	14.3	9.2	1.6	1.1	1.0	0.6	2.4
Yemen	-	-	-	-	-	-	-
Argentina	46.4	37.1				43.7	45.5
Chile	29.9	22.4				19.8	20.2
Philippines	8.1	1.4				2.0	3.1

Source: International Financial Statistics, IMF.

4- Stock Markets

Capital markets in diversified Arab countries are relatively new and generally small when compared with other developing countries. The Egyptian equity market is the largest with a capitalization of about 29 US$ billion, followed by Morocco and Jordan (see Table 4A & B). However, Amman's equity market comes first with respect to capitalization to GDP ratio, about 60 percent followed by Morocco and Egypt. Furthermore, value traded in diversified Arab countries' equity markets is generally modest with the Egyptian market taking the lead followed by Morocco. The number of listed companies is on the rise but this was not reflected in the value traded, indicating that although listed, their shares were not necessarily traded in the market.

Table 4A. Capital Market Indicators; 1992-2000

	1992	1993	1994	1997	2000
Market Capitalization in billions of US$					
Egypt	3.3	3.8	4.3	20.8	21.9
Jordan	3.4	4.9	4.5	5.4	5.8
Morocco	1.9	2.7	4.4	12.2	13.7
Tunisia	0.8	1.0	2.6	2.3	2.6
Emerging markets					
Argentina	18.6	44.0	36.9		
Chile	29.6	44.6	68.2		
Thailand	58.3	130.5	131.5		
Market Capitalization as a percent of GDP					
Egypt	7.9	8.1	8.3	20.8	23.2
Jordan	66.2	87.4	75.3	77.4	79.4
Morocco	6.7	10.1	14.2	36.8	43.2
Tunisia	5.2	6.9	16.5	12.2	12.7
Emerging markets					
Argentina	8.2	17.2	13.1	17.8	
Chile	72.0	102.2	125.7	93.8	
Thailand	56.4	108.5	91.8	99.2	

Source: International Financial Statistics, IMF.

Table 4B. Capital Market Indicators; 1992-2000

	1992	1993	1994	1997	2000
Value Trade in millions of US$					
Egypt	300	170	360	600	690
Jordan	1,310	1,380	620	770	940
Morocco	0	1000	790	1,070	1,840
Tunisia	0	0	300	970	1,730
Emerging markets					
Argentina	15679	10339	11371		
Chile	2029	2797	5263		
Thailand	72060	86934	80188		
Number of Domestic Companies Listed					
Egypt	656	674	700	760	820
Jordan	103	101	95	139	152
Morocco	62	65	61	49	54
Tunisia	17	19	21	34	44
Emerging markets					
Argentina	175	180	156		
Chile	245	263	279		
Thailand	305	347	389		

Source: International Financial Statistics, IMF.

II- GCC Countries

The GCC countries have a fairly large number of banks with an extensive network of branches. Banks in the GCC countries are financially strong and well capitalized, (Jbili, Galbis and Bisat, 1996). In 2000, the Saudi American Bank was the largest Arab bank with assets exceeding 25 US$ billion. Most of the banks in GCC are family-owned, with modest government equity participation and a large number of specialized banks are fully owned by the government. Moreover, the GCC countries have an open economic system with free movement of capital and exchange rate regimes, which are pegged to the US dollar. This institutional setting has implications for the conduct and the effectiveness of monetary policy, which is geared toward maintaining stability of the local currency against the US Dollar. This section presents a review of the structure and key indicators of financial systems in the GCC countries.

1. Interest rates

The same two indicators related to interest rates are also utilized here, namely, the level of real interest rates, which demonstrates the allocative efficiency of financial resource use and the gross interest rate margins (i.e. the difference between deposit and lending rates) which point to the level of financial sector competition.

Because of the region's low inflation rate, real interests rate have generally been positive but a bit higher than the real interest rates prevailing in some of the diversified Arab countries and other developing countries (see Table 5A & B). While most of the GCC countries maintained restrictive regulations on nominal interest rates in the past, in the 1990s most GCC countries have been removing these regulations and market forces now largely determine interest rates. Nevertheless, some restrictions remain in a

few countries, such as a ceiling on deposit interest rates and caps on lending rates or on consumer loans.

On the other hand, the gross interest rate margins in GCC countries were smaller in comparison to diversified Arab countries, ranging from 1 to 3 percent except for Bahrain where there is a wider margin of about 7 percent.

Table 5A. Interest Rate Indicators (GCC); 1995-2000 (%)

	1995	1996	1997	1998	1999	2000
	Real Deposit Rates					
Bahrain	3.8	4.7	2.8	5.1	-1	6.9
Kuwait	3.1	2.5	5.3	6.1	2.7	3.9
Oman	6.2	6.8	7.2	9.3	7.7	8.7
Qatar	1.0	-.9	3.6	3.7	4.1	7.2
Saudi Arabia	3.9	4.3	5.6	6.5	7.2	7.5
United Arab Emirates	-	-	-	-	-	-

Source: International Financial Statistics, IMF.

Table 5B. Interest Rate Indicators (GCC); 1995-2000 (%)

	1995	1996	1997	1998	1999	2000
	Gross Interest Rate Margin					
Bahrain	6.7	7.3	7.0	7.2	7.1	6.8
Kuwait	2.4	2.7	2.9	2.6	2.8	3.0
Oman	1.9	2.4	2	1.6	2.2	2.5
Qatar	1.4	1.8	1.5	1.4	1.4	1.3
Saudi Arabia	-	-	-	-	-	-
United Arab Emirates	-	-	-	-	-	-

Source: International Financial Statistics, IMF.

2- Monetary Aggregates

As illustrated before, the conventional measures of financial deepening are the ratio of currency to deposits, the ratio of M2 to GDP and the ratio of M1 to M2. While the first two ratios are intended to demonstrate the depth of the market; the third ratio provides an indication of the importance of long-term banking and the degree of sophistication in the financial market in GCC countries. (See Table 6A, B & C).

The currency to deposit ratios are low in Kuwait, Qatar, Bahrain, the UAE and to a lesser degree in Oman and Saudi Arabia indicating fairly sophisticated financial markets and public confidence in the GCC banking system. Oman and Saudi Arabia ratios are in line with other developing countries, however, their levels represent a significant improvement from the level prevailing at the beginning of the decade and suggest a post-liberalization improvement in financial intermediation.

Moreover, the GCC countries are well monetized, the ratio of money supply, M2, to GDP is high, ranging between 50 to 80 percent, and have been relatively stable over the time period reflecting the financial sector success in attracting deposits. The high degree of monetization and low ratio of currency to deposits are all a testament to the increased confidence in banks and the ability of the financial sector to provide advanced consumer services and utilize state of the art technologies such as ATMs, credit and debt cards, tele-banking services and online banking. Such technologies have been supported by advanced instant computerized payment and settlement mechanisms (Eltony & Al-Mutairi, 2000).

Furthermore, the GCC banking sector has also been successful in mobilizing longer-term financial assets as evidenced by the low ratio of M1

to M2. This also gives reinforces the previous result of increasing public confidence in the GCC financial sector.

Table 6A. Monetary Indicators (GCC); 1995-2000, (%)

	1995	1996	1997	1998	1999	2000
	Currency to Deposit Ratio					
Bahrain	7.8	7.5	7.1	5.3	6.3	6.0
Kuwait	4.4	5.1	4.7	4.8	6.1	5.4
Oman	18.5	16.5	13.5	12.9	18.8	19.2
Qatar	8.2	7.7	7.8	6.9	7.1	6.2
Saudi Arabia	29	25.1	25.2	24.1	27.9	23.8
United Arab Emirates	8.5	8.4	8.4	9.1	10.3	8.6

Source: International Financial Statistics, IMF.

Table 6B. Monetary Indicators (GCC); 1995-2000 (%)

	1995	1996	1997	1998	1999	2000
	M2 to GDP Ratio					
Bahrain	65.8	65.1	67.4	80.8	78.6	79.2
Kuwait	93.1	78.8	84.1	97.6	84.6	70.4
Oman	28.5	27.8	33.4	39.4	37.8	38.2
Qatar	62.9	59.6	52.5	62.5	58.5	54.6
Saudi Arabia	50.4	48.9	49.7	58.7	56.4	48.9
United Arab Emirates	55.3	53.1	52.3	57.8	55.4	58.7

Source: International Financial Statistics, IMF.

Table 6C. Monetary Indicators (GCC); 1995-2000 (%)

	1995	1996	1997	1998	1999	2000
			M1 to M2 Ratio			
Bahrain	22.9	22.5	21.6	19.5	21.8	20.7
Kuwait	16.1	17.0	16.4	15.1	17.9	17.9
Oman	31.2	30.8	27.0	23.7	22.5	22.8
Qatar	20.0	19.8	19.1	18.1	16.1	15.5
Saudi Arabia	51.9	51.4	51.9	49.7	52.0	52.6
United Arab Emirates	25.6	25.6	26.8	28.1	27.5	26.8

Source: International Financial Statistics, IMF.

3- Credit Aggregates

The credit aggregates indicators utilized here are the same as or diversified Arab economies namely, private sector credit as a percent of GDP, credit to the public sector to GDP and the monetary authority credit to the financial sector as a percent of total financial sector credit (see Table 7A, B & C).

In the GCC countries, the private sector share in the total credit provided by the banking sector is generally higher than in the diversified Arab economies, but modest when compared with other developing countries, reflecting the limited role of the private sector in the economic activities and the dominant role of the public sector. For the most part, the share of credit to the private sector has been increasing since 1990 in all GCC counties and part of the private sector's needs has been met either through borrowing from abroad or offshore banking.

On the other hand, in the GCC the banking sector has been generally active in lending to the public sector, with Kuwait, Qatar and Saudi Arabia having the highest ratios. The large fiscal deficit that resulted from the Gulf

war and the subsequent decline in world oil prices as well as other factors such as the floating of government bonds to finance incentives to the agriculture sector in Saudi Arabia, the financing of the so-called "bad debt crises" in Kuwait and the financing of major gas and petrochemical development projects in Qatar are all typical reasons for increasing credit to the public sector. However, the public sector share of total credit provided by the banking system in the GCC has been declining since the early 1990s, from about 70 percent to about 40 percent in Kuwait and from 44 percent to 33 percent in Qatar, which should be viewed as a significant post reform improvement.

The reliance of the banking sector in GCC countries on credit from monetary authorities is very low and decreasing over the time period, which is indicative of a low level of reliance on the central bank for their operations. While this ratio is higher in Saudi Arabia, about 4.5 percent, it was also declining over the time period, which is a post reform improvement.

Table 7A. Credit Indicators (GCC); 1995-2000 (%)

	1995	1996	1997	1998	1999	2000
Credit to Private/Total Credit						
Bahrain	155.6	169.4	157.7	138.6	121.8	156.3
Kuwait	32.2	42.4	50.8	53.6	55.5	59.9
Oman	99.8	100.6	107.1	99.6	108.4	99.6
Qatar	56.8	52.6	57.0	55.9	51.9	67.0
Saudi Arabia	74.2	77.2	70.6	71.4	65.4	70.2
United Arab Emirates	102.8	101.0	99.3	100.2	98.9	108.5

Source: International Financial Statistics, IMF.

Table 7B. Credit Indicators (GCC); 1995-2000 (%)

	1995	1996	1997	1998	1999	2000
	Credit to Public/Total Credit					
Bahrain	(55.6)	(69.4)	(57.7)	(38.6)	(21.8)	(56.3)
Kuwait	67.8	57.6	50.2	46.4	44.5	40.1
Oman	0.2	(0.6)	(7.1)	0.4	8.4	0.4
Qatar	43.2	47.4	43	44.1	48.1	33
Saudi Arabia	25.8	22.8	29.4	28.6	34.6	29.8
United Arab Emirates	(2.8)	(1.6)	0.7	(0.2)	1.1	(8.5)

Source: International Financial Statistics, IMF.

Table 7C. Credit Indicators (GCC); 1995-2000 (%)

	1995	1996	1997	1998	1999	2000
	Credit from Central Bank/Total Credit					
Bahrain	-	-	-	-	-	-
Kuwait	0.1	0	0.1	0.01	0	0.2
Oman	-	-	-	-	-	-
Qatar	0.4	0.3	0.6	0.2	0.3	0.5
Saudi Arabia	11.4	8.5	9.7	13.1	8.3	4.5
United Arab Emirates	0.1	0.1	0.06	0.04	0.05	0.05

Source: International Financial Statistics, IMF.

4- Stock Markets

Capital markets in GCC countries are also relatively new and rapidly expanding as the role of the private sector is increasing and the demand for equity investment is rising. Nevertheless, GCC equity markets are generally small when compared with other developing countries but larger when

compared with diversified Arab countries. By far the largest Arab equity market is in Saudi Arabia, with a capitalization of about 70 US$ billion, followed by Kuwait and Bahrain with about 27 and 6.3 US$ billion respectively (see Table 8A & B).

However, Bahrain's equity market comes first with respect to capitalization to GDP ratio (about 112 percent) followed by Kuwait and Saudi Arabia. Furthermore, value traded as a percent of GDP is highest in Kuwait (about 107 percent) followed by Saudi Arabia and Oman.

Table 8A. Capital Market Indicators in GCC; 1988-2001

	1988	**1997**	**2001**
Market Capitalization (US$ Million)			
Bahrain	1,964	7,826	6,384
Kuwait	11,836	25,880	26,682
Oman	692	7,108	3,202
Saudi Arabia	22,940	59,386	69,621
Market Capitalization of Listed Companies (% of GDP)			
Bahrain	46.8	135.2	112.1
Kuwait	57.2	85.2	87.3
Oman	8.5	54.0	33.7
Saudi Arabia	22.6	42.3	47.1

Table 8B. Capital Market Indicators in GCC; 1988-2001

	1988	1997	2001
Total Value Traded Ratio (% of GDP)			
Bahrain	2.3	8.1	15.7
Kuwait	13.1	103.1	107.1
Oman	2.9	29.4	22.4
Saudi Arabia	5.4	12.7	28.5

5. Other Important Features of the Arab Financial Sector

In general, Arab bank lending is predominantly short term and is heavily concentrated in traditional sectors, such as trade, construction and real estate. These sectors accounted for about 30-45 percent of the total Arab banks' credit. Meanwhile, the industrial sector accounted for less than 10 percent of total Arab credit. More importantly, non-performing loans in some countries pose a serious problem. For example, the non-performing loans constituted about 50% of total banks' loans in Algeria, 46% in Yemen. 31% in Tunisia, 20% in Egypt and 11% in Morocco, Shaker (2001).

Furthermore, the GCC banking sector has recently experienced an unprecedented upsurge in consumer loans. The share of consumer loans in the portfolio of GCC banks reached 30 to 40 percent of total banking sector credit, which led central banks in the region to put caps on consumer loans. This trend mainly reflects the high demand for consumer loans to finance purchases of durable goods by an increasingly young and relatively wealthy population. It also reflects a rising involvement of the GCC banking sector in financing the purchasing of equities in the local stock market.

One important group of banking services that have experienced rapid growth over the last ten years in almost all Arab countries are the Islamic financial services. The assets of Islamic banks and Islamic investment institution in Arab countries amounted to about US$ 80 billions at the end of the year 2000 (Shaker, 2001). Many Arab commercial banks have added Islamic accounts and banking services side with by side their regular banking operations. An increasing number of new Islamic investment institutions have been launched during the last five years, especially in the GCC countries. They tend to be focused on financing and leasing operations and also manage wide-ranging portfolios of equities in companies and business whose activities are compatible with Islamic rules. The major policy challenge currently facing monetary authorities in the Arab countries is how to bring these Islamic financial institutions, activities under the same supervision and regulation as imposed on regular commercial banks.

Furthermore, the financial sector in Arab countries suffers from high concentration in some countries and over banking in others. For example, the 25 largest Arab banks have about 59 percent of total assets, 46 percent of aggregate credit, 65 percent of aggregate deposits and 56 percent of equities. The banking sectors of six Arab countries, Saudi Arabia, Egypt, UAE, Kuwait, Lebanon and Morocco, have about 75 percent of total assets and 80 percent of deposits of all Arab banks. Furthermore, the largest three banks in Saudi Arabia have about 40 percent of total assets and about 35 percent of the deposits.

On the other hand, there are about 74 banks in Lebanon while the Lebanese financial sector represents only 7 percent of total assets of the Arab financial sector. In Bahrain there are about 47 banks and in the UAE there are about 46 banks while their share in total Arab assets is not more

than 3 percent, while the eleven banks of Saudi Arabia represented about 25 percent of total Arab assets.

For the most part, the recent years have witnessed a flare of activities in the area of merger and acquisition in the Arab banking sector in a bid to expand domestic and overseas markets. For example, in 1999, the Saudi American bank acquired the United Saudi bank to form the largest Arab bank. Moreover, Arab countries reviewed here have all established capital adequacy requirements that are stricter than those set under the Basle accord. In the area of prudential supervision, in general, all Arab central banks carry out on site scrutiny and off site analysis of banking sector financial performance and liquidity provisions. However, very few Arab central banks have issued guiding principles for bank management standards and even fewer have regulated and supervised non-banking financial institutions such as Islamic Banking, Mutual Fund and Investment and Brokerage institutions. International accounting standards, risk management standards and warning systems for early detection of banking crises exist only in a few Arab countries; mainly in the GCC countries, Egypt, Jordan and Tunisia. Finally, in recent years, some Arab countries have introduced deposit insurance schemes while others are in the preparation and implementation phases of introducing such schemes.

IV. Conclusions

The implementation of financial reforms has already caused major improvements in monetary and credit aggregates in the banking sector in many Arab countries. However, there appear to be plenty of room for even more improvements over the next few years. It is highly likely that many Arab reforming countries would still experience declining currency to deposit ratios; would also experience a change from foreign to domestic

currency deposits; and a substitution away from short term banking deposits and liabilities to long term counterparts. Moreover, for Arab countries in their early phases of financial reforms such as Syria, Algeria and Yemen, the scope for structural improvements is even greater.

Financial reform in the Arab countries has definitely had a noticeable impact on the cost of intermediation as manifested by real interest rates and gross interest margins. However, there is scope for even more improvements over the next years as competition enhancing measures and administrative costs reduction interventions are further adopted.

In Arab countries, the banking sector is still mainly catering to the public sector. The existence of inherent biases against the private sector attaining banking credit should be amended. There is a need for the monetary authorities of these countries to strengthen and promote private sector activities and ensure that the public sector does not crowd it out. These challenges and reforms need to go hand in hand with structural reforms, including privatization, deregulation and liberalization, as well as sustained efforts to maintain financial stability through prudent fiscal and monetary policies and prudential supervision measures. There is also an urgent need to establish a central risk bureau in all Arab countries.

Finally, Arab stock markets remain largely underdeveloped, small and face various constraints. For the most part, corporate securities and secondary markets for government bonds have not emerged as significant vehicles for linking money and capital markets or as an engine for extending financial sector depth. Those can be revitalized by an acceleration of the privatization drive; supporting the structural changes in the banking sector in the period ahead and empowering the financial sector to effectively compete in the global economy.

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