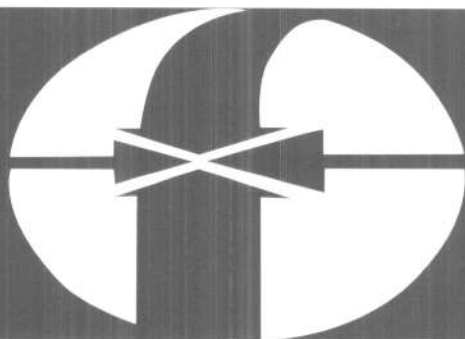


# Savings and Development



“GIORDANO DELL’ AMORE” FOUNDATION

A Centre for Financial Growth and Development Assistance

established by

*Fondazione Cassa di Risparmio delle Province Lombarde*



Quarterly Review - No. 2 - 2004 - XXVIII

Poste Italiane Spa  
Spedizione in abbonamento postale al 70% - Filiale di Milano  
DCB Milano



# Savings and Development

Editor

**Arnaldo Mauri**

*Università di Milano*

Co-editors

**Oscar Garavello**

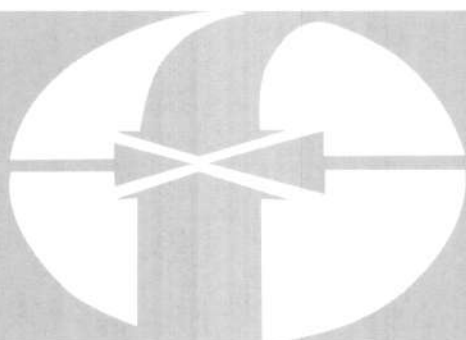
*Università di Milano*

**Mario Masini**

*Università di Bergamo*

Publisher

**Felice Tambussi**



**"GIORDANO DELL' AMORE" FOUNDATION**

A Centre for Financial Growth and Development Assistance

established by

*Fondazione Cassa di Risparmio delle Provincie Lombarde*



Milan - Italy

Quarterly Review - No. 2 - 2004 - XXVIII

# "Giordano Dell'Amore" Foundation

## BOARD OF DIRECTORS

Mario Masini	Chairman
Giovanni Ancarani	Director
Roberto Artoni	Director
Maurizio Cavallari	Director
Luca Galli	Director
Arnaldo Mauri	Director
Paolo Morerio	Director
Paolo Raineri	Director
Felice Tambussi	Director

## BOARD OF AUDITORS

Ernesto Franco Carella	Member
Gabriele Cioccarelli	Member
Dario Colombo	Member

"GIORDANO DELL' AMORE" Foundation is a non-profit institution established by Fondazione Cassa di Risparmio delle Provincie Lombarde. Its goal is to conduct research and to provide training, technical assistance and advisory services in economics, finance and banking to government agencies and public and private entities of developing and transitional countries.

La FONDATION "GIORDANO DELL' AMORE" est une institution sans but lucratif établie par la Fondazione Cassa di Risparmio delle Provincie Lombarde qui se propose de promouvoir la recherche et d'offrir des services de formation, d'assistance technique et de consultation en matière d'économie, de finance et de banque aux agences gouvernementales et aux institutions publiques ou privées des pays en développement ou en transition.

Via L. Manara, 15/17 - 20122 Milano - Italy  
Tel. 02 5418441 - Fax 02 55193005  
e-mail: [publications@fgda.org](mailto:publications@fgda.org) - <http://www.fgda.org>



## Savings and Development

### EDITORIAL BOARD

André Babeau	Université Paris Dauphine
Dale W Adams	Ohio State University
Sergio Bortolani	Università di Torino
Peter J. Drake	Australian Catholic University
David T. Edwards	University of Bradford
Jack M. Guttentag	University of Pennsylvania
Sándor Ligeti	University of Budapest
Ronald I. McKinnon	Stanford University
Paolo Mottura	Università Bocconi
Hugh Patrick	Columbia University
K. Puttaswamaiah	Bangalore
Roberto Ruozzi	Università Bocconi
J.D. Von Pischke	Washington, D. C.

### ADVISORY BOARD

Louis Emmerij	Consultant, Inter-American Development Bank
Douglas A. Forno	The World Bank
David Forbes Watt	Director Investment Centre FAO
U Tun Wai	Senior Consultant, IMF Institute

---

## Contents

### HAVE MIDDLE EAST AND NORTH AFRICA COUNTRIES ACHIEVED A CRITICAL MASS OF CHANGE IN THEIR FINANCIAL SYSTEMS?

*by Jean-Claude Berthélemy* ..... 107

### RATES OF INTEREST, CREDIT SUPPLY AND CHINA'S RURAL DEVELOPMENT

*by Enjiang Cheng and Zhong Xu* ..... 131

### THE POTENTIAL FOR FINANCIAL SAVINGS IN RURAL MOZAMBICAN HOUSEHOLDS

*by Oliveira Amimo, Donald W. Larson, Mauricio Bittencourt, and Douglas H. Graham* ..... 157

### ROTATING SAVINGS AND CREDIT ASSOCIATIONS: CHARACTERIZATION WITH PARTICULAR REFERENCE TO THE ETHIOPIAN IQQUB

*by Dejene Aredo* ..... 179

### DEVELOPING KUWAIT SOCIAL SECURITY SYSTEM

*by Mahmoud A. Behbehani* ..... 201

---

# HAVE MIDDLE EAST AND NORTH AFRICA COUNTRIES ACHIEVED A CRITICAL MASS OF CHANGE IN THEIR FINANCIAL SYSTEMS?

Jean-Claude Berthélemy\*

University Paris 1 Panthéon Sorbonne, TEAM - CNRS

## 1. Introduction

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

This paper provides an assessment of the current situation of financial sectors in MENA countries,<sup>1</sup> in order to suggest some policy areas in which progresses could be achieved. Given the wide diversity of situations, with market, transition and State-controlled economies, and with rich oil exporting countries and much poorer and populated economies, this paper cannot really do justice to the nuances that are needed to formulate adequate policy advices. Its aim is principally to propose a framework of analysis and to suggest that, although it cannot replace precise country-by-country assessment, this framework provides useful insight into why financial development in the MENA region has been only relatively modest so far.

Two alternative approaches with financial liberalization have been advocated in the economic literature and implemented by governments and central banks in developing countries: gradualism vs. shock therapy (Grais and Kantur, 2003). Gradualist policies have involved step-by-step liberalization of interest rates and removal of State control on bank's and other financial intermediaries' activities. Shock therapy means, like in the

---

\* An earlier version of this paper was presented at the IMF/World Bank annual meetings in Dubai, September 2003. I gratefully acknowledge helpful comments by Muhammad Al-Jasser, Shaukat Aziz, Ibrahim Dabdoub, Nawel Bentahar, Semi Cherif, Mohammed Hussain, Abdelali Jbili, Ludvig Söderling and Aristomene Varoudakis. All errors and shortcomings are mine.

<sup>1</sup> The geographical definition of MENA used throughout this paper corresponds to the World Bank's definition. In World Bank classifications, it includes 15 developing economies (Algeria, Djibouti, Egypt Arab Republic, Iran Islamic Republic, Iraq, Jordan, Lebanon, Libya, Malta, Morocco, Oman, Saudi Arabia, Syrian Arab Republic, Tunisia, West Bank and Gaza, and Yemen Republic), to which we add the 5 high income economies located in the region (Bahrain, Israel, Kuwait, Malta, Qatar and United Arab Emirates).

---

Southern Cone of Latin America in the 1970s or in some transition economies more recently, a much quicker reform process, with in particular a speedy liberalization and opening of money and financial markets, as well as privatization of financial institutions. Both options have merits and weaknesses. Experiences with shock therapy have shown that it may disrupt financial market stability. However, gradualism may prevent the achievement of a critical mass of change in the financial sector.

The reason why financial development may require a critical mass of change is that financially repressed economies may be locked in a sort of poverty trap, where financial underdevelopment and poor economic performances reinforce each other: there is a two-way interaction between economic development and financial depth, leading to multiple equilibriums (Berthélemy and Varoudakis, 1996). This argument is reviewed in Section 2.

MENA countries have generally chosen gradualism rather than shock therapy. Today, after more than a decade of financial reforms, a number of these economies are still typically in a low equilibrium, with inadequate financial services and poor economic performance. In order to get out of this trap, it may be necessary to implement strong reforms and policy initiatives leading to sizeable changes in the financial sector, rather than merely to eliminate the most obvious flaws of the previously applied financial repression policies.

Section 3 shows that financial reforms implemented by MENA countries over the past 10 to 15 years, although necessary and helpful, have only led to modest results in terms of financial deepening. This suggests that some bigger structural changes are actually still needed to promote a dynamic and efficient financial sector. Section 4 reviews some of these challenges and suggests that, beyond a mere liberalization of the sector, MENA countries need to achieve improvements in three areas that are key factors for the development of credit markets: an effective protection of creditor rights; the implementation of policies aimed at reducing financial fragility, given the significant size of non-performing loans that banks have in their books; and the promotion of an adequate financial information infrastructure. Finally, Section 5 concludes.

## **2. Why Do We Need a Critical Mass of Change in the Financial System?**

Many papers insist on the key role played by financial development in the eco-

---



---

conomic growth process. A well-functioning financial sector stimulates savings and improves capital allocation. Recent papers, using advanced econometric techniques, suggest that there is a robust causal link from financial development to economic growth (Wachtel, 2001). On the other hand, it is equally true that in a poor economic environment, financial intermediaries cannot develop profitable services, for lack of large enough amounts of savings to intermediate as well as of demand of capital. Consequently, the finance and growth nexus typically poses a chicken and egg dilemma.

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

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

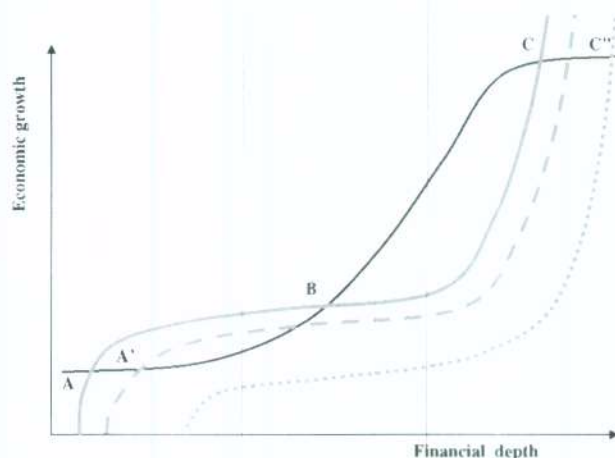
This kind of situation is illustrated in Figure 1, where the grey curves represent financial depth as a function of economic growth, while the black curve represents the reverse dependence of economic growth on financial depth. Points A and C correspond typically to stable equilibriums, and point B is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

The consequences of this theory for the analysis of financial reforms are obvious. Typically, financial repression policies hamper financial activity, and lead to the poverty trap equilibrium. It is even possible that there remains only one (low-level) equilibrium.

---

Such adverse effects will have long-lasting consequences: if the economy has been initially driven to the poverty trap, a mere reversal of initial financial repression policies will probably be insufficient to bring back the economy to the high-level equilibrium.

**Figure 1:** *Multiple equilibriums*

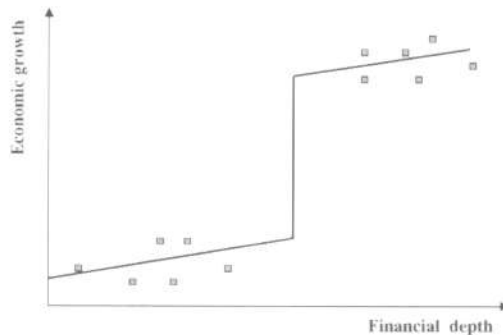


This argument is illustrated in Figure 1: if after a financial repression policy, illustrated by the low-level equilibrium A, marginal liberalization reforms are implemented, this leads only to a shift from A to A', which does not change much economic performances. What is needed is a critical change,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

The existence of multiple equilibriums is not a mere theoretical possibility. It can be empirically investigated through tests designed to detect convergence clubs: countries with poor financial development (typically financially repressed developing economies) tend to cluster in a slow growth – low income group, while countries with more developed financial intermediation systems (typically OECD countries) will converge together at much higher levels. As a consequence, when assessed with cross-section

data, the empirical relationship between financial depth and economic growth is not linear and should look like a discontinuous kinked curve, as illustrated in Figure 2. This leads to a structural break in the relationship between the two variables, which can be easily tested, through convergence club tests. Berthélemy and Varoudakis (1996) successfully performed such a test on a cross-section of 95 developed and developing economies. This approach can of course be generalized to other potential sources of multiple equilibriums. For instance, Berthélemy and Varoudakis have identified not only 2 but 4 convergence clubs, defined both by financial depth and by educational development (see also Berthélemy, 2002). When it comes to formulating policy conclusions based on this analysis, this generalization should be kept in mind: in our case, a critical mass of change in the financial sector would presumably be insufficient to promote fast growth, if other adverse initial conditions, possibly linked to other multiple equilibrium occurrences, continue to prevail.

**Figure 2:** *Convergence clubs*



Berthélemy and Varoudakis (1997) developed further their tests in order to use panel data information, instead of only cross-section data. When using panel data with fixed effect estimation methods, the existence of multiple equilibriums leads to a small and non-significant effect of financial depth on growth, as shown also by Watchel (2001). This is perfectly consistent with our multiple equilibriums hypothesis, as illustrated in Figure 2: countries in a low-level equilibrium have smaller fixed-effects than those in higher level equilibriums and the slope of the regression line of economic

---

growth on financial development is reduced accordingly. Therefore, thresholds were simply tested by Berthélemy and Varoudakis (1997) on fixed effects estimates. With these tests they identified two threshold points related to financial development instead of only one, defined, on one hand, by the savings collection role of the financial system, which requires only a rudimentary financial industry, and, on the other hand, by its capacity to promote growth through improved total factor productivity, which may depend on the existence of a more sophisticated financial system, capable of efficiently allocating the intermediated capital. According to data used by Berthélemy and Varoudakis (1997), which covered six five-year periods over the years 1960 to 1990, four MENA countries, namely Iran, Morocco, Syria and Tunisia, were located on the borderline between the upper-level and the intermediate-level convergence clubs, while three others (Algeria, Egypt and Jordan) had a financial depth indicator putting them in the upper-level convergence club.

These findings suggest that several MENA countries may actually be in a low-level equilibrium trap with respect to their financial sector development. The ranking of Algeria and Egypt, in the upper-level convergence club, as well as the position of Syria close to the borderline between the two convergence clubs, show however the limits of these results, and deserve some discussion. The test implemented by Berthélemy and Varoudakis (1997) was based on a crude measurement of financial depth, the ratio of liquid liabilities to GDP, but of course there are a number of other dimensions in financial development, which need more systematic exploration. The issue is not only the amount of capital that is intermediated, but also the experience and efficiency of financial intermediaries, their capability of offering adequate and diversified financial services, the existence of well-functioning legal and informational infrastructures that underlie the development of a credit market, and the ability of financial intermediaries and supervision authorities to prevent financial fragility. In the prereform period, the liquidity ratio was presumably a meaningless indicator of the true financial depth in countries where money and credit were tightly controlled by the government, such as in particular Algeria and Syria.

### **3. Reforms and Progresses Achieved so far in the MENA Region**

Until the end of the 1980s, most countries in the MENA region had repressed financial systems, in which interest rates were controlled, most (when not all) banks

---

---

were state-owned, credit allocation was directed by the government, and foreign competition was prevented. Since the mid-1980s, however, significant reforms have been implemented (Chalk et al., 1996; Creane et al., 2003).

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

First of all, quantitative indicators of intermediation activity by the banking sector suggest that by and large some progress has been achieved in the MENA region since the early 1990s. This is illustrated in Table 1, where the ratio between domestic credit to the private sector and GDP is reported. This ratio has first declined at the start of the reforms in several countries (notably Algeria, Egypt and Tunisia), where bank assets were previously inflated by government directed credits. This was particularly the case in Algeria, which used to have a centrally planned economy, resulting in a significant monetary overhang (see Jbili et al., 1997). Since then, the domestic credit ratio has particularly progressed in Egypt, Malta, Morocco and Oman, with a growth higher than 50 percent, suggesting the possible existence of a critical change in the banking sector of these countries over the past 10 to 15 years. However, among these countries, only Malta has reached a ratio close to those observed on average in high income OECD countries.<sup>2</sup> There is therefore so far not enough evidence that the above-mentioned countries have achieved enough structural change in their financial systems to promote a sustained banking sector development.

One could argue that some longer time is necessary to converge to a financial development stage comparable to the advanced countries' level. However, if a critical mass of change had been achieved in the above-mentioned reforming countries, this

---

<sup>2</sup> There is of course some diversity within the OECD, and most new members of the OECD and Turkey, which are not high-income countries, have ratios comparable to those of MENA countries. Throughout the rest of this paper, the OECD averages refer to high-income OECD members.



would have at least accelerated the speed of convergence of their financial depth towards the OECD level.<sup>3</sup> Overall this has not been the case. Only one country, Egypt, had a speed of convergence of its financial depth indicator higher than 2 percent over the past ten years. Even in that case, financial depth has decelerated since 1998, while it is still at a rather low level by comparison with the OECD average country. Moreover, in that particular case, the significance of monetary aggregate evolutions is uncertain: domestic-currency denominated liquidity has increased partly as a result of a reduction of dollarization of the economy; also, the ratio of bank credit to GDP has mechanically increased as a result of exchange rate movements (20 percent of loans are in foreign currency).

**Table 1: Ratio of domestic credit to private sector to GDP (percent)**

	1985	1990	1995	2000	2001	2002
Algeria	60	44	5	6	7	..
Bahrain	44	30	57	55	56	..
Djibouti	57	52	48	32	26	24
Egypt, Arab Rep.	36	31	37	59	62	61
Iran, Islamic Rep.	30	33	24	28	33	35
Israel	60	58	70	87	..	..
Jordan	66	72	73	76	75	74
Kuwait	81	..	39	55	69	..
Lebanon	..	79	58	92	91	91
Libya	25	31	33	24	..	..
Malta	55	78	96	117	121	..
Morocco	32	34	48	59	55	53
Oman	20	23	29	37	39	39
Qatar	29	37	35	29	..	..
Saudi Arabia	74	61	63	52	55	..
Syrian Arab Republic	8	7	11	9	8	8
Tunisia	67	55	69	66	68	68
United Arab Emirates	34	37	49	48	55	..
Yemen, Rep.	..	6	5	5	6	6
Middle East & North Africa	43	41	40	43	46	47
High income OECD average	88	108	119	138	138	134

Source: World Development Indicators, World Bank and IMF (UAE, 2000 & 2001). Countries without available data are not shown. The MENA aggregate includes Malta but excludes the other high income economies.

<sup>3</sup> The speed of convergence is defined here with reference to convergence towards the level observed on average in OECD countries 10 years ago. It is computed on an annualized basis. Results are not sensitive to the precise definition of this target.

It should be noted, also, that the ratio of domestic credit to private sector to GDP has declined in Algeria, Djibouti, Libya and Saudi Arabia, suggesting that the MENA region as a whole has so far achieved quite diverse performances in financial sector reforms.

The size of banking activity provides however only very partial information on the banking sector efficiency. Another indicator that can be considered is the interest rate spread charged by banks, given that most MENA countries have liberalized their interest rates since the end of the 1980s. This is true in particular of Algeria, Egypt, Israel, Morocco, and Tunisia (see Grais and Kantur, 2003). Figures reported in Table 2 suggest that spreads are at rather high levels, with the notable exception of Malta. In Libya and Syria, interest rates are still controlled, and therefore not very informative of the actual cost of banking intermediation. In Algeria and Egypt, although interest rates have been liberalized, there is still a majority of state-owned banks, which still apply, notably for social reasons, distorted deposit and lending rate policies, which reduce their interest margins. In other countries where this information is available, interest rate spreads are very high by international standards (in the median OECD country, the interest rate spread was equal to 3.7 percentage points in 2002).

**Table 2: Interest rate spreads (percentage points)**

	1985	1990	1995	2000	2001	2002
Algeria	..	..	3.0	2.5	3.3	3.3
Bahrain	..	1.0	6.1	5.9	8.1	7.2
Djibouti	..	..	..	..	8.6	10.1
Egypt, Arab Rep.	4.0	7.0	5.6	3.8	3.8	4.5
Israel	324.6	12.0	6.1	4.2	3.9	3.9
Jordan	..	2.2	3.0	4.8	5.1	5.8
Kuwait	1.5	..	1.8	3.0	3.4	3.3
Lebanon	4.0	23.1	8.4	6.9	6.3	5.5
Libya	1.5	1.5	..	4.0	4.0	4.0
Malta	3.0	4.0	2.9	2.4	2.1	1.7
Morocco	-0.3	0.5	..	8.2	8.2	8.6
Oman	1.2	1.4	2.8	2.4	4.7	5.7
Qatar	3.5	3.5	..	..	..	..
Syrian Arab Republic	5.0	5.0	5.0	5.0	5.0	5.0
Tunisia	4.3	..	..	..	..	..
Yemen, Rep.	..	..	..	5.5	4.5	..

Source: World Development Indicators, World Bank. Countries without available data are not shown.

Another aspect of the financial development concerns the emergence of capital markets. This aspect is perhaps less critical, given that capital markets usually deve-

lop only at a rather advanced stage of development of the financial system. Moreover, it should be kept in mind that bank-based financial systems, where equity markets play a relatively minor role, can still be fairly developed, such as in Germany. However, even in countries where equity market have existed for a long time (Egypt, Jordan, Kuwait, Lebanon and Morocco), the capital market has been until now rather limited.

Again, reforms implemented in recent years have gone in the right direction, with in particular stock market liberalizations in Egypt, Morocco and Tunisia in the mid 1990s. However, only Egypt has a relatively large stock market, with more than 1100 companies listed. Also, ratios of market capitalization to GDP are typically low, with the only exception of Bahrain and Jordan, as illustrated in Table 3. Privatizations (particularly in Egypt, Morocco and Tunisia) have led to some increase in market capitalization, but this has not been enough to sustain a dynamic development of the stock markets.

**Table 3:** *Ratio of market capitalization of listed companies to GDP (percent)*

	1985	1990	1995	2000	2001	2002
Bahrain	..	..	..	83	83	..
Egypt, Arab Rep.	..	4	13	29	25	29
Iran, Islamic Rep.	..	..	7	34	9	..
Israel	..	6	41	58	..	..
Jordan	..	50	69	58	72	76
Kuwait	..	..	54	58	..	..
Lebanon	..	..	4	10	7	8
Malta	..	..	5	56	37	..
Morocco	..	4	18	33	27	23
Oman	..	..	16	17	17	20
Qatar	..	..	..	31	..	..
Saudi Arabia	..	..	32	36	39	40
Tunisia	..	4	22	15	12	10
United Arab Emirates	..	..	..	8	11	..
West Bank and Gaza	..	..	..	22	21	..
Middle East & North Africa	..	..	20	31	26	..
High income OECD average	..	51	67	118	103	..

Source: World Development Indicators, World Bank and IMF (for UAE GDP). Countries without available data are not shown. The MENA aggregate includes Malta but excludes the other high income economies.



One reason why market capitalization attains only modest levels in MENA countries is that, usually, the owners of small and medium size enterprises are reluctant to issue shares on the equity market. Moreover, when such companies are listed, most of the shares remain familyowned, which reduces to a large extent the turnover in the market. This may also partly explain why data on capital market turnover show that the existing capital markets in MENA countries have a very small trading activity, as compared with capital market in developed countries: generally, the turnover is below 20 percent (with the only exceptions of Israel and Saudi Arabia), while the average turnover in OECD capital market was in 2002 equal to 150 percent (see Table 4).

**Table 4:** *Turnover ratio in stock markets (percent)*

	1985	1990	1995	2000	2001	2002
Bahrain	..	..	..	4	3	3
Egypt, Arab Rep.	..	..	11	35	14	16
Iran, Islamic Rep.	..	..	16	..	13	11
Israel	..	96	26	36	45	52
Jordan	..	20	11	8	17	15
Kuwait	..	..	53	21	..	..
Lebanon	..	..	..	7	4	5
Malta	..	..	16	..	3	3
Morocco	..	..	46	9	10	11
Oman	..	12	11	14	15	13
Qatar	..	..	..	5	..	..
Saudi Arabia	..	..	16	27	32	30
Tunisia	..	3	..	23	13	14
United Arab Emirates	..	..	..	..	4	3
West Bank and Gaza	..	..	..	..	10	10
Middle East & North Africa	..	..	18	..	20	13
High income OECD average	..	55	83	131	139	150

Source: World Development Indicators, World Bank. Countries without available data are not shown.

The MENA aggregate includes Malta but excludes the other high income economies.

Although they provide a useful picture of the progress in financial intermediation activity achieved in MENA countries, the previous indicators do not tell us whether the financial sector supply adequate sources of financing to private businesses. Only micro-economic information can answer this critical question. Such information is

---

available in the World Bank's World Business Environment Survey (2000) for three economies in the region, namely Egypt, Gaza strip and Tunisia. I consider here the available information for Egypt and Tunisia.

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

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

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

Heavy paperwork is also mentioned frequently, which suggests that the lending activity is still characterized by heavy regulations and that some further lessening of such regulations is needed.

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

---

**Table 5: Frequency of problematic financing issues in business environment**

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

Note: ratios reported are the percentages of surveyed firms for which the obstacle is major or moderate.

Source: World Business Environment Survey (WBES), 2000, World Bank Group.

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

There are obviously differences among MENA countries, as already illustrated by the differences between Egypt and Tunisia. Therefore, what is observed for these two countries cannot be generalized to other countries. However, these data are revealing of some major weaknesses of MENA country financial sectors: high interest costs, heavy bureaucracy, uneasy relationships between lenders and borrowers and inadequate information systems.

Section 4 reviews these challenges, which need to be taken up by MENA country governments and by the different actors in the financial markets in order to promote significant financial development.

#### 4. Challenges Ahead

Deeper change in financial sectors is necessary if reforming MENA countries are to achieve more significant progress in their financial intermediation system in the years to come. Promarket reforms should be strengthened in two main areas: reducing remaining restrictive regulations in the financial sectors and promoting competition among the different financial intermediaries. Moreover, recent experiences with

financial liberalization policies suggest that such policies need also to be supplemented by the provision of an adequate legal and regulatory environment and the promotion of necessary financial market infrastructures; when this framework is absent, not only shock therapy policies may weaken the financial system, but also an efficient credit market cannot develop.

#### 4.1 Regulatory and Supervisory Framework

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

According to the Heritage foundation, which provides a qualitative index of restrictiveness of such regulations, restrictiveness is high or very high in seven countries (Algeria, Egypt, Iran, Iraq, Saudi Arabia, Syria and Yemen). This proportion is even higher than in the second half of the 1990 decade, when only six MENA countries had highly or very highly restrictive regulations. Table 6 shows also that generally speaking regulation restrictiveness in the banking and financial sector has not decreased in recent years, quite the contrary. This table shows further that only two countries, Bahrain and Jordan, face low or very low restrictions.

**Table 6:** *Restrictiveness of regulations in banking and finance sector*

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

Source: Heritage foundation

By comparison, currently close to 70 percent of OECD countries have low or very

low restrictions in their banking regulations, and none have high or very high restrictions. Moreover, a large majority of OECD countries have reduced their regulation restrictiveness, contrary to MENA countries. This suggests that, notwithstanding the reforms already implemented, there exists significant room for further liberalization of banking sectors in MENA countries.

Liberalization and de-control of the banking sector do not imply their de-regulation. Such financial reforms must be accompanied by the building of a strengthened supervisory framework; otherwise financial liberalization can only lead to financial fragility and crises. This is all the more important as banks have often inherited from the pre-reform period heavy non-performing loans portfolios. A complete and speedy liberalization of the banking sectors would have not been advisable prior measures be taken to clean portfolios and recapitalize banks, and to establish proper prudential regulations and monitoring of depository institutions. Some progresses have been gradually achieved by MENA countries since the early 1990s, sometimes in response to major bank crises such as the bankruptcy of the Petra Bank in Jordan in 1990 and the collapse of the Bank of Credit and Commerce International in the UAE in 1991, and sometimes within the framework of structural adjustment programs (Morocco, Tunisia). However, available data on non-performing loans still point to a significant financial fragility in a number of countries. In recent years, non-performing loans have increased significantly in Egypt and Lebanon, and they remain at rather high levels, close to 20 percent of the total loan portfolio, in Jordan, Morocco and Tunisia (Table 7).

**Table 7: Ratio of non-performing loans to total loans (percent)**

	month	2000	2001	2002	2003
Egypt	March	13.6	15.6	16.9	19.5
Iran	December	4.4	5.4	5.7	..
Jordan	December	18.4	19.3	19.8	..
Kuwait	December	19.2	10.3	..	..
Lebanon	March	19.2	22.8	27.2	29.7
Morocco	September	17.5	16.8	18.0	..
Oman	December	7.5	10.6	11.3	..
Saudi Arabia	December	10.4	10.1	8.8	..
Tunisia	December	21.6	19.2	20.7	..
United Arab Emirates	December	12.7	11.2	..	..

Source: IMF staff estimations.

Note: reported data refer to gross NPLs (instead of net of precautionary reserves)



## 4.2 Competition

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

Insufficient competition in the financial sector may constitute a handicap for MENA countries. Standard indicators suggest that the degree of concentration in the banking sector is high in MENA countries, where the share of the five largest banks in total bank assets varies generally between 65 and 80 percent (Table 8). These levels of concentration are significantly higher than the average concentration observed in OECD countries, which is equal to 48 percent. The only exception is Lebanon, where the bank concentration ratio is equal to 40 percent.

**Table 8: Indicator of competition in the banking system**

	5-bank concentration ratio (%)	Percentage of banking system's assets in banks that are 50% or more private owned	Percentage of banking system's assets in banks that are 50% or more foreign owned
Bahrain	71	96	28
Egypt	65	33	4
Israel	80	—	0
Jordan	68	100	68
Lebanon	40	100	27
Morocco	75	76	19
Oman	77	100	11
Qatar	76	57	15
Saudi Arabia	69	100	0
Tunisia	66	68	19

Source: World Bank's Bank supervision and regulation database and author's computation with data from Association Professionnelle Tunisienne des Banques

Recent research results on banking sector competition produced by Gelos and

---

Roldós (2002) and by Claessens and Laeven (2003) suggest however that standard concentration indicators do not measure accurately the degree of competition in the banking industry. They propose to use measures based on the Panzar and Rosse (1987) methodology, which relies on econometric estimates of the elasticity of total revenues of banks with respect to their input prices. This methodology cannot be applied in MENA countries, for lack of availability of the necessary micro-economic data, but results proposed by Claessens and Laeven suggest that competition in the banking sector is heavily influenced by barriers to entry, in particular those opposed to foreign banks. On this account, MENA countries have implemented so far very diverse policies. Jordan has a widely opened banking sector, with 68 percent of bank assets in banks that are 50 percent or more foreign-owned. Part of the high share of foreign banks' assets is due to the preference of migrants for deposits in foreign-owned banks, but this does not explain all of it: migration is a widespread phenomenon in the Middle East. Although smaller, the share of bank assets owned by foreign-controlled banks is also rather high in Bahrain (28 percent), Lebanon (27 percent), Morocco (19 percent) and Tunisia (19 percent). On the other hand, in Egypt, foreign-controlled banks own only 4 percent of bank assets. In Egypt, and in other countries with high or very high restrictions in banking regulations, such as Algeria, a higher degree of openness to foreign banks could be beneficial to the economy. As shown by the experience of Saudi Arabia, this may be however implemented through cooperation between local and foreign banks, without necessarily opening the market to foreign-controlled banks.

Another indicator of the degree of competition in the banking industry is the proportion of bank assets owned by private banks, or by banks with a majority of private shareholders. Again Bahrain, Jordan, Lebanon, Morocco and Tunisia enjoy, according to this indicator, a significant degree of competition, with more than two-third of bank assets owned by private-controlled banks, while this ratio is only equal to one-third in Egypt.

Finally, competition may be enforced by the development of a diversified financial sector, while currently traditional bank loans are still the principal sources of financing. On this account, a lot needs to be done in most MENA countries, concerning the development of instruments such as lease finance, and capital market segments such as secondary markets for government debt paper and bond markets. This may need private initiative, but also the development of proper regulations.

---

---

### 4.3 Legal Framework

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

As shown in Table 9, theoretically speaking creditor rights are sometimes better protected in MENA countries than in the median OECD country.<sup>4</sup> This is the case of Algeria, Iran and Syria. However, in other cases (Egypt, Jordan, Lebanon and Tunisia), they are worse protected. These observations would lead us to conclude that the nature of the legal system does not seem to play a systematically adverse role in MENA countries. However, such observations are relevant only if legislations are actually enforced, or at least if they are equally enforced in the different countries. The "rule of law" indicator available in the governance dataset assembled at the World Bank by Kaufmann et al. (2003) shows doubtlessly that agents in MENA countries have significantly less confidence in the rules of society than agents in OECD countries.<sup>5</sup> This is true in particular of Algeria, Iran and Syria, which means that their supposedly high level of protection of creditor rights is to a large extent meaningless.

---

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

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

---



**Table 9: Legal framework and financial infrastructure indicators**

	Creditor Rights Index	Rule of Law indicator	Quality of public credit registry information
Algeria	3	-0.5	..
Egypt	1	0.1	50
Iran	3	-0.6	28
Israel	3	1.0	..*
Jordan	1	0.3	67
Lebanon	1	-0.3	..
Morocco	2	0.1	17
Saudi Arabia	2	0.4	50
Syria	3	-0.4	..
Tunisia	0	0.3	36
UAE	2	0.9	58
Median OECD	2	1.6	
Europe			78

Source: World Bank, Governance Dataset (Rule of Law); and "Doing Business" indicators, 2003 (Creditor rights & quality of public credit registry).

\* In Israel, there is no PCR, but there is a Private Credit Bureau

These observations lead us to submit that, although in several MENA countries improving the legislation on creditor rights would be advisable, on this front the major challenge faced by the region goes beyond the mere financial sector legislations, and concerns more generally the necessity to improve governance.

#### 4.4 Financial Infrastructure

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

---

public and a private credit registries (e.g. in Germany) or, in a few instances (France, Slovak Republic), only a public credit registry.

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

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

The impact of such services on the development of firms' access to credit may however depend critically on the quality of the information collected, which becomes totally useless if it is not fully reliable. On this account, MENA countries have poor performances, as compared with the European OECD countries where public credit registries exist. On basis of the information available in the World Bank's "Doing Business" website, the quality of information collected by the public credit registries can be considered as particularly poor in Iran, Morocco and Tunisia.<sup>6</sup> This suggests that, notably in Morocco and Tunisia, which have otherwise relatively well progressed in their financial sector reforms, more needs to be done in this area in order to promote a significant development of credit markets. In other MENA countries, only Jordan enjoys a quality of information provided by its public credit registry comparable to the quality standard available in European countries.

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

---

<sup>6</sup> The PCR quality of information index summarises scores on question regarding the process of data collection and verification. These concern the existence of legal penalties for reporting inaccurate, the ability of consumers to inspect data, the legal requirement to respond to borrower complaints, the delay of submission of data, the actual submission of data on time by most financial institutions, the time allowed to correct reported errors, the delay of availability of data for distribution and the duration of existence of the registry.

---

---

## 5. Conclusion

Overall MENA countries have implemented cautious and gradual financial sector reforms over the past 10 to 15 years. Their financial systems are still dominated by relatively concentrated and highly oligopolistic commercial bank sectors. Although restrictive regulations in the banking sectors have been softened, there are still a number of impediments to competition, diversification and innovation, such as those concerning the involvement of foreign banks. Capital markets are generally recent, with the notable exceptions of Morocco, Egypt and Jordan. The numbers of listed companies, the capitalization of stock markets and their trading activity are limited, and capital market segments such as bond markets are still underdeveloped. In general, access to finance is uneasy and in particular small and mediumsize businesses face significant financing obstacles.

To some extent, this picture can be related to the slowness of financial reforms, which have not been able to stimulate a critical mass of change, although it has also minimized so far the risks of emergence of financial sector crises. But the absence of critical change in financial sector must be also related to broader issues such as the need to strengthen the rule of law and to improve corporate governance, which are critical for the development of a credit market.

Not all MENA countries face however the same shortcomings. Egypt, Jordan, Lebanon, Morocco and Tunisia, as well as GCC countries such as Saudi Arabia, have already a significant bank intermediation activity, although in some of these countries the banking sector could benefit from further pro-competitive reforms, including privatization of stateowned banks and diversification of financial services, and from the further development of financial market infrastructure. On the other hand, Algeria, Iran, Iraq, Libya and Syria, where public authorities are still very much directly involved in the financial sector, still need more basic pro-market reforms.

---

## References

- Beck, Thorsten, Asli Demirgüç-Kunt, and Vojislav Maksimovic (2003), "Bank Competition, Financing Obstacles and Access to Credit", World Bank Policy Research Working Paper 2996.
- Berthélemy, Jean-Claude (2002), "Convergence Clubs and Underdevelopment Traps", in J. Braga de Macedo, C. Foy and C.P. Oman, ed., *Development is Back*, OECD, Development Centre Studies, 61-76.
- Berthélemy, Jean-Claude, and Aristomene Varoudakis (1996), "Economic Growth, Convergence Clubs, and the Role of Financial Development", *Oxford Economic Papers*, 48, 300-328.
- Berthélemy, Jean-Claude, and Aristomene Varoudakis (1997), "Financial Development, Savings and Growth Convergence: A Panel Data Approach", in R. Hausmann and H. Reisen, ed., *Promoting Savings in Latin America*, OECD Development Centre, 53-69.
- Chalk, Nigel, Abdelali Jbili, Volker Treichel, and John Wilson (1996), "Financial Structure and Reforms", in *Building on Progress: Reform and Growth in the Middle East and North Africa*, IMF, 35-50.
- Claessens, Stijn, and Luc Laeven (2003), "What Drives Bank Competition? Some International Evidence", World Bank Policy Research Working Paper 3113.
- Creane, Susan, Rishi Goyal, A. Mushfiq Mobarak, and Randa Sab (2003), *Financial Development in the Middle East and North Africa*, IMF.
- Gelos, R. Gaston, and Jorge Roldós (2002), "Consolidation and Market Structure in Emerging Market Systems", IMF Working Paper WP/02/186.
- Jappelli, Tullio, and Marco Pagano (1999), "Information Sharing, Lending and Defaults: Cross-Country Evidence", Centro Studi in Economia e Finanza, Università degli Studi di Salerno, Working Paper n°22.
- Jbili, Abdelali, Vicente Galbis, and Amer Bisat (1997), "Financial Systems and Reform in the Gulf Cooperation Council Countries", in *Financial Systems and Labor Markets in the Gulf Cooperation Council Countries*, IMF, 1-24.
- Jbili, Abdelali, Klaus Enders, and Volker Treichel (1997), "Financial Sector Reforms in Algeria, Morocco, and Tunisia: A Preliminary Assessment", IMF Working Paper WP/97/81.
- Kaufmann, Daniel, Aart Kraay, and Massimo Mastruzzi (2003), "Governance Matters III: Governance Indicators for 1996-2000", World Bank, [www.worldbank.org/wbi/governance/pdf/govmatters3.pdf](http://www.worldbank.org/wbi/governance/pdf/govmatters3.pdf)
- La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny (1998), "Law and Finance", *Journal of Political Economy*, 106, 1113-1115.
- Lee, Jong-Kun (2002), "Financial Liberalization and Foreign Bank Entry in MENA", mimeo, World Bank.
- Panzar, John C., and James N. Rosse (1987), "Testing for 'Monopoly' Equilibrium", *Journal of Industrial Economics*, 35, 443-456.
- Wachtel, Paul (2001), "Growth and Finance: What Do We Know and How Do We Know It", *International Finance*, 4, 335-62.
-

---

**Abstract**

*This paper rests on the idea that there are multiple equilibriums in financial development, and provides illustration of this thesis on the Middle East and North Africa (MENA) region. After many years of financial repression, MENA countries have started liberalizing their financial sectors in the 1990s. Progresses obtained have been minimal. A critical mass of change was needed to escape the financial underdevelopment equilibrium where they had been trapped by financial repression. This paper identifies directions in which reforms and policy initiatives would be necessary: decontrolling banking sectors, strengthening their regulations, and improving financial infrastructure and the legal framework.*

*Keys words: multiple equilibriums, financial sector, growth, Middle East and North Africa*  
*JEL classification: O160*

---

**Résumé**

*Ce papier repose sur l'idée qu'il existe des équilibres multiples en matière de développement financier, et propose une illustration de cette thèse sur la région Afrique du Nord – Moyen Orient (MENA). Après de nombreuses années de répression financière, les pays de la région MENA ont commencé à libéraliser leurs secteurs financiers dans les années 1990. Les progrès obtenus ont été modiques. Une masse critique de réformes est nécessaire pour échapper à l'équilibre de bas niveau de développement financier dans lequel ces pays ont été conduits en raison de la répression financière. Ce papier identifie les orientations de réformes et les initiatives de politique économique qui seraient nécessaires pour cela : la suppression des mesures de contrôle administratif dans les secteurs bancaires, le renforcement de leurs réglementations prudentielles, l'amélioration des infrastructures financières et du cadre juridique.*

*Mots clés: équilibres multiples, secteur financier, croissance, Afrique du Nord – Moyen Orient*