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**GROWTH OF
DEVELOPMENT FINANCE INSTITUTIONS
AND
FINANCIAL RESOURCE NEEDS
OF
SELECTED ESCWA COUNTRIES**

**(BAHRAIN, JORDAN, KUWAIT,
SYRIAN ARAB REPUBLIC,
UNITED ARAB EMIRATES AND
YEMEN ARAB REPUBLIC)**

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I. INTRODUCTION

This study has been prepared in accordance with the work programme and priorities for the period 1984/85 in the field of Public Administration and Finance which the Commission approved during its tenth session. It is the final output of programme element 1.2, titled "Growth of Development Finance Institutions and the Financial Resource Needs of ESCWA Countries".

ESCWA countries like most developing countries, are confronted with the problem of slow pace of capital formation in their development process. In their endeavours to promote economic development, ESCWA countries are hampered by low propensities to save. Adequate and efficient channels through which savings can be mobilized, managed and allocated for investment purposes are equally lacking. In fact, many of the development projects undertaken in ESCWA countries, if they are not government projects, are often financed with funds of the entrepreneurs themselves. This practice has proved to be not the most optimal and efficient way of resource mobilization, management and allocation, for the absence of developed financial markets in these countries has not made possible a fair comparison of return from alternative uses of available funds.

With respect to availability of financial resources, the Gulf oil-exporting countries of Western Asia (surplus countries) are in a more favourable position than other ESCWA countries (deficit countries). They have enjoyed oil revenue surpluses throughout the 1970s and early 1980s and accumulated enviable amounts of reserves. Formation and implementation of their development plans are based on the availability of oil revenues. In addition to financing these plans, surplus countries have made available financial resources through various bilateral and multilateral channels to other ESCWA and developing countries, in order to promote regional as well as economic and social development in other regions.

The extent of surplus countries' use of national and regional development finance institutions in the process of allocating oil revenue surpluses for development purposes in ESCWA region is evaluated along with an appraisal of regional cooperation efforts facilitated by these surpluses.

The "huge" oil revenue surpluses resulted by the two oil price increases in 1973/74 and 1979/80, exceeded what West-Asian banking systems with their then modest facilities and international banking experience could handle. The surplus countries turned therefore to the highly sophisticated international banking and financial markets to handle their surpluses.

Since then, however, ESCWA countries' banking facilities have improved. A better organized banking system comprising a number of local and regional commercial, investment, savings and development banks has emerged to meet the growing requirements of resources mobilization, management and allocation. However, except may be for the development banks, most components of this system are profit-oriented and expect that their business in the region should result in rates of return comparable to those elsewhere abroad.

While the emergence of such financial intermediaries has been welcomed as an important facet of financial market development, it has not been able to mobilize and allocate all of the region's development finance needs. The paucity of viable productive ventures exists in part due to inexperienced entrepreneurship and lack of developed capital markets at both national and

regional levels. The region's governments have naturally paid attention to development projects with higher "social" than monetary returns. Although the objective of growth of national economy requires a fair compensation of the return from alternative uses of available resources, this objective has been hard to realize because of the difficulties in imputing non-pecuniary or social return on public investments. Development-motivated public investments pose such a problem. However, the problems facing such a governmental involvement are not simply the social returns, but also the fact that there is no private sector tradition of undertaking long-term investment and risk-taking in ESCWA region. Given these circumstances, the development finance institutions have a crucial role to play. In the surplus countries, they can be vital in channelling efficiently financial resources to the economy and in providing technical and managerial assistance to infant industries. In the deficit countries, the institutions can play a greater role in marshalling resources to finance such projects and activities.

This study will try to evaluate the process of economic development in selected ESCWA countries in light of needs to financial resources, and the ability of development finance institutions to meet these needs.

Chapter II provides projections of absolute resource needs required for "adequate" economic growth, as well as estimates of the abilities of the selected countries to meet their resource requirements. Financial, capital and banking markets including Islamic banking markets and the role of these markets in mobilizing, management and allocation of financial resources are examined and analysed. The Chapter will also deal with other financial institutions such as insurance companies, social security systems and pension funds in some of the selected ESCWA countries, and analyse their merits and functions in mobilizing financial resources. In the last section of this chapter a detailed analysis of relations between oil revenue surpluses and financial markets, and the development prospects of these markets is emphasized.

An examination and analysis of savings and financial markets development in these countries is made in this chapter. It is hoped that the analysis of these subjects will facilitate a better understanding of the problems that the selected and other ESCWA countries face in mobilizing, managing and allocating financial resources.

Although commercial banks in ESCWA region are not (and cannot be) development finance institutions, for the time being, due to the nature of their business, nevertheless, they have been dealt with in this study in as much as their state of affairs has been generally affected by recent economic development in ESCWA region, and in as much as they can or are willing to play a role in mobilization, management and allocation of financial resources through available mediums and instruments of development finance in the region's financial markets.

Chapter III deals with the selected countries' development banks and institutions in terms of goals, objectives, operations, fund sources and use and overall effectiveness of these banks and institutions in promoting capital formation and economic growth.

While a detailed analysis of state of affairs of regional development finance institutions is beyond the scope of this study, however, these

institutions are shortly introduced and examined in Chapter IV in the context of their interaction with the national and local ones, their participation in regional economic development and their assistance in regional economic cooperation.

Chapter V provides summary and conclusion of the study. Some thoughts as how to enhance role of development finance institutions in economic development and integration in the region, are presented.

The countries selected for this study which are Bahrain, Kuwait, Jordan, Syria, Yemen Arab Republic and the United Arab Emirates represent the diversity found in the region in terms of stage of economic development, type of economy and extent of oil revenue surpluses. Kuwait and the UAE are oil exporting countries and have incurred large oil revenue surpluses. Their economic development is constrained by the limited absorptive capacity of the national economy. The two countries have invested heavily in infrastructure and petrochemicals to remedy this situation. Although the public sector in both countries shares more than 50 percent in GDP, the private sector is encouraged to become more involved in most of the economic activities. Kuwait and the UAE have been financial surplus countries and thus in a position to provide financial resources to ESCWA deficit countries.

Bahrain is a services economy and offshore banking centre country. Although this centre has developed to a rather external one as an offspring of Euromarkets than a regional one, Bahrain can still provide some services and good banking facilities to the region and thus is worth being included in the study.

Jordan is a diversified middle-income and non-oil producing economy. It has a relatively developed financial system including a number of development banks and institutions whose activities would be examined in this study.

Syria is a low-income and highly absorptive economy. Its means of production is largely state-owned, for the economy is a "socialist" or centrally-directed one.

The YAR is one of ESCWA two countries* classified as least developed. Although its government is largely involved in the country's economic activities, the private sector is strongly encouraged to participate in these activities.

It is hoped that this study will prove useful to those interested in the issue of development finance institutions, be these development banks or financial markets or Islamic banks or investment companies or institutional investors or others. It is also hoped that the ESCWA countries that still have not established some of these development finance institutions will draw on the experience of the institutions of the other countries considered. The role that development finance institutions can play in the development process in ESCWA countries is considerable. This study will try to offer some insight into this role and examine how successful these institutions have been playing it, and what could be done to have a more satisfactory performance.

* The other country is the Yemen Democratic Republic.

II. FINANCIAL RESOURCE NEEDS OF SELECTED ESCWA COUNTRIES

A. Capital Formation

(1) Capital Requirements for Economic Development

The accumulation of capital is a necessary but insufficient condition for economic growth. Capital is needed as input for the production process. For output to grow, an increase in capital should occur. The relationship between capital and output is expressed in the so-called capital-output ratio whose level varies according to stage or level of economic development. In least developing countries the capital-output ratio is quite high since for every unit of output produced, capital associated directly or indirectly with output must be used.

Capital indirectly associated with output includes infrastructural facilities such as roads, electricity and communications. An economy at a later stage of development implies that infrastructural investments have already been made. Thus a given unit of output would require less input of capital^{1/}.

The capital-output ratio is an integral part of an economic growth model that can be used to project future investments or capital requirements^{2/}. Economic growth is directly related to the ratio of savings to national income and indirectly to the capital-output ratio^{3/}.

The required investment for a given level of economic growth and a constant capital-output ratio can be specified as follows:

$$\frac{I}{k} = \text{GDP}$$

where I = Investment
 k = Capital-output ratio
 GDP = Change in gross domestic product.

1/ For further discussion of which capital-output ratio is relevant under different economic conditions see Simon Kuznets. Economic Growth of Nations, Cambridge, Mass.. Harvard University Press, 1971, pp. 70-75.

2/ This model is commonly referred to as the "Harrod-Domar growth Model". See E.S. Domar, Expansion and Employment, American Economic Review, March 1947, pp. 34-55; and RF Harrod, An Essay in Dynamic Theory, Economic Journal, March 1934.

3/ A simple formulation of the model is as follows:

I = S		where: S = Savings
sY = S	====	I = sY
I = K	====	Y = National Income
	====	K = Capital
	====	I = Investment
k = $\frac{K}{Y}$	====	s = Savings ratio
		k = Capital-output ratio
====		= Change
Y = $\frac{I}{k}$		

Table II.1 below shows the future investment needs of the selected ESCWA countries. The results are based on the International Development Strategy (IDS) for the United Nations Development Decade's goal of a 7 percent economic growth rate for developing countries, and on the assumption of a capital-output ratio of 3.5 percent.

Table II.1 Required Investments for Projected GDP in Selected ESCWA Countries (1986-1990), in US dollar million

	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
<u>BAHRAIN</u>					
Projected GDP	5,492.5	5,877.0	6,288.4	6,728.6	7,199.6
Required Investment	1,257.6	1,345.8	1,439.9	1,540.7	1,648.5
<u>JORDAN</u>					
Projected GDP	4,227.6	4,523.5	4,840.1	5,178.9	5,541.4
Required Investment	968.1	1,035.7	1,108.1	1,185.8	1,268.8
<u>KUWAIT</u>					
Projected GDP	21,909.1	23,442.7	25,083.7	26,839.6	28,718.4
Required Investment	5,016.6	5,367.6	5,743.5	6,145.7	6,575.8
<u>SYRIA</u>					
Projected GDP	21,074.0	22,549.2	24,127.6	25,816.5	27,623.7
Required Investment	4,860.4	5,163.2	5,524.4	5,911.2	6,325.2
<u>UAE</u>					
Projected GDP	31,380.6	33,577.2	35,927.6	38,442.5	41,133.4
Required Investment	7,185.5	7,688.1	8,226.4	8,802.2	9,418.2
<u>YAR</u>					
Projected GDP	3,278.2	3,507.7	3,753.2	4,015.9	4,297.0
Required Investment	750.4	803.3	859.3	919.4	983.9

Source: ESCWA calculations from different national sources.

(2) Infrastructure

(2.1) Transportation

Development of transportation infrastructure in ESCWA region has been a major concern in development planning during the last 10 to 15 years.

In the last decade, however, the construction of highway and road systems has been boasted to a degree in some ESCWA countries that they can compare favourably with some developed countries.

Of the countries selected for this study, the YAR still has the least-developed highway and road system. Despite its efforts to develop a satisfactory system, large parts of the country are still served with unpaved roads.

Inter-country highway systems are an important facet in achieving economic growth through regional co-operation. Jordan's highway system aims at linking the country with its neighbours, and a ferry service has been established two years ago to provide a land-link with Egypt.

The Gulf region has also emphasized regional links in its highway network system. A causeway linking Bahrain with Saudi Arabia, supposed to be inaugurated later in 1986, is expected to be beneficial to all countries of the Gulf region as it aims at facilitating Bahraini services to these countries and vice-versa.

A railway network has not been seriously considered to meet transportation needs in ESCWA region. ESCWA countries instead have concentrated their efforts in developing transportation infrastructure on highway rather than railway construction. The very limited railway networks that exist serve national transportation needs rather than regional or interregional ones.

However, inter-regional transportation needs are partly served by shipping and port facilities. As of 1982, total gross registered tonnage of ESCWA region has been estimated at 9.4 million^{1/}. This amounts to slightly over 2 percent of the world total^{2/}. The shipping capacity of the region largely serves the oil industry; and 65 percent of this capacity is accounted for by just two countries, namely Kuwait and Saudi Arabia. Major ports are located in the Gulf region and serve mainly the oil and petrochemical industries. Although other ESCWA countries have improved and extended their ports' facilities, many still consider land transportation as a more efficient means of regional and interregional transportation. In respect to civil aviation, the region had in 1982 eight major airlines with 191 aircrafts that served around 19.5 million passengers^{3/}. But the region is also served by foreign airlines.

(2.2) Human Capital Development

The ESCWA region is not very "fortunate" in having a considerable wealth in skilled human resources. But the region is characterized by a highly mobile labour force. In fact, workers are willing to relocate from one country to another. Workers from Egypt, Jordan and the YAR make up a major labour force in the Gulf countries. Their remittances have substantially improved their countries' balance of payments and relieved them from major foreign exchange problems.

Due to same language, culture and religion, workers migrating within ESCWA region adjust relatively easy to living conditions of their host countries.

Human capital development involves training at academic as well as vocational levels. Table II.2 below shows that expenditures on education in

1/ ESCWA, Mid-term Review and Appraisal of Progress in the Implementation of the IPS for The Third UN-Development Decade in the ESCWA region, Baghdad 1984, p. 148.

2/ Ibid.

3/ ESCWA, Mid-term Review and Appraisal, Op.cit, p. 152.

the selected ESCWA countries have made up a "substantial" portion of total government expenditures. Bahrain's expenditures on education (latest available data are for the fiscal year 1982/83), indicate that they consistently have made up over ten percent of total government expenditures. The expenditures of Syria, though low in the seventies and early eighties, have increased in the last few years except for 1984 when they dropped by around 0.9 percent below 1983 level.

**Table II.2 Government Expenditure on Education
(as a Percentage of Total Government Expenditures)**

	<u>1980/81</u>	<u>1981/82</u>	<u>1982/83</u>	<u>1983/84</u>	<u>1984/85*</u>	<u>1985/86*</u>
Bahrain	14.0	12.7	13.2	n.a.	n.a.	n.a.
Jordan ^{a)}	7.5	8.0	8.0	8.1	n.a.	n.a.
Kuwait	8.4	9.1	9.5	9.9	10.2	n.a.
Syria ^{a)}	4.5	6.5	6.9	7.6	6.7	7.9
UAE	8.7	7.2	10.0	9.3*	8.9*	7.3*
YAR	16.2	18.4	19.9	20.0	n.a.	n.a.

Source: ESCWA calculations from different national sources.

a) 1980, 1981, 1982, 1983, 1984 and 1985.

* Preliminary estimates

Jordan's expenditures on education have increased throughout the seventies but remained relatively constant during the last few years of the eighties. Contrary to Kuwait whose expenditures increased steadily without interruption despite decreased oil revenues, the UAE's expenditures on education have fluctuated due mainly to the sharp fall in total government expenditures. Preliminary estimates for 1984/85 and 1985/86 indicate that the UAE's expenditures on education have fallen absolutely as well as relatively, i.e., relative to the fall in government expenditures.

The YAR's commitment to education is indicated by the increasing share of government expenditures devoted to education. The YAR's expenditures upto fiscal year 1983/84 have been relatively higher than in any of the selected countries.

The ESCWA countries commitment to education implies education at all levels. Major universities are found in all of the selected countries except Bahrain, which, however, has been considered recently to site a major university for the countries of the Gulf Cooperation Council^{1/}.

^{1/} The countries of the Gulf Cooperation Council are Kuwait, Bahrain, Saudi Arabia, Qatar, the UAE and Oman.

On the other hand, all selected countries suffer under a serious shortage of vocational training facilities. Table II.3 below shows that the number of students enrolled in vocational training programmes is small compared with that of students enrolled in secondary and higher (academic) training programmes.

Table II.3 School Enrollment in Selected ESCWA Countries
(Secondary, Vocational and Higher Enrollment)*

	<u>1980/81</u>	<u>1981/82</u>	<u>1982/83</u>	<u>1983/84</u>
<u>BAHRAIN</u>				
Secondary	3637	4680	5000	n.a.
Vocational	2810	4063	5844	n.a.
Higher	...	...	...	...
<u>JORDAN</u>				
Secondary	87673	90583	94008	n.a.
Vocational	12001	17242	20549	n.a.
Higher	25753	36994	41117	n.a.
<u>KUWAIT</u>				
Secondary	62768	68160	75537	82987
Vocational	4972	5218	5770	n.a.
Higher	8713	10335	12085	14390
<u>SYRIA</u>				
Secondary	159386	165059	173131	188539
Vocational	25148	33619	42225	53745
Higher	110832	113507	115229	123735
<u>UAE</u>				
Secondary	7786	9713	11639	13769
Vocational	202	241	722	615
Higher	2516	3098	3779	4502
<u>YAR</u>				
Secondary	9895	11645	11984	n.a.
Vocational	902	1028	1085	n.a.
Higher	4519	5172	6960	n.a.

Source: ESCWA Statistical Abstract, 8th issue 1985;
Department of Statistics, 1985.
Department of Statistics, 1985.

* : Excluding religious schools.
n.a. : Not available.
... : Non-existent.

Bahrain which, so far, has been relatively successful in diversifying its economy and has turned the country into a useful services centre for the Gulf region, has given great priority to vocational training programmes, particularly in the services and administration businesses. Vocational students graduating in Bahrain in 1982 accounted for around 22 percent of

total graduating students. In Jordan they were 11 percent, in Kuwait 1 percent and in Syria 9 percent^{1/}.

The relatively low student enrollment and graduation rates at vocational training centres in ESCWA region are the result of a lack of students' interest and motivation in vocational training. On the other hand vocational training has no big tradition in ESCWA countries which only in the last 15 to 20 years have begun establishing modern industries of some significance for which specifically trained personnel is necessary. It should also be borne in mind that until very recently, vocational training has been widely avoided by large segments of the population, for it has been considered of no social prestige and as such associated with the so-called lower class of the population.

However, a major problem governments of deficit countries face in enhancing vocational training programmes is the lack of necessary funds. For example, estimations of the Jordanian authorities in 1983 indicate that vocational training costs of three years for one student, average at about US \$12.000. Despite these costs the Jordanian authorities have in the last few years devoted additional funds for vocational training that has increased the number of vocational graduates which the Jordanian economy cannot absorb for the time being. Estimations of the Jordanian authorities for 1983 indicate that costs of creating a working place for one vocational graduate would be around US \$ 20.000 in average^{2/}, an amount a deficit country like Jordan cannot afford.

(2.3) Institutional Development

The importance of institutional infrastructure for the process of economic development need not be emphasized. For economies to prosper and grow, governments should be well-established and efficient enough to provide sufficient legal regulations and guarantees for investors as well as political and economic stability.

With the exception of Syria and the YAR, the jurisdictions of the countries selected for this study have been influenced by the jurisdiction of Britain which was the major colonial power in the region. The Syrian jurisdiction has been influenced by the French one, for France was the country's colonial power. In the YAR, the jurisdiction is "mostly" a mixture of Islamic and tribal laws and customs. In recent years, however, application of modern jurisdiction, mostly French inspired, has taken fold, particularly in commerce. Still, system of government in all of these countries is characterized by strong cultural and religious traditions as reflected in law and day-to-day government business.

Economies in almost all of these countries are dominated by public sector activities. The share of these activities in GDP ranges from around 60 percent in "capitalist" Bahrain to around 85 percent in "socialist" Syria. In

^{1/} ESCWA calculations from different national sources.

^{2/} The Hashemite Kingdom of Jordan, Ministry of Labor and Social Affairs, Amman 1985.

the capitalist countries, Kuwait and the UAE, governments do not only own and operate the oil industry, they are also involved in most other economic activities such as services and manufacturing.

However, recent developments in ESCWA countries governments' economic activities indicate that most of these governments, including the government of socialist Syria are beginning to encourage private sector economic activities, either by offering incentives as the case with Jordan and Syria in the agricultural business, or by funding the sector's participation in government industries as the case with Bahrain, Kuwait and the UAE.

The Jordanian government which strongly encourages, and, in some cases, protects activities of the private sector, has in the last few years shown that it is willing to participate in large-scale businesses deemed strategic to Jordan's economic development but risky or expensive to be undertaken by the private sector alone.

The Syrian government is directly involved in almost all economic activities of the country, and almost all industries are state-owned. But, confronted with galloping economic difficulties for many years and pressured by an increasing burden of subsidies for consumption and basic food industries, the Syrian government has recently begun offering incentives to the private sector to participate in these industries and to completely undertake them as it deems necessary. Actually, despite the socialist system of the economy, there has always been some co-existence between the government and the private sector, particularly in the construction and agro-industries, as well as in commerce.

The YAR, on the other hand, still has the least developed government infrastructure of the selected countries. Completely isolated until fairly recently, the YAR rural areas are still controlled by strong tribal communities that have not fully accepted the authority of the central government, thus making obstacles for government efforts to enhance economic and social development in these areas.

One example of these obstacles is found in the proposed oil pipeline where the time considered to complete its construction has become unreasonably lengthy due in part to the time allocated for the morbid and sensitive government negotiations regarding right-of-ways through rural areas controlled by tribal communities. To overcome such "political and socio-administrative" obstacles, the government has encouraged rural elections designed to give tribal communities in rural areas a greater voice in central government issues.

B. Factors Determining level of Financial Resources

(1) Domestic Savings

(1.1) Factors Determining Domestic Savings

(a) Interest Rate

In its role as an important determinant in overall savings, interest rates have recently come under closer scrutiny by economists evaluating development policies. Contrary to common belief, low interest rates are said to be not very important for investment encouragement, for they do not

stimulate higher savings and thus do not assist in making available sufficient funds for necessary development investments.

In fact, low domestic interest rates could force savers to look abroad for investment opportunities of higher returns, thus stimulating capital flight. A typical reaction of monetary authorities to this process is restricting international capital movements, thus further distorting economic relationships and efficiency of the national economy.

On the other hand, low interest rates could, in the long-term, weaken banking activities in that they divert savings to non-typically banking business activities such as real estate business and stocks, thus implying a speculative rise in "prices" of mediums of these activities. In doing so, low interest rates would lead to a general economic slow down, as economic activities would be concentrated mainly in these speculative businesses and no longer in other "productive" economic sectors. That is in fact what happened in the last few years in most of the selected ESCWA countries, particularly in Kuwait, the UAE and Jordan where most of the private sector activities were concentrated in speculative business areas such as real estates and stock exchanges, rather than in productive business areas.

A policy of market-oriented (or determined) interest rates can be a cure for a myriad of economic problems including that of low savings levels.

Table II.4 shows the development of real interest rates, i.e., the nominal interest rates minus the inflation rates, during the period 1980 to 1985. A closer look at this development reveals a volatility of the rates which have often been negative. The volatility which is the result of inflation rather than specific interest rate policies of the countries' monetary authorities has resulted in a lack of savers confidence, since saving is elastic with respect to interest rates.

Table II.4 Development of Real Interest Rate
(nominal interest rate - inflation rate) between 1980 and 1985

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985*</u>
Bahrain	+2.3	-9.5	-11.3	-4.2	-2.1	-2.3
Jordan	-10.6	-11.7	-3.5	-1.1	+2.1	+1.5
Kuwait	-5.6	-16.2	-16.5	-6.3	-4.5	-3.2
Syria	-12.2	-17.8	-19.6	-13.6	-14.1	-14.2
UAE	-2.3	-1.2	-6.5	-7.2	-5.4	-5.3
YAR	+3.5	+2.1	-7.2	-6.4	-6.3	-2.4

Source: ESCWA calculations from various national sources.

* : Preliminary.

However, interest rate policies aiming at raising levels of savings are normally guided by a "satisfactory" degree of freedom of action available to the financial system in any country.

This applies not only to Syria where interest rates are rather politically than economically motivated and determined, but also to Jordan and North-Yemen where few restrictions on capital movement apply, though in varied degrees.

On the other hand, with the freedom of capital movement that marks the financial system in each of Kuwait, Bahrain and the UAE, interest rate policies are mostly determined by external financial factors such as the international interest rate differentials and exchange rate fluctuations rather than by internal economic factors.

(b) Financial Systems

Other factors influencing the level of savings center around the structure and performance of the financial system, its accessibility to the public, and its degree of sophistication in terms of width and depth of scope of business*.

In the last few years, efforts have been made in some of the selected countries such as Jordan to improve accessibility to the financial system to further segments of the population. Some of these efforts included diversification of financial instruments offered by the system and automation of some of the commercial banking services. Although automation is still in its infancy, however, it has encouraged bank customers to make more use of the system to settle and process financial and credit transactions. Other efforts made, for instance, in Jordan to facilitate public accessibility to the system include up-grading business of the postal service system to become a deposit-taker institution, extending services to everywhere in the country, with more than 265 branches and around 170.000 personal savings account.

The Jordan Housing Bank has followed suit and is now reaching almost every village in the country through its so-called mobile branch or bank. The commercial bank of Syria, which is the only commercial bank in the country, has also been successful in branch banking.

In the YAR, however, lack of branch banking is lamented and some commercial banks refuse, from time to time, additional deposits in order to avoid excessive liquidity.

On the other hand, establishing branch banking in rural areas involves high cost and may not be considered economically feasible. The experience of Jordan, Syria and the YAR illustrates problems with bank communication, lack of physical facilities and trained personnel, and the reluctance of this personnel to move to rural areas.

Actually, these problems add up in the YAR to the mentioned reluctance of the country's banks against branch banking in rural areas.

* The width of a financial market is characterized by the variety of the financial instruments available. The depth is characterized by the sophistication of these instruments.

Furthermore, there are some concerned circles particularly in the YAR, Syria and to a lesser degree Jordan, that point out that branch banking is not of much use to rural areas since it tends to reallocate resources from these areas to urban areas where bank businesses are usually concentrated and rates of return are higher.

The lack of access to the banking system, the absence of banking habit of large segments of the population and the traditional, but -more or less -religiously motivated, distrust against banking in general, have resulted in that these segments, particularly the low income ones, have increasingly become hoarders of cash as well as purchasers of consumer durables in lieu of saving in the financial system. While, ceteris paribus, withdrawal of resources from consumption, in the case of hoarding, can free resources for investment, the use of the financial markets can enhance this process. With the purchase of consumer durables, the "level" of investment depends firstly on the available investment opportunities and their comparative rates of return, and secondly on the investment "mentality" of the marchants and, thirdly on the ability of the financial system to attract "sales money" of these merchants.

(c) Religion*

With the establishment of Islamic banks and financial institutions in most of the selected ESCWA countries in mid-seventies and early eighties, "savings" of some segments of the population, particularly those who refuse dealing with the commercial banking system due to religious reasons, began channelling through these banks and institutions instead of being hoarded or used for purchasing consumer durables.

Present estimations indicate that around US \$15 billion are still hoarded by these segments of the population which are unable or unwilling to utilize both banking systems. The extent to which Islamic banks and financial institutions have become able to attract deposits, illustrates the importance these banks and institutions have gained within the structure of the various financial systems in ESCWA region.

(1.2) Private Savings

Table II.5 below shows private savings in the six selected ESCWA countries. It indicates that during the last oil boom period, or the "unusual decade", private households in the oil-exporting countries, i.e. Kuwait, the UAE and Bahrain, have experienced dissavings, and that this situation has not reversed since the present economic recession has started in 1982/83.

The same process has taken place in the other three non-oil exporting countries, as well. Private savings in these countries originate mostly from worker remittances. Contrary to the oil-exporting countries, private savings in non-oil exporting countries play an important role in development financing, though not primarily through intermediation of the financial markets, but rather through stimulating supply and demand of goods and services.

* For further details, see Islamic Banking in section (C, 2.3) of this chapter, p. 37 ff.

Table II.5 Private Savings in Selected ESCWA Countries
1980-1985, (in 1975 US Dollars million)

		<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u> *	<u>1985</u> **
Bahrain	Current	1,033.0	789.1	266.0	250.3	245.6	198.1
	Constant	572.4	402.4	122.4	100.1	86.0	57.4
Jordan	Current	965.6	893.5	615.9	425.0	400.1	362.7
	Constant	560.0	464.2	307.9	200.0	176.0	145.0
Kuwait	Current	4,730.3	9,631.0	4,269.1	3,216.3	1,333.2	630.5
	Constant	3,358.5	6,260.2	2,604.2	1,801.1	666.6	264.8
Syria	Current	2,061.7	1,901.3	1,775.9	2,225.3	1,219.2	733.3
	Constant	1,793.7	1,597.1	1,420.7	2,002.8	1,036.3	601.3
UAE	Current	8,785.6	9,519.7	8,664.4	4,025.2	3,842.6	1,221.0
	Constant	7,028.4	5,902.2	6,671.6	2,817.6	2,613.0	781.4
YAR	Current	470.1	593.7	105.5	93.7	64.2	23.7
	Constant	230.3	273.1	47.5	40.2	25.7	8.8

Source: ESCWA calculations from various national sources.

* : Preliminary figures.

** : Estimates.

Table II.5 indicates further that inflation rates in all of the six countries have been high, thus decimating real value of private savings, especially in Bahrain, Jordan, Kuwait and the YAR. This development can be attributed to the negative interest rates experienced in these countries over the last few years (see table II.4, p.11).

(1.3) Government Savings

Table II.6 below shows government savings. It indicates that government savings have been a major source of investment funding in some of the countries under review, where governments undertake responsibility for major development finance.

In the "centrally-planned" economy of Syria, the government is the only decision maker in the process of development finance. The government of each of Bahrain, Kuwait and the UAE, although committed to encouraging private sector's economic activities, it plays a major role in financing the country's development process due to the monopolistic position it entertains in the oil industry, which is the major source of national income for each of Kuwait and the UAE and an important one for Bahrain.

In Jordan, where private sector has always been active in business life of the country, the government (or public) sector's share in GDP is still large, around 55 percent.

In the YAR, the absence of private sector activities in development finance is largely due among other things, to the lack of resources, skilled manpower, and insufficient infrastructure.

In all of these countries, except Jordan and Kuwait, governments have in most cases excluded financial intermediaries in channelling government financial resources to development finance, thus missing an opportunity in developing and strengthening financial markets and in establishing the awareness of the private sector in development investment.

Table II.6 Government Savings in Selected ESCWA Countries
1980-1985 (in 1975 US Dollars million)

		<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984*</u>	<u>1985**</u>
Bahrain	Current	672.0	644.4	654.8	456.4	585.6	353.7
	Constant	376.2	329.3	301.3	176.3	198.1	99.2
Jordan	Current	-369.0	-251.1	-229.9	-122.6	-192.1	-224.4
	Constant	-214.7	-130.6	-115.0	-57.9	-84.4	-89.8
Kuwait	Current	20,356.1	10,513.7	3,539.0	1,270.8	1,091.6**	186.3
	Constant	14,452.8	6,834.0	2,158.6	711.6	546.0	78.2
Syria	Current	3,611.8	3,511.0	4,228.4	4,734.4	4,548.2	4,952.2
	Constant	3,148.0	2,962.4	3,396.6	4,238.5	3,880.7	4,082.9
UAE	Current	1,393.3	1,501.2	-421.6	-253.3	-482.1	-89.0
	Constant	1,114.7	926.7	-324.6	-177.3	-327.9	-57.2
YAR	Current	131.6	201.8	339.6	564.9	396.6	219.3
	Constant	64.4	92.8	152.8	242.9	158.6	81.1

Source: ESCWA calculations from various national sources.

* : Preliminary estimates.

** : Budget estimates.

However, in the three selected non-oil countries where revenues from domestic sources make up an important portion of total government revenues, problems arise when governments try to accrue revenues through fiscal measures. For example, measures aimed at increasing tax revenues are difficult to implement, not only because they are politically unpopular (as the case in Western democracies), but also because these countries still do not have sophisticated financial practices. On the other hand, reducing expenditures remains a difficult problem since governments play the major role in economic development and provide many politically popular services. For example, measures to cut down subsidies for basic needs such as food or transportation, or to lay off workers from public services' or government's owned companies would be politically undesirable.

In addition to these problems, the high rates of inflation that have prevailed in most of these countries in the pre-current recession have raised costs of goods and services provided by governments.

However, public financial management in ESCWA region has shown that even where a government proved able to maintain a fiscal surplus, attempts at investing the surplus in the most appropriate manner have proved unsatisfactory, simply because the absence of profit motives in government investment often results in mismanagement and in decisions that are often politically rather than economically motivated.

Syria, for example, has found out that further state control in the agricultural industry and in some sectors of the services industry, such as trade, is very "expensive" and inefficient. Syria therefor is making efforts aimed at encouraging private investments in these sectors, hand in hand with government investments.

The Jordanian government which has a tradition of encouraging private sector investments, has been underlining this tradition by participating in joint-large-scale projects with the private sector to reduce the risk element to this sector.

These and other developments in other ESCWA countries indicate a policy towards reducing government involvement in development finance (in some economic sectors) in favor of private sector involvement.

Another obstacle facing most countries under review, particularly the non-oil exporting ones, in accruing fiscal surpluses is the poor (managerial and financial) standing of publicly-owned companies, which, at the time they were established, were thought to be a major source of government income. The obstacle is embodied in the governments forcing these companies to keep "prices" of their goods and services to the consumers at low levels. On the other hand, in order to keep unemployment (relatively) low, the governments sometimes force the management of these companies to hire more labor than needed, or to continue hiring un-needed labor force regardless of the economic feasibility of such policies.

In both cases, this practice results in increase in operating as well as overhead costs and thus in reducing operating profit.

These problems do not exist to such an extent in the Gulf oil-exporting countries, where oil revenues make up the major source of government income, and the oil industry is capital-rather than labour-intensive industry whose markets are foreign and not domestic ones.

(1.4) National Savings
(Government Savings+Private Savings)

Table II.7 shows total national savings for each of the six countries. It indicates savings in nominal as well as real terms, whereby 1975 is the base year.

Real savings in all of these countries except Syria have dropped considerably between 1980 and 1985 due in part to the high rates of inflation that prevailed in each of these countries in the pre-current recession.

According to official Syrian sources, real saving in Syria has remained almost constant during the period.

Table II.7 National Savings (Government savings+Private savings)
in Selected ESCWA Countries, 1980-1985
(in 1975 US Dollars million)

		<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984*</u>	<u>1985**</u>
Bahrain	Nominal Savings	1,705.0	1,433.5	920.8	706.7	831.2	551.8
	Real Savings	948.6	731.7	423.7	276.4	284.1	156.6
Jordan	Nominal Savings	596.6	642.4	386.0	302.4	208.0	137.8
	Real Savings	345.3	333.6	192.9	142.1	91.6	55.2
Kuwait	Nominal Savings	25,086.4	20,144.7	7,808.1	4,487.1	2,424.8	816.8
	Real Savings	17,811.3	13,094.2	4,762.8	2,512.7	1,212.6	343.0
Syria	Nominal Savings	5,673.5	5,412.3	6,004.3	6,959.7	5,767.4	5,685.5
	Real Savings	4,941.7	4,559.5	4,817.3	6,241.3	4,917.0	4,684.2
UAE	Nominal Savings	10,178.9	11,020.9	8,242.8	3,771.9	3,360.5	1,132.0
	Real Savings	8,143.1	6,828.9	6,347.0	2,640.3	2,285.1	724.2
YAR	Nominal Savings	601.7	795.5	445.1	658.6	460.8	243.0
	Real Savings	294.7	365.9	200.3	283.1	184.3	89.9

Source: ESCWA calculation from national sources.

* : Preliminary figures.

** : Estimates.

The dramatic deterioration in national savings in the oil-exporting countries can be attributed to the drop in both government and private savings, thus suggesting a sort of established overconfidence of both parties in a permanency of high oil revenues and a general expectation of continued high incomes.

The table also reads that the spillover of the seventies and early eighties has established a similar sort of confidence and expectations in the non-oil exporting countries where (again except for Syria) government savings as well as private savings have deteriorated as dramatically as those of the oil exporting countries.

However, there are no information available to accurately indicate extent of national savings participation in development finance in all of the six countries, but the negative real interest rates observed in the six countries during the last few years (table II.4, p. 11), suggest that a considerable volume of capital flight has taken place from these countries to other countries, mainly developed ones, where real rates of return were higher.

(1.5) Savings Gap
=(Savings--Investments)

Table II.8 shows savings gap and savings gap ratio as well as the ratios of both savings and investment for the six countries in the time between 1980 and 1985. The table indicates that during this period most of these countries have experienced a steady deterioration in savings gap and savings gap ratio. With respect to the two oil-exporting countries Kuwait and the UAE, this development is attributed to the decreased level of savings in conjunction with a nearly unchanged course of investment.

Contrary to the development of UAE's GDP which changed only slightly between 1980 and 1985 (table II.9), thus softening the deterioration in the country's savings gap ratio, the sharp decline in Kuwait's GDP by around 26 percent between 1980 and 1985 has further-worsened Kuwait's saving gap ratio. Table II.8 shows that the country's savings gap ratio has deteriorated from a positive 77.9 percent in 1980 to a negative 16.4 percent in 1985, thus reflecting a total drop of around 94 percent in just 6 years, or a dissaving of around US \$24.8 bn. Kuwait's saving has also dropped dramatically in relation to GDP, namely from 91 percent in 1980 to just 4 percent in 1985.

With savings of around US \$25 bn in 1980 (table II.7) and investment of only US \$3.6 bn (table II.10), Kuwait "enjoyed" a savings surplus (or positive savings gap) of US \$21.4 bn. In 1985, however, when investment increased by around half a billion US dollar over the 1980 level, but savings decreased substantially, namely from US \$25.1 bn in 1980 to a minor sum of US \$816 mn. in 1985, savings surplus (or positive savings gap) of around US \$21.4 bn has turned to a deficit of around US \$3.4 bn, thus indicating a dissaving of US \$24.8 bn. This development in Kuwait's savings gap indicates that in order to finance investments, Kuwait has relied on other financial sources, which most probably have been the country's foreign assets, for they are the only source available.

The same development is witnessed in the UAE. While the widening of the country's savings gap ratio (i.e., the drop in the country's savings surplus) can be considered relatively minor compared with that of Kuwait, the reasons behind the widening were somehow different. In fact, these reasons can, by mere arithmetical consideration, be attributed firstly to the country's almost unchanged GDP between 1980 and 1985, and secondly, to the absolutely as well as relatively slower decrease of savings compared with that of Kuwait.

However, despite this development in UAE's GDP, both the drop in savings from US \$10.2 bn in 1980 to around US \$1.1 bn in 1985, and the change in investments during the period, have resulted in widening the country's savings gap (or eliminating the savings surplus which was US \$1.8 bn in 1980 and turned to a deficit of US \$6.4 bn in 1985). Thus a dissaving of around US \$8.2 bn occurred. As the case with Kuwait, the development in UAE's savings gap indicates that in order to finance investments, the UAE has relied on other financial sources which most probably have been the country's foreign assets.

Table II.8 Savings Ratios, Investment Ratios and Savings Gaps^{1/}
for Selected ESCWA Countries (1980-1985)

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
<u>BAHRAIN</u>						
S/GDP (%)	43.6	31.7	19.8	14.6	16.6	10.7
I/GDP (%)	34.6	32.4	42.6	42.7	40.8	37.5
S-I (US \$ mn) ^{1/}	350.9	32.2	-1,059.0	-1,363.3	-1,210.3	-1,375.4
S-I/GDP (%)	9.0	-0.3	-22.8	-28.1	-24.2	-26.8
<u>JORDAN</u>						
S/GDP	18.2	18.1	10.1	7.7	5.2	3.4
I/GDP	41.2	49.7	46.2	35.5	32.0	27.7
S-I	-758.9	-1,132.8	-1,378.4	-1,102.9	-1,067.7	-985.2
S-I/GDP	-23.1	-31.6	-36.2	-27.9	-26.8	-24.9
<u>KUWAIT</u>						
S/GDP	91.0	83.3	39.2	20.4	11.2	4.0
I/GDP	13.2	17.2	24.6	19.9	21.0	20.3
S-I	21,450.0	15,976.4	2,896.3	102.4	-2,136.2	-3,350.0
S-I/GDP	77.9	66.1	14.6	0.03	-9.8	-16.4
<u>SYRIA</u>						
S/GDP	43.0	31.9	32.9	37.4	30.1	29.0
I/GDP	27.2	22.9	22.6	23.6	23.7	21.9
S-I	2,077.1	1,523.9	1,859.1	2,555.6	1,215.8	1,363.9
S-I/GDP	15.7	9.0	10.2	13.7	6.3	6.9
<u>UAE</u>						
S/GDP	33.5	32.6	26.1	13.2	12.0	4.0
I/GDP	27.6	25.6	27.7	30.5	32.0	25.8
S-I	1,775.4	2,367.1	-505.6	-4,987.3	-4,982.6	-6,430.5
S-I/GDP	5.8	7.0	-1.6	-17.4	-17.7	-21.9
<u>YAR</u>						
S/GDP	21.7	27.0	12.7	17.6	13.8	7.9
I/GDP	43.7	41.0	33.5	23.1	20.9	20.0
S-I	-608.2	-416.5	-729.2	-209.2	-241.4	-369.3
S-I/GDP	-22.0	-14.1	-20.8	-5.6	-7.2	-12.0

S/GDP : Savings ratio (Savings related to GDP);

I/GDP : Investment ratio (Investment related to GDP);

S-I : Savings gap (Savings minus Investment);

S-I/GDP: Savings gap ratio (Savings gap related to GDP).

^{1/} A positive sign indicates that savings exceed investments;

A negative sign indicates that Investments exceed savings, i.e., savings alone cannot finance the country's investments, and therefore other sources of finance must be tapped.

Source : ESCWA calculations from various national sources.

Table II.9 Gross Domestic Product (GDP)
for Selected ESCWA Countries, 1980-1985
(in current US \$ million)

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Bahrain	3,911.9	4,516.3	4,643.7	4,845.9	4,993.2	5,133.2
Jordan	3,285.5	3,581.8	3,812.5	3,949.0	3,983.4	3,951.0
Kuwait	27,549.4	24,173.9	19,895.6	22,010.3	21,706.2	20,475.8
Syria	13,197.2	16,940.6	18,274.4	18,611.2	19,140.4	19,695.3
UAE	30,365.0	33,793.0	31,504.8	28,636.3	28,118.2	29,327.7
YAR	2,768.2	2,950.1	3,499.4	3,750.0	3,351.1	3,063.8

Source: ESCWA calculations from various national sources.

Tables II.7 and II.8 show that development in savings and savings gap of Kuwait and the UAE (and the other Gulf oil-exporting countries) has reduced spillover to the other four countries under review. The negative development of these four countries' savings and savings gap supports this view.

Of these countries, Bahrain has experienced between 1980 and 1985 the most impressive relative increase in GDP and in investments, (tables II.9 and II.10). Bahrain's 1985 GDP of around US \$5.1 bn was around 31 percent over that of 1980, and the country's 1985 investments of around US \$1.9 bn. were around 42 percent over those of 1980. The development of both GDP and investments has, however, been accompanied by a sharp decrease in the country's savings, namely from around US \$1.7 bn in 1980 to around US \$0.6 bn in 1985 (table II.7); and further by a deterioration of both savings gap and savings gap ratio (table II.8). In fact, savings gap has turned from a surplus of US \$351 mn in 1980 to a deficit of US \$1.4 bn in 1985, and savings gap ratio from a plus of 9 percent to a minus of 26.8 percent. Similar to Kuwait and the UAE, Bahrain has also relied on other financial sources, mainly its foreign assets to finance investments.

Savings, savings gap and savings gap ratio of Jordan, Syria and the YAR, pose real problems for these countries, as levels of the three variables depend solely on the spillover from the Gulf oil-exporting countries.

Table II.10 Investment (= gross fixed capital formation)
for Selected ESCWA Countries, 1980-1985
(in current US \$ million)

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Bahrain	1,354.1	1,465.7	1,979.8	2,070.0	2,041.5	1,927.2
Jordan	1,355.5	1,781.2	1,764.4	1,405.3	1,275.7	1,123.0
Kuwait	3,639.4	4,168.3	4,911.8	4,384.7	4,561.0	4,166.8
Syria	3,596.4	3,888.4	4,145.2	4,404.1	4,551.6	4,321.6
UAE	8,403.5	8,653.8	8,748.4	8,759.2	8,343.1	7,562.5
YAR	1,209.9	1,212.0	1,174.3	867.8	702.2	612.3

Source: ESCWA calculations from various national sources.

Jordan's saving in 1985 has been considerably less than its 1980 level (table II.7). Both the increase of GDP (from US \$ 3.3 bn in 1980 to US \$4 bn in 1985, table II.9) and the decrease of investment (from US \$1.4 bn in 1980 to US \$1.1 bn in 1985, table II.10) have resulted in a deterioration of the country's already negative savings gap and savings gap ratio (table II.8).

Although the negative development of both ratios between 1980 and 1985 has not been as dramatically as in some other selected countries, it still shows a considerable deviation (for the Jordanian standard) in the years 1981 and 1982. The deterioration in both years can be attributed to the higher level of both investments and GDP in 1981 and to the sharp drop of savings in 1982.

Tables II.7 and II.10 indicate that development of Jordan's savings and investments correlate strongly, in more or less a one-year lag, with that of Kuwait and the UAE (and other Gulf oil-exporting countries, thus reflecting the degree of dependence of economic activities in Jordan (and in the other non-oil countries) on the degree of development of economic activities (say: oil revenues) of the oil-exporting countries; and further supporting the theory of spillovers.

Except for the deviation in 1982 and 1983, Syria's savings remained almost unchanged throughout the period 1980 to 1985. The deterioration in Syria's savings gap from the equivalent of US \$2.1 bn in 1980 to US \$1.4 bn in 1985 can be attributed, arithmetically, however, to the increase in the country's level of investments, namely from the equivalent of US \$3.6 bn in 1980 to US \$4.3 bn in 1985 (table II.10).

The downward development in savings gap ratio, though not as dramatic as in other countries, is due to the rise in GDP-which is the denominator-by around 46 percent or US \$6.5 bn in 1985 over 1980.

In all selected countries, therefore, development of savings and savings gap ratio has been negative. But it has been worse in the two oil-exporting countries, Kuwait and the UAE. In Kuwait, 1985's saving has been just around 3 percent of that of 1980, and in the UAE 11 percent.

While Kuwait as well as the UAE and Bahrain have been able to finance savings gap through foreign assets, Jordan, Syria and the YAR have not been able to do the same, for they possess neither sufficient foreign assets nor adequate domestic income sources. The result was that these countries either had to look for "foreign" financial sources, for instance through borrowing as the case with Jordan or to postpone or cancel investment projects as the case with both Syria and the YAR and to a lesser degree with Jordan, too.

The deterioration in savings gap and savings gap ratio has, for all of these countries, been originated mainly from the deterioration in national savings. In Jordan, however, the increase in investments and GDP has contributed partly, though arithmetically, to this deterioration, as both variables are components of the equation.

Table II.11 shows that the limited financial resources of the non-oil exporting countries under review will continue being so until 1990, at least. The table shows a projection for savings, required investments and savings

gap. Projected savings are based on projected GDP as shown in table II.1 (page 5). Since savings ratios have been declining region-wide (table II.8), savings ratios of 1985 have been used for the projection. The required investments shown in table II.1 and table II.11 are the investments needed to promote a 7 percent annual rate of growth of GDP for each country as envisaged by the International Development Strategy.

Table II.11 Projected Savings, Required Investments and Savings Gaps of Selected ESCWA Countries, 1986-1990 (in US \$ mn)

	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
<u>BAHRAIN</u>					
Projected Savings(s)	587.7	628.8	672.9	720.0	770.4
Required Investments(I)	1,257.6	1,345.8	1,439.9	1,540.7	1,648.5
Savings Gap(S-I)	-669.9	-717.0	-767.0	-820.7	-878.1
<u>JORDAN</u>					
Projected Savings(s)	143.7	154.0	165.0	176.1	188.4
Required Investments(I)	968.1	1,035.7	1,108.1	1,185.8	1,268.8
Savings Gap(S-I)	-824.4	-881.7	-943.1	-1,009.7	-1,080.4
<u>KUWAIT</u>					
Projected Savings(s)	876.4	937.7	1,003.3	1,073.6	1,148.7
Required Investments(I)	5,016.6	5,367.6	5,743.5	6,145.7	6,575.8
Savings Gap(S-I)	-4,140.2	-4,429.9	-4,740.2	-5,072.1	-5,427.1
<u>SYRIA</u>					
Projected Savings(s)	6,111.4	6,539.2	6,997.0	7,486.8	8,010.9
Required Investments(I)	4,860.4	5,163.2	5,524.4	5,911.2	6,325.2
Savings Gap(S-I)	1,251.0	1,376.0	1,472.6	1,575.6	1,685.7
<u>UAE</u>					
Projected Savings(s)	1,255.2	1,343.1	1,437.1	1,537.7	1,645.3
Required Investments(I)	7,185.5	7,688.1	8,226.4	8,802.2	9,418.2
Savings Gap(S-I)	-5,930.3	-6,345.0	-6,789.3	-7,264.5	-7,772.9
<u>YAR</u>					
Projected Savings(s)	259.0	277.1	296.5	317.3	339.5
Required Investments(I)	750.4	803.3	859.3	919.4	983.9
Savings Gap(S-I)	-491.4	-526.2	-562.8	-602.1	-644.4

Source: ESCWA projection based on national sources.

A negative sign in savings gap indicates that a gap (a savings deficit) exists, while a positive sign indicates that savings exceed investments, or that there are more than enough savings available to finance required investments.

Table II.11 shows that savings gaps will continue to persist in all of the countries except Syria whose savings in 1990 would reach the equivalent of US \$1,685.7 mn or would increase by US \$295.7 mn over 1985 savings.

However, Syrian savings should be looked at with some reservation for two reasons. Firstly, official Syrian financial statistics regarding government savings (which are the difference between government revenues and government expenditures) have been showing a balanced budget during the last decade, while other statistics show a budget surplus -- a contradictory situation, indeed.

Secondly, considering Syrian savings in US dollar according to the official Syrian exchange rate of SL vs US \$ is not just unrealistic, but also misleading, because the official Syrian exchange rate of SL 3.9250=US \$1.0 is one of three other official exchange rates in addition to the exchange rate of SL 16-20 per US \$1.0 in the parallel (or black) market which in the writer's opinion seems to be the more realistic and reasonable rate for the inconvertible Syrian Lira. It is therefore rather advisable to consider Syrian savings, particularly those of the government (if there are really any) and the savings projection in the relation of the exchange rate average of 16-20 divided by the official exchange rate of SL 3.9250=US \$1.0.

The persistence of savings gaps indicates that financial resources of these countries, particularly the non-oil exporting ones, would not be sufficient to generate the funds necessary for projected investments which are needed for the envisaged 7 percent annual growth rate of GDP. Other financial sources must therefore be made available.

(2) External Sources of Financing

Table II.11 shows that domestic financial sources of the non-oil exporting countries would not be sufficient to generate the necessary financing for the required development investments, and therefore other financial sources, mostly external ones, should be made available.

In addition to worker remittances, loans and grants which in the last few years have together made up around 80 percent of total foreign exchange earnings of these countries, some efforts have been made by these countries to create additional sources of investment financing through establishing and promoting export-oriented as well as import-substituting industries. The increasing deficit in the current account balance of most of these countries during the last few years shows that these efforts have not been very successful (table II.12).

Although an average of around 25 percent to 35 percent of the deficit of these countries is attributed to imports of capital goods considered to be necessary inputs for development projects, the contribution of these projects to foreign exchange generation for these countries has so far been minimal. Moreover, since most of these projects are mostly "turn-key" projects and their process of production and consequently their output depends largely on imported inputs, be it raw materials, technology or management, rather than on domestically produced ones, most of these projects, particularly the capital-intensive ones, have become a drain on foreign exchange earnings of these countries.

The current account deficit of non-oil exporting countries could have developed much larger, have not worker remittances softened the trend. In fact, worker remittances in the last decade contributed between 40 percent and 50 percent to foreign exchange earnings of these countries. The contribution

Table II.12 Current and Capital Account of
Selected ESCWA Countries, 1980-1984 (in US \$ mn)

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
<u>BAHRAIN</u>					
Current Account	390.7	550.5	664.4	243.1	-10.6
Capital Account	10.4	-3.0	-94.9	41.2	70.7
<u>JORDAN</u>					
Current Account	373.9	-38.9	-332.7	-390.7	-218.8
Capital Account	106.0	217.0	320.0	433.0	228.0
<u>KUWAIT</u>					
Current Account	15,302.0	13,778.0	4,873.0	5,715.0	5,570.0
Capital Account	-37.0	384.0	-244.0	-902.0	-1,155.0
<u>SYRIA</u>					
Current Account	251.0	-275.0	-251.0	-815.0	-852.0
Capital Account	-25.0	48.0	-8.0	309.0	326.0
<u>UAE</u>					
Current Account	10,070.0	9,208.0	7,001.0	5,275.0	7,137.0
Capital Account	-620.0	-1,725.0	-1,062.0	-957.0	-177.0
<u>YAR</u>					
Current Account	-685.2	-655.2	-607.4	-559.0	-300.0
Capital Account	475.2	233.4	168.0	159.0	99.0

Source: Various national sources.

of the remittances in these countries' economic development (say, capital formation), however, has not met the high-rise expectations.

In Jordan, for example, some 55 percent of worker remittances between 1975 and 1985 were spent by the workers themselves or their relatives in Jordan on building own family housing, around 36 percent on imported consumption goods, and 5 percent on buying equities in public and private shareholding companies and on establishing own small businesses, and only the rest of just 4 percent found a way into economic development projects (table II.13).

In the YAR, use of worker remittances has been even less productive than in Jordan. Around 60 percent of Yemeni workers remittances were spent on imported consumption goods, 37 percent on building own family housing, 2 percent on establishing own small businesses and buying "equities in companies" and only as much as 1 percent were used to develop or establish private, mostly agri-projects.

In Syria, worker remittances were not put to better use. Just around 1 percent of Syrian worker remittances were used in "investment projects", which are mostly private and in the agri-sector, while some 60 percent of the

Table II.13 Use of Worker Remittances in Jordan, YAR and Syria
Average of 1975 to 1985, in percentage (%)

	<u>JORDAN</u>	<u>YAR</u>	<u>SYRIA</u>
Family housing	55	60	60
Import of consumption goods	36	37	39
Purchase of equities	5	2	-
<u>Development projects</u>	<u>4</u>	<u>1</u>	<u>1</u>
Total	100	100	100

Source: ESCWA calculations from various national and international sources.

remittances were used for building own family housing and the rest of 39 percent for imported consumption goods.

Table II.13 indicates that contrary to common belief, worker remittances of these countries were not used in long-term investment development projects. In the short-term, worker remittances have undoubtedly contributed greatly to acceleration of economic activities. Building family houses by such large a dimension of worker remittances has encouraged establishing cement and other related building industries, and/or contributed to make full use of the production capacities of the already existing ones. Moreover, increasing imports of consumption goods has raised economic activity in trade as well as services sector. Both situations, however, indicate that there existed a big demand for family housing and consumption goods and point at a substantial capital outflow from these countries. Consumption goods had to be imported as they could not be satisfied by domestic production.

In the long-term, the increased economic activities induced from both building family housing and importing consumption goods, do not assist in any way these countries in achieving long-term economic development goals, as value added to the economy resulted from such a way of spending worker remittances would exist only in the year of spending, and hence economic effects of this spending would be short-lived.

Despite this discouraging finding, the remittances have, however, improved foreign exchange reserves of these countries and enabled them to import necessary capital goods for planned development projects, (regardless of the development feasibility of the projects).

External aid to the selected non-oil exporting countries has been another source of development finance. Table II.14 shows external aid received by Jordan and the YAR between 1980 and 1985.

External aid to both countries --and to Syria, (for which, no statistics are available) began falling dramatically in 1984 when effects of decreasing oil revenues of Arab oil donor countries have become increasingly perceptible.

Despite the fall in external aid, its share in total investment has remained almost constant and is still substantial for Jordan. Although the share of external aid in total investments has remained substantial in YAR, it fell from 59 percent in 1982 to 54.2 percent in 1983 and further to 43.0 percent in 1984 and 36.7 percent in 1985.

Table II.14 External Aid to Jordan and the YAR
1980-1985 (in US \$ mn)

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985*</u>
<u>JORDAN</u>						
Grants	680.4	625.2	566.5	541.6	322.8	280.0
Loans & technical assistance	261.8	229.4	185.7	222.0	334.7	300.0
Total aid	942.2	854.6	752.2	763.6	657.5	580.0
Percentage of Investment	69.5	48.0	42.6	54.0	51.5	51.6
<u>YAR</u>						
Grants	145.8	332.4	462.3	186.0	142.2	75.0
Loans & technical assistance	559.6	358.3	231.5	285.1	160.2	150.0
Total aid	705.4	690.7	693.8	471.0	302.4	225.0
Percentage of Investment	58.0	57.0	59.0	54.2	43.0	36.7

* : Preliminary estimates.

Source: ESCWA calculations based on various national and international sources.

Contrary to Jordan, the sharp fall in the YAR's share in total investment is explained by a relatively higher decrease of the country's investment than the relative decrease of external aid it received.

Composition of external aid received by Jordan and YAR has also changed with loans and development technical assistance becoming more important than grants which have been decreasing since 1983. This development undoubtedly reflects the increasing financial stress of the Arab Gulf oil-exporting countries, which are the main donors, but on the other hand also indicates a rising trend of a "new old" policy of development aid of (Arab and non-Arab) donor countries by conditioning aid to development and related projects rather than simply putting it at the disposal of the receiving countries.

C. Financial Markets, Banking Markets and Economic Development

(1) Financial markets

Financial markets play a major role in mobilizing domestic savings and directing them to the proper channels of investment financing. When the access of foreign investors to these markets is free, and profit-making investment opportunities and transfer of profit and dividends are unrestricted, financial markets can play a major role in attracting and allocating both foreign and domestic resources for investment financing.

The level of development of financial markets and the extent of their width and depth remain important determinants for the ability of these markets to perform these objectives. The lesser financial markets are fragmented, the lesser the risk inhibited and the more savings and investment deposits are attracted. Artificially fixed interest rates (usually the result of certain "official" measures and policies) would not exist in a free financial market.

Artificially low interest rates would enable mostly government investments to be undertaken. Assuming monopoly position or government protection in these markets, only big private and usually profitable enterprises would benefit from these rates, for they are the only enterprises that would be able to attract savings and other financial funds for investments under these circumstances.

In the absence of efficient financial markets, savings and other financial funds would still find a way in the investment business, but allocation of these resources would be disorderly organized.

Where financial markets are rudimentary, or artificially fixed interest rates result in credit rationing, private investments tend to be self (or internally) financed or facilitated by family savings or borrowing since the characteristics and motivations of savers (i.e., investors) bear little resemblance to those of entrepreneurs. When investments are undertaken in this direct way, savers may not make the most efficient use of available resources, and would not have a wide range of alternative projects from which to choose.

Only by chance is the individual saver (investor) satisfied in terms of risk preference and project yield due to the limited choices available. Also entrepreneurs who depend on personal contacts for financing may find themselves unable to raise the adequate funds necessary to utilize the most efficient means of production.

Financial markets replace personal relationships between savers (investors) and entrepreneurs (borrowers). They provide savers the chance to diversify their portfolios thus reducing risk and allowing for investment in the highest yield projects at a given rate of risk. The savers also benefit in that less time would be needed to acquire information about investment opportunities. On the entrepreneurial side, less time would be needed to raise funds. Thus, with developed financial markets, savings would be channelled to investment projects that offer the highest yield.

The development of financial markets in western countries generally coincided with industrialization and was stimulated by demands for funds from growing industrial concerns and also from governments undertaking large infrastructural projects. This type of financial market development which is called among economists "demand-following" development, springs from the demand stimulated by economic development. If such kind of markets is actively promoted, the process becomes what is called "supply-leading" development, for the supply of financial instruments would promote economic development. The so created financial market would transfer resources from traditional sectors to modern industries that enhance and foster economic growth. It could also act as a stimulant to entrepreneurial activity by raising confidence and providing alternative new sources of financing.

Once established, the supply-leading and demand-following characteristics of the financial market would interact. The private sector would develop with the initial use of resources provided by the financial instruments as it grows. The demand-following characteristic would gain in importance and eventually the financial market would operate independently. The promotion of financial markets is viewed here as a means of encouraging savings, a channel for efficiently allocating scarce resources and as an engine for economic growth.

As new industries merge and traditional ones expand, economic growth would take place. Additional savings would be generated and larger and more efficient and profitable projects would be undertaken, further stimulating economic growth.

However, if active promotion of financial markets is made public policy, development of these markets may not stimulate investment or assist in resources allocation, since larger firms which are the most beneficiaries from a well-developed market already have access to financial resources either by private issues or by institutional financing. Furthermore, the argument that resources will be allocated to the most efficient producers who are the most successful in business, may not be valid whenever monopoly power and government protection often determine course of business. The lack of information may lead to a lack of confidence in the markets, thus crippling their effectiveness and even the ability to operate with little or no government support. Therefore, if development policies based on "strong" financial markets are adopted, one should be aware of the potential problems and pursue policies aimed at avoiding them.

Financial deepening refers to the evolution of a financial market from a non-existent or fragmented system with few participants (and no secondary market) to a well-developed market offering a wide range of financial services for both the saver (investor or lender) and the borrower. With financial deepening, an active secondary market ensures anytime-liquidity of financial instruments and promotes confidence of savers (investors) in it. To promote the channelling of savings (deposits) for investments, financial deepening is a necessary, though not sufficient condition for enhancing economic growth, as it still could be hampered by financial repression emanating from various policies such as interest rate ceilings or maintaining artificially low interest rates, policies resulting in high levels of inflation, and, last not least, policies of a tax system that discriminates against income from financial assets. Financial repression prevents financial deepening from taking place, thus causing the economy to miss viable investment opportunities.

The criticism expressed on pages 10 ff. and elsewhere in this study regarding low interest rates in ESCWA countries under review, and hence the shortage in investment funding, would not be justified if financial deepening existed in the markets of these countries. However, financial development can be measured by certain financial ratios, mainly:

- (1) the ratio of money supply M1 related to money supply M2;
- (2) the ratio of private savings related to money supply M2; and finally
- (3) the ratio of money supply M2 related to GDP.

The first ratio indicates cash and near cash (currency in circulation plus sight deposits) related to the sum of savings and time deposits. The lower the ratio the higher the savings and time deposits and thus the more the use of the financial and banking system by the public for investing in non-cash assets. Consequently, the more sophisticated and deepened the structure of the financial system will be.

The second ratio indicates the share of private savings in total sum of savings and time deposits. The higher the share the higher the ratio and thus the higher the interest of the public in saving and consequently the more extensive the use of the financial system for this purpose. Therefore the larger the ability of the system will be in mobilizing financial resources for use for mid- and long-term investment and financial assets. Hence, the more sophisticated the system will develop.

The third ratio indicates the relation between the country's available "financial liquidity" (cash, near-cash and other related financial assets) and the GDP. The higher the liquidity the more conservative the involvement of the financial and banking system in mid- and long-term investment in financial assets, and thus the smaller the participation of this system in the country's investment and capital formation activities.

While these ratios provide an indication of the deepening of one country's financial system over time, there is no a-priori reason to compare ratios between countries. Other factors, such as savings habits and level of initial financial sophistication would only distort such a comparison.

Table II.15 shows that "financial development" has been more sophisticated in each of Bahrain, Jordan, Kuwait and the UAE than in Syria and the YAR.

Table II.15 Indicators of Financial Development in Selected
ESCWA Countries, 1975-1984

	<u>M1/M2</u>	<u>PS/M2</u>	<u>M2/GDP</u>
<u>Bahrain</u>			
1975	0.33	0.27	0.50
1980	0.37	0.74	0.36
1981	0.34	0.41	0.43
1982	0.34	0.13	0.45
1983	0.30	0.11	0.46
1984	0.29	0.11	0.44
<u>Jordan</u>			
1975	0.78	0.08	0.92
1980	0.60	0.29	1.01
1981	0.59	0.25	1.00
1982	0.56	0.15	1.04
1983	0.54	0.10	1.12
1984	0.50	0.09	1.15
<u>Kuwait</u>			
1975	0.32	1.08	0.26
1980	0.23	0.45	0.38
1981	0.31	0.69	0.57
1982	0.28	0.29	0.73
1983	0.25	0.21	0.68
1984	0.20	0.09	0.70
<u>Syria</u>			
1975	-	-	-
1980	0.91	0.34	0.46
1981	0.89	0.26	0.47
1982	0.88	0.21	0.47
1983	0.88	0.21	0.59
1984	0.86	0.09	0.69
<u>UAE</u>			
1975	-	-	-
1980	0.31	1.38	0.21
1981	0.31	1.20	0.24
1982	0.29	1.01	0.29
1983	0.25	0.41	0.35
1984	0.19	0.31	0.45
<u>YAR</u>			
1975	0.83	1.30	0.81
1980	0.87	0.25	0.68
1981	0.85	0.29	0.69
1982	0.87	0.04	0.74
1983	0.88	0.02	0.86
1984	0.89	0.01	1.02

Source: ESCWA calculations from various national sources.

In the first group of countries, M2, particularly its savings and time deposits component, has increased faster than M1 (cash and near-cash). In Bahrain, Jordan and Kuwait there has been even a decrease in M1 in some years that has been almost equal to a simultaneous increase in savings and time deposits, thus indicating a movement from liquid assets to "investment assets", i.e., to mid- and long-term investments. This development indicates an increased awareness of the public of the benefits of using the financial and banking system as an investment vehicle. Such a development could be said neither for Syria nor the YAR. While in Syria the ratio has decreased only slightly, namely from 0.91 in 1980 to 0.86 in 1984, it has increased in the YAR. The development of the ratio in both countries indicates, though with different degrees, that the public still prefers holding cash assets instead of saving and investment deposits.

In all of the six countries, the share of private savings in total sum of savings and time deposits (M2) has decreased rather than increased.

The M2 to GDP ratio has increased overall, thus indicating a respective further deepening of the financial and banking system in these countries. However, for Jordan and the YAR, the increase also indicates a higher than "normal" level of liquidity of the system and consequently a rather cautious attitude in investing in mid- and long-term assets.

(2) Banking Markets

(2.1) Development of the Banking System in ESCWA Region

The modern bank in ESCWA region is a western innovation. It was first introduced in Egypt by the British in the later part of the last century. The first Egyptian-owned bank, Bank Misr, was established in 1920 and shareheld by some 120 wealthy Egyptians. Initially the bank dealt mainly with agricultural lending, but evolved later to perform some businesses of a development finance institution. Bank Misr "success" attracted the attention of other countries in the region. In 1929, Syria sent a delegation to Egypt to study the bank's structure and working arrangements. Bank Misr provided some technical assistance to Syria in establishing Banque de Syrie et du Liban, which performed the businesses of a central bank for Syria and Lebanon.

The first owned Arab commercial bank to be established in ESCWA region was the Arab Bank, founded by Abdul-Hamid Shuman in Jerusalem/Palestine in 1929. During its first years of business, Arab Bank customers were mainly small businesses and private persons. Being as conservative as its founder, Arab Bank lending policy was (and still is) a restrictive and selective one. The Bank prospered - even in the wake of many political turmoils resulting in the loss of many of its assets - and has grown to become in 1985 the second largest private commercial bank in ESCWA region in terms of assets as well as deposits,^{1/} and one of the largest 500 banks in the world in terms of total assets (see Table II.16). The Arab Bank, headquartered in Amman since 1948,

^{1/} The largest private commercial bank in the ESCWA region is the National Commercial Bank of Saudi Arabia.

has branches throughout ESCWA region - except in Kuwait, Iraq, Syria and South Yemen - and affiliates, subsidiaries and branches in almost all financial centres of the world.

After gaining independence from Western colonial powers, many ESCWA countries took control over the banking infrastructure. Nationalization of banking industry was seen as a means of eliminating foreign influence. Egypt nationalized its banks in 1961, and Syria followed suit during its union with Egypt in the United Arab Republic. In 1965, Syria integrated all banks operating in the country into the Commercial Bank of Syria, two development finance institutions and a postal savings fund. Iraq established the Rafidain Bank in 1941. Other privately-owned banks were allowed to operate until 1964 when they and all other segments of the banking and financial system were nationalized. A consolidation of the banking system gradually occurred that ultimately left the Rafidain Bank as the only commercial bank in Iraq. South Yemen nationalized all financial institutions, including banks, in 1969. Foreign banks were merged into the National Bank of Yemen.

In Saudi Arabia, modern banking started in 1925 when a branch of the Dutch Trade Bank opened offices in Jeddah, mainly to serve Mecca Pilgrims coming from Indonesia which was then a Dutch colony, and Dutch ships passing through the Red Sea. Foreign-owned banks that increased in number and presence in Saudi Arabia after the 1973/74 oil price increases, were required starting in 1975 to be jointly owned with Saudi nationals with these sharing at least 60 per cent of the bank equity. This process was completed in 1983. A similar arrangement exists in Oman, which requires a minimum of 51 per cent Omani ownership in any bank.

Bahrain, Jordan, Lebanon, Qatar and the YAR permit foreign-owned banks to establish branches that operate alongside domestic banks. Bahrain began establishing an offshore banking and financial centre in 1975 and has been enjoying ever since the status of an important regional financial centre. However, with the decrease of oil prices in the last few years, and its subsequent effects on banking business in the Gulf region, some international banks and financial institutions that established presence in Bahrain, have withdrawn from the country; others have reduced operations and staff, and some others are rethinking their future presence.

The banking system in Jordan started effectively into being after the relocation of the Arab Bank from Jerusalem to Amman in 1948. By 1975 there were 13 commercial banks in Jordan with only 18 branches. By early 1984, there were 18 commercial banks, 8 of which foreign, with over 200 branches along with 4 mortgage houses, 7 financial and investment institutions and 7 specialized banks and institutions. By end 1985, the number of branches of these banks and institutions has increased to 281, thus reaching almost every urbanized area in Jordan. With the "mobile bank" of the Housing Bank of Jordan, the Jordanian banking system is now present in every village and available to every segment of the population in the country. In addition to these banks and institutions, there has been by end of 1985 11 representative offices of foreign banks and 75 money changers with 42 located in Amman.

Kuwait's banks are wholly-owned by Kuwaitis. This is due to a banking policy designed to prevent any foreign participation in the country's domestic banks. Kuwait has a relatively active money and capital market, due largely to the oil revenue surpluses and the increased use of the banking and

financial system by Kuwaiti and foreign citizens. Kuwait's success in developing its banking and financial system along with the success of other Gulf countries has come largely at the expense of Lebanon, which before the Civil War that has been going on since 1975, enjoyed the most developed banking system in the region. Domestic and foreign banks flourished in Beirut that used to offer a relative political stability. The onset of the Civil War in 1975 coincided with the advent of major oil revenue surpluses in the Gulf region and eliminated the possibility of Lebanon becoming a more sophisticated regional banking centre. Most domestic banks, however, have relatively adapted to the Civil War with many expanding and establishing branches in various sections of the city and suburbs. Few of these banks have left the country and some have sold assets, including loans, and closed offices.

Contrary to Kuwait, Qatar as well as the UAE permit foreign banks to operate in the country. There are 16 banks operating in Qatar of which only 5 are locally-owned and incorporated. In the UAE, Dubai's merchants had long been performing some banking services such as lending and trading in "acceptances" as part of their business. Before 1960, the Dubai Sheikdom had only two banks which, however, were British serving mainly the British community. Shortly after founding the United Arab Emirates, in the early seventies, a UAE-currency Board, a sort of a central bank, was established in 1973. In 1980, a UAE Central Bank took over. Due to some irregularities and lending practices of some commercial banks and financial institutions that led some of them to face financial difficulties, the UAE Central Bank had imposed in the last few years strict reporting procedures and lending guidelines and began reducing number of branches of foreign banks in the country. The UAE with around 30 foreign banks in addition to the domestic ones has been considered an overbanked country. To cure problem banks, the UAE Central Bank has been encouraging these banks to merge with other "healthier" ones.

The establishment of the Yemen Bank for Reconstruction and Development in 1962 introduced the YBRD to the banking world. The YBRD acted as a commercial bank, development bank and central bank until the Central Bank of Yemen was established in 1971. In late seventies, foreign-owned banks as well as joint-partnership banks were allowed to operate in the country along with newly-established Yemeni development finance institutions. Today, the YBRD operates as a commercial bank only with branches throughout the country.

(2.2) Current Banking Situation in ESCWA Region

The banking system in most of ESCWA countries has been further developed and refined during the last ten years mostly due to abundant oil revenue surpluses of oil-exporting countries in the Gulf.

Today, the system includes in most of ESCWA countries central banks, commercial banks, investment and merchant banks and companies, specialized financial and banking institutions and others.

The involvement in international banking and finance activities, the hiring of "sophisticated" international bankers and expertise and the management contracts these banks and financial institutions have made with major international banks and finance houses in Europe and the USA, have assisted them in becoming more sophisticated in performing not just domestic banking and financial business, but also international. Modern banking technology adopted by some of them has made banking more comfortable and attractive to customers, and developed banking habit in the public.

The last decade's sudden financial wealth of the Gulf countries and its spillover to other ESCWA countries have been larger than the national economies of these countries could first use. This can be attributed to the Gulf countries low absorptive capacity, and the absence of suitable and competitive business opportunities and reliable investment climate to make full use of the spillover potential in the other ESCWA countries with higher absorptive capacity.

In addition to major international banks and financial houses that have been attracted by the abundant banking and financial business opportunities in ESCWA countries, especially in Bahrain's offshore centre and the UAE, major ESCWA banks and financial institutions have become a vehicle for recycling the region's financial assets (or petrodollars) to Western countries and international financial centres, instead of establishing the potentials for gradually facilitating the transfer of oil revenue surpluses of the Gulf countries to other ESCWA countries.

Also by taking a position of an intermediary between ESCWA private investors and small banks and financial houses on the one side and major international banks and financial institutions on the other, major ESCWA banks and financial institutions have played the same role major international banks have played in the process of recycling. In fact, while between 75% and 85% of total liabilities of major ESCWA (Arab) banks come from ESCWA countries, only 30% to 40% of their total assets are employed in ESCWA countries.

This low degree of involvement of major ESCWA (Arab) banks in investment and finance activities and accordingly in development finance business within the region, is underlined by the fact that out of total Arab external debt of around US\$135 bn. at end of 1985, the maximum Arab banks' exposure to Arab countries has been just US\$ 13 bn., or around 9.6%.

On the domestic level, the economic problems that have surfaced in the region in the past three years, have exposed ESCWA (Arab) banking and financial businesses to a number of difficulties. They have showed how sophisticated Arab banking and financial management in general is: ESCWA countries have not been able to develop a solid banking infrastructure, be it in terms of integrated banking and financial systems, qualified bankers and financial managers, efficiently diversified banking and financial businesses or, in terms of innovation and imagination in these businesses.

The current banking situation in ESCWA region might be described by the following statements: In the so-called "unusual decade" of abundant financial wealth, the absence of clear and precisely defined legal, accounting and auditing systems was not a worry. Contracts were unscrutinised, details were ignored and risk scrapped from the vocabulary of Arab bankers. "Everybody was making money". The majority of Arab banks and financial institutions were set up in the seventies and early eighties, often as extensions of family trading empires, or reflections of similar interests of some individuals to finance flourishing trade and construction business which these families and individuals were quick to catch on to. Lending was the major activity of these banks and financial institutions. While the boom in trade and construction lasted, these banks and institutions did not need to look beyond it, nor did they acquire the expertise to do so. They were willing to lend funds on the basis of name rather than balance sheet, and they were serving mainly interests and businesses of their major shareholders.

Almost all banks and financial institutions with such lending and business policy have been affected by the fall in oil revenues and the resulting drop in government spending. The fall in domestic private loan portfolio of these banks and financial institutions reflects the economic slow-down in the ESCWA countries. The contra accounts of most banks have slumped, thus reflecting decreasing trade, in relative terms, however.

The ESCWA countries private sector is fundamentally weak, and there is almost no other market than the one provided by the governments. The market for the depressed construction, contracting and trade business is dictated by the governments or by the corporations and companies in which the governments own a majority of their equity or an important stake of this equity.

Under the present economic conditions, good lending opportunities have become rare and there is not only the vexed problems of collateral, but also that of good projects. Faced with limited lending opportunities and mounting non-performing loans, major ESCWA banks have been questioning the basic rationals behind their operations, as a major proportion in the drop of their profits is due to the increased provisions for non-performing loans.

Due to this situation ESCWA banks and financial institutions face, and due to the limited business finance opportunities presently available in ESCWA region, larger ESCWA Arab banks, especially those located in Bahrain, Kuwait and Saudi Arabia in addition to the Arab Bank of Jordan, have begun diversifying their business by turning their focus away from commercial banking to investment and merchant banking and other financial and investment advisory services. Some of these banks have also sought to expand abroad and be physically present in major international banking and finance centres. Some others sought expansion through acquisition by buying already established banks and financial institutions with a viable customer base. A third group of banks sought the expansion simply by jumping on the fee income band wagon, although almost all world banks are doing the same. In fact, these banks have been confronted with the basic question as to what they have to offer in these areas of international banking and finance, since they neither have a solid foreign customer base nor the expertise to compete in this business. On the other hand, the securitization, globalization and deregulation of markets, institutions and instruments are the basic scenes characterizing the new era of international banking and financial business, and demanding strategic thinking and carving out market niches which are not the areas for banks that are not imaginative and do not possess or attract the necessary expertise.

Table II.16 The Largest 20 ESCWA Arab Commercial Banks in Terms of Assets in 1985

Bank	Assets (US\$ Mn)	Total Deposits (US\$ Mn)	Pre-Tax Profits on Assets (%)	Net Interest on Assets (%)	Capital Assets Ratio (%)	Growth in Pre-Tax Profits 1984-85 (%)	Total Employees	Pre-Tax Profits Per Employee (US\$)	Growth in Assets 1984-85 (%)	Rank Among the World's TOP 500
	33387	30862	2.99	...	4.47	30.01	12560	74309	15.27	77
	(US\$ Mn)	(US\$ Mn)	(%)	(%)	(%)	(%)	(Number)	(US\$)	(%)	1985
1. Rafidain Bank (Iraq)	15101	877	0.18	...	5.81	80.41	6429	4244	-5.12	150
2. National Commercial Bank (Saudi Arabia)	13066	1188	1.00	2.46	9.09	0.91	4820	25104	18.19	168
3. Arab Banking Corporation (Bahrain)	11738	576	0.80	102	4.91	14.64	3500	25383	10.86	180
4. Arab Bank (Jordan)	11223	823	1.56	150	1.47	5.41	7433	21333	23.00	185
5. National Bank of Egypt (Egypt)	9827	170	...	...	...	...	13000	...	...	214
6. Bank Misr (Egypt)	9344	172	...	...	1.85	...	3228	...	...	227
7. Commercial Bank of Syria (Syria)	8962	696	0.88	...	7.76	17.07	1938	41065	2.88	235
8. National Bank of Kuwait (Kuwait)	8486	1079	1.65	...	12.72	-14.34	5109	27843	6.79	244
9. Riyadh Bank (Saudi Arabia)	7741	715	0.90	...	9.24	4.85	487	139363	5.34	261
10. Gulf International Bank (Bahrain)	6301	540	0.00	...	8.57	...	1028	...	...	305
11. Gulf Bank (Kuwait)	5993	610	1.04	124	2.20	10.18	7553	7779	13.95	321
12. Banque du Caire (Egypt)	5944	501	0.24	102	1.69	1.16	1185	12151	2.63	325
13. National Bank of Abu Dhabi (UAE)	5661	436	0.00	...	7.70	...	1397	...	-4.95	331
14. Commercial Bank of Kuwait	5232	405	0.25	...	3.37	...	702	19273	-0.04	350
15. Al-Ahli Bank of Kuwait (Kuwait)	5133	639	2.10	128	2.63	12.45	722	141458	12.19	362
16. National Bank of Dubai (UAE)	4445	248	0.60	51	1.16	5.58	632	41930	...	405
17. Arab-African International Bank (Egypt)	4003	109	1.31	46	1.27	2.71	6381	7388	...	439
18. Bank of Alexandria (Egypt)	3840	398	1.26	...	10.37	-39.02	1434	33375	0.73	452
19. Saudi-American Bank (Saudi Arabia)	3692	262	0.84	...	7.10	-36.47	1910	15858	3.79	462
20. Al-Bank Al-Saudi Al-Fransi (S. Arabia)										

Source: Euromoney Magazine, June 1986.
The Banker Magazine, July 1986.

(2.3) Islamic Banking

Islamic banking is a relatively new creation in the banking and financial system in ESCWA region and in the world.

Most Islamic banks and financial institutions were created in mid-seventies and early eighties during the era of abundant financial wealth in the Gulf and other Arab oil-exporting countries. Islamic banks and financial institutions base their operations on Koranic Law or Sharia. They install a religious committee or advisor to guide management in the operational process of decision making, since the conformity of banking and financial practices to religious standards is often nebulous. All agree, though, that interest or "riba" is forbidden.

Islamic banks, so far, seem not to have been facing great difficulties in attracting depositors. Some scholars even argue that Islamic banks have attracted savings into the banking system that otherwise would not have been possible, and instead would have continued being hoarded by devoted Moslems who oppose dealing with interest-paying banking practices.

So far, Islamic banks have proved to be relatively successful in performing their business. But they still face problems in finding or accepting projects whose financing must strictly coincide with Islamic banking principles (see exhibit at the end of this section).

While Islamic banks in ESCWA region have been relatively successful in business, this has not been the case with Islamic banks and financial institutions in international financial markets or "un-Islamic communities", where the whole (retailing as well as wholesaling) banking and financial business is traditional and based on the interest rate codex. These "outsider" banks have often found themselves unable to participate in typical banking businesses, and were therefore often excluded from or losing profitable banking and financial business opportunities.

For example, the Dar Al-Mal Al-Islami (DMI) investment bank established in 1981 with headquarters in Geneva (Switzerland) has often found itself confronted with the decision either dealing with the Euromarkets as they are or being excluded from these markets altogether. The DMI sustained from becoming involved in most of these markets businesses and turned its focus on (speculative) future market businesses, particularly in gold and commodities, which, however, are still an area of debate as to whether they conform to the Islamic banking principles.

On the other hand, Kuwait Finance House (KFH) in which the Kuwaiti government has a majority stake, and has attracted large deposits during the first few years of operations and at one time took around 10% of all new deposits in the Kuwaiti financial system, has found out recently that due to its large losses in real estate business and Suk El-Manakh, the remaining local business that may conform to Islamic banking principles is no longer sufficient to achieve the bank's objectives of islamization of the Kuwaiti financial system, especially as the KFH has made no profits for more than 3 years.

It could be assumed, however, that if Islamic banks and financial institutions are furnished with modern and capable management they can still find a potential for growth in ESCWA region. In fact, Islamic banks can play a major role in development finance, as most Islamic banking principles are in harmony with development banking and finance principles. However, the interest rate has an important role in the process of efficiently allocating resources, according to typical banking practice. Interest rate is the "cost" of borrowing money. Available funds are "rationed" according to which project can afford this cost. Only the most profitable projects will be undertaken. Entrepreneurs and project managers have strong incentives to keep costs down and operate efficiently. In the absence of interest payments, borrowing money may be considered "free", and profit and efficiency incentives may not be as strong. Without interest rates upon which to base project selection, the most efficient projects may be discarded for projects with less economic desirability. Funds might not be put to their best use. Islamic banks can avoid this, however, by choosing projects carefully and becoming more directly involved with their management. Nevertheless, their activities will not be the same as those of typical banks, and their management and operational costs will generally be higher.

EXHIBIT

Islamic Banking and Financing Principles

A discussion of Islamic banking and financing principles cannot be exhaustive, nor are only certain types of principles that are Islamic. The principles described in this exhibit were developed by Islamic banks and financial institutions, but there are many kinds of traditional banking and financing principles that can be modified to fit within the limits of Islam. Indeed, nearly any kind of banking and financing that can be done by traditional banks and financial institutions can be restructured so as to be acceptable to Islamic banks and financial institutions.

1. Murabaha (Trade-financing)

Cost plus transaction, under which the client asks the bank to buy a specific commodity and promises to purchase it from the bank with the addition of an agreed surcharge. Repayment can be deferred, and in instalments.

Explanation: When a company with traditional banking relationships wishes to purchase raw materials or inventory for which it does not have the funds to pay the purchase price, it will typically borrow the amount of the purchase price from its bank, which may take a charge or lieu against the goods purchased and require the company to repay the amount borrowed plus an agreed amount of interest.

An Islamic institution cannot extend such a loan but it can help the company to make the purchase by buying the goods from the supplier and selling the same to the company at a profit. The company, instead of repaying the principal amount of the purchase price plus interest to a bank, simply pays the Islamic financial institution for the goods purchased on an agreed date.

The critical difference between a Murabaha financing and traditional purchase financing is that the Islamic institution in a Murabaha must take title to the goods in question and transfer that title to the ultimate purchaser. However, this passage of title raises questions of defects in title, claims, risk of loss, and insurance that must be carefully considered in the Murabaha contract.

2. Musharaka (Joint ventures)

Partnership or participation in capital with profits and losses shared, often for limited period only, with bank phasing out its participation.

Explanation: If a company has a project or business opportunity that requires both financing and management assistance, it may find an Islamic institution willing to enter into a partnership, or Musharaka, arrangement whereby the company and the Islamic institution are partners in the true sense, sharing management authority, profit and losses, according to an agreement made when the partnership is formed. This is Islamic finance in pure sense, in that it carries out the fundamentals of sharing and putting wealth to productive use. The considerations in entering into a Musharaka arrangement are the same as the considerations in any joint venture or partnership. The parties must address the general questions of what the partnership is intended to do, how it will be managed, how the profits and losses will be shared, and how the arrangement can be terminated (either by the passage of time, by actions of the parties, or on the occurrence of specified events).

3. Mudaraba (Profit-sharing finance)

A contract whereby one party provides capital which the other uses for trade purposes, with profits shared in a ratio agreed beforehand. Losses resulting from normal trade are borne by the investor.

Explanation: For companies that require financial assistance, but not management or administrative assistance for a project or business opportunity, Islamic institutions have available the Mudaraba contract, in which the Islamic institution provides the necessary financing and agrees to share profits with the project manager according to a formula - but to absorb all losses from the project or venture. Because of this feature of sharing profits but absorbing all losses, the Mudaraba contract will have little practical application other than for customers with whom the Islamic institution has had extensive experience.

4. Ijar wa iktina (Leasing and hire purchase)

A contract of lease and/or hire under which the user usually ultimately purchases the item.

Explanation: Leasing and hire purchase arrangements that do not contain references to interest rates or payments are also ideal Islamic finance vehicles, as they provide the Islamic institution with non-interest income from an asset that is being put to productive use by the lessee. There are not necessarily great differences between an Islamic lease and a traditional lease, but there are certain requirements of the Islamic lease that prevent it from being misused by those who would "lease" almost anything in order to comply technically with the requirements of Islam. Specifically, the Islamic lease for hire purchase contract must involve an asset being put to real use rather than a dormant asset that is leased as a matter of convenience; the term of the lease must be related to the life of the asset in question; and the asset cannot be used in connection with activities or products prohibited in Islam.

The foregoing explanations of the types of Islamic banking and financing principles are very general, but it should be borne in mind that nearly every traditional commercial transaction involves a sale, a lease, a sharing arrangement or some combination of those elements. No matter how sophisticated and complex financing transactions may have become over the years, therefore, virtually all of them can be dissected into simple components and reconstructed to fit within one of the accepted general forms of Islamic contracts.

(3) Capital Markets*

(3.1) Requirements of a capital market

Capital markets exist whenever and wherever exchange and/or issuing of securities take place.

Capital markets are typically regulated by law and usually have a governing body. In well-developed capital markets new issues (securities) will be subscribed and underwritten in the primary market, but dealing with them and with old issues, as well, takes place in the secondary market.

The establishment of a viable secondary market has often been a problem in developing countries due mainly to the inability of most of these countries, firstly, to exactly define objectives and means of a secondary market and; secondly, to develop and attract contributors and participants in these markets, be they market makers, or dealers, or agents; and thirdly, to establish the necessary regulations, rules and procedures that efficiently and accurately control, determine and direct activities of the market and support its further development.

These complications have been an impediment in the way of developing capital markets in ESCWA countries, since in the absence of a viable secondary market, securities of longer maturities would not be marketed and accordingly would not become marketable securities in order that they be considered liquid assets by the investors (savers) and become attractive investment instruments to them.

Emerging capital markets therefore encounter a number of complications. On the demand side, securities, if unmarketable, are viewed as less liquid than other instruments of savings, and as savers are normally unfamiliar with the market's financial instruments, they are reluctant to purchase them; information is not adequate and there exists no wide range of instruments that can satisfy savers' demands. On the supply side, selling of stocks or bonds is often interpreted as a loss of management control, either perceived or real. Also, entrepreneurs are often unwilling to provide necessary information on a regular basis about their companies.

* For further details see section (5) of this chapter, Oil Revenue Surpluses and Financial Markets in ESCWA region.

These complications are found in the ESCWA region. In addition to the legal restrictions imposed on doing business by foreigners in some capital markets in the region, these complications have been considered important justification for foreign investors not to participate on a large scale in the business of local capital markets and thus provide support for their further development.

Savers' confidence is an important ingredient for the success of a capital market, and is partially determined by political stability and a relatively unfettered private sector. Although governments may encourage development of capital markets, for instance, by designing for these markets a "liberal regulatory policy" or by assisting in new issues either by participating in these issues to encourage private sector to follow suit or by being themselves the issuers while leaving management of the issues to the private sectors, it is ultimately the private sector that determines degree of success of these markets.

But in order to flourish and become a medium of originating, organizing and allocating funds for investment and development finance, capital markets need be bedded in a free market economic system with political stability and a strong private sector.

In the countries under review, but also in other ESCWA countries, the degree of private sector activities measured by its share in GDP, varies from country to country. The private sector in Kuwait, Bahrain, Qatar, Saudi Arabia and the UAE undertakes major economic activities except in the oil industry which is controlled by the government. In Jordan, although the authorities encourage private sector activities either by following a relatively liberal economic and monetary policy or by refraining from direct interference in management and business policies of the sector, the public sector still controls industries considered strategic for the "development" of the country, such as the phosphate and touristic industries. The public sector, however, participates in private sector projects that need a large capital base which the private sector alone is not willing to consider or thinks of it as risky to be undertaken. A capital market already exists in Jordan. The Amman Financial Market, though still small regarding volume as well as value of stocks traded, is becoming more and more sophisticated with a relatively well organized parallel market.

In Syria and Iraq, the private sector is very peripheric. There exists therefore no capital market in both countries. In South Yemen, a private sector does not factually exist. In Egypt, although private sector has been strongly encouraged in the last few years to participate in the country's economic activities, there still exists no capital market. In the YAR, although private sector is increasingly becoming active in business life, the absence of public shareholding companies and the lack of skilled professionals in banking and finance have been an obstacle to even think of establishing a capital market.

(3.2) Recent Developments in Capital Markets in ESCWA Region

Actually, there are only two local capital markets in ESCWA region of which one is in Jordan and the other in Kuwait. But there is also the Bahraini offshore market which has become a useful regional one. The Amman Financial Market in Jordan which was established in 1978, is still "small"

regarding volume as well as value of stocks traded, but it offers a wide range of stocks of listed public shareholding companies and a few development bonds in the parallel market. However, there are no market-makers (in "real sense") who must have a specified minimum of capital and guarantee with this capital trading operations of their stock portfolio, nor are bid and offer prices fixed in the market according to supply and demand but rather arbitrary in the scene.

The Kuwaiti stock market, on the other hand, although older than the Amman capital market and trades other securities in addition to stocks of listed public shareholding companies, still faces two main issues that handicap its further development:

1. *The collapse of the so-called Suk El-Manakh, which was a market for speculation with post-dated cheques in imaginary companies, has strongly deteriorated confidence of the public in trading in corporate stocks in general, especially as most of Kuwaiti public shareholding companies were involved, directly or indirectly, in the Suk;*
2. Limiting trading in and ownership of corporate stocks to Kuwaiti nationals has taken away the possibility that non-Kuwaitis, be they investors or market makers or dealers or agents, may have used their market participation to assist in the market development by, for instance, initiating new market instruments, operations' mechanisms or organizational procedures and regulations.

Co-operation between capital markets in ESCWA region, namely between the Amman Financial Market and the Kuwaiti Capital Market is thin and limited to exchange of information about volume and value of stocks traded. Efforts to strengthen the co-operation in the wake of proposed free capital flows among ESCWA countries have failed, mainly for political reasons, but also for the failure of these markets to place and list bond issues of Arab banks syndicated loans for - at least - Arab borrowers, that could have enabled them to have their debt or equity securities be traded, and accordingly could have enabled them to raise further long-term funds.

Following is a short summary of recent developments in capital markets of ESCWA region.

Bahrain

There is still no formal stock market in Bahrain. But the country's government is working on plans to establish a Bahraini stock exchange. However, there is a local share market where shares (stocks) of Bahraini public shareholding companies are traded on a limited scale on basis of trust and personal relationships. A bond market which was supposed to emerge when the government issued so-called bonus bonds in 1977, 1978 and 1983 which was largely accepted by the banks and the pension fund, did not realize. The stock exchange section at the Ministry of Commerce and Agriculture monitors trading in stocks of around 20 public shareholding companies and some 15 so-called exempt companies which together make up a market capitalization of around BD 2 bn. Settlement of transactions is on a cash and carry (CC) basis and the share certificates change hands only on receipt of payments.

The government has been consulting the International Finance Corporation (IFC) to study the present system of share dealing and to report on the feasibility of developing a Bahraini stock exchange. First measures sought for this development would aim at drafting a capital market law, establish measures designed to improve existing information system and then subsequently setting up a traditional trading floor. Increasing mechanization of trading and information system could follow at a later stage if it proves justifiable by a respective volume of trade. An eventual complete automation of trading would depend on the expansion of the market into a regional or international stock market.^{1/} The informal Bahraini share market potential is limited partly due to the small number of the country's population. A large demand does not exist even though nationals of countries of the Gulf Co-operation Council are allowed to participate in the market. Another factor limiting demand is the relatively low per-capita income of the Bahraini compared to that of per capita income in other Gulf countries.^{2/}

On the supply side, even though Bahrain is encouraging private sector activities, the non-oil sector, except banking, remains small. Therefore, the number of local corporates that might be considered candidates for issuing securities, remains limited.

Jordan

The Amman stock exchange (or the Amman Financial Market - AFM as it is officially called) exists since 1978. It regulates some important administrative aspects of a capital market including "dealers'" admission procedures, dealers' profit and commission rates, rules for processing transactions, fines on violations and, reporting procedures.

The AFM endeavours to instil confidence in both small and big investors. In fact, the market has experienced the relatively most qualified and fastest development among other capital markets in ESCWA region. The volume of trading has increased from 2.5 mn. shares valued at JD 5.6 mn in 1978 to 31.25 mn. shares valued at JD 64.23 mn in 1985. The growth, however, has experienced over the years the usual ups and downs of financial markets, depending on economic conditions, level of interest rate and market expectations of market participants, particularly the investors. During the last years (1981-1983) of the boom period that lasted from 1974 to 1983, the volume of trading increased from 29.23 mn. shares valued at JD 75.42 mn in 1981 to 34.60 mn. shares valued at JD 112.25 mn. in 1982 (Table II.17). This represents an increase of 48.8% in value and 18.4% in number of shares traded. In 1983, however, the increase over 1982 was modest, namely just 6.6% in value and 5% in number of shares traded. But in 1984, with the side-effects of the economic recession in the Gulf oil-exporting countries, there was a considerable slowdown in economic activity. Trading in shares slumped by around 22.2% in number to just 28.25 mn. shares and by 55.6% in value to just JD 53.9 mn. The revival of the AFM in 1985 with an increase of 10.6% in number of shares traded and 21.2% in value of these shares may be attributed to the hitherto positive effects of government policy.

^{1/} Bahrain Monetary Agency, Bahrain: An International Financial Centre, 1984.

^{2/} Per capita income in 1982: Bahrain: US\$8,000; Kuwait: US\$20,000; UAE: US\$22,000; Saudi Arabia: US\$9,400; Qatar: US\$18,000.

However, the development at the AFM ought to be seen in light of the following perspectives:

1. The 1982/81 large growth of 48.8% in value of traded shares but the modest growth of just 18.% in number of these shares can be attributed to overpricing (i.e., speculation) of (in) these shares;
2. The 1983/82 growth of 6.6% in value of traded shares and 5% in number of these shares, that corresponds to an increase of JD 7.36 mn. in value for 1.72 mn. additional traded shares, is rather the normal course of the hitherto experienced growth in value as well as in number of trading.
3. The 1984 sharp drop in value as well as in number of traded shares indicates a sharp drop in prices of these shares and a "stillstand" combined with a decline in the trading itself.
4. Both the stillstand and decline in trading indicate that either capital flight occurred or there is still enough liquidity available in the country but that this liquidity has filtered into private hands, i.e., commercial banks, thus increasing the liquidity of these banks. In fact, this and the stable level of profitability of the banking sector over the last few years, in contrast to the deteriorating level of profitability of other sectors, have qualified stocks of banks and some other financial institutions to be the only stocks traded in 1985 with increase in value as well as in number.

Table II.17 Development of Trading in Stocks in the Amman Financial Market, According to Sectors

	Value of traded stocks in JD Mn.					Number of traded stocks in JD Mn.				
	1981	1982	1983	1984	1985	1981	1982	1983	1984	1985
Industry	32.07	32.83	20.89	14.65	11.85	13.90	14.70	13.31	12.38	9.93
Banking	28.90	49.09	86.94	33.04	47.09	9.83	10.97	16.41	10.73	15.72
Services*	7.83	14.52	6.64	2.82	2.81	4.63	7.10	5.17	3.19	4.22
Insurance	6.62	8.81	5.14	2.58	2.57	0.87	1.83	1.43	1.95	1.38
	<u>75.42</u>	<u>112.25</u>	<u>119.61</u>	<u>53.09</u>	<u>64.32</u>	<u>29.23</u>	<u>34.60</u>	<u>36.32</u>	<u>28.25</u>	<u>31.25</u>
Development in percentage of trading in stocks in the AFM.										
%	82.00	48.80	6.60	-55.60	21.20	63.30	18.40	5.00	-22.20	10.60

Source: Central Bank of Jordan, Annual Report, 1985.

* Include tourism, hotel industry, electricity companies and some investment companies.

Except for the slump-year 1984 where value as well as number of traded shares of all other sectors (which are industry, services and insurance, as classified by the AFM) decreased, stocks of banks and most other financial institutions have been the only stocks that have experienced a steady upward trend over the last five years, in value as well as in number of traded stocks.

A parallel market also exists in Amman where shares of companies not listed in the AFM are traded. Trading in this market has declined dramatically at the start of the recession in 1984 and continued with the same intensity in 1985 (Table II.18).

Table II.18 Development of Trading in Stocks in the
Amman Parallel Market, 1982-1985

	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Number of traded stocks (Mn. stock)	11.24	24.82	12.57	6.05
Value of traded stocks (JD mn.)	16.04	21.82	6.23	2.41

Source: Central Bank of Jordan, Annual Report, 1985.

This development is of no surprise as these companies which are not obliged to publish any information about their financial and business state of affairs, are usually the first to be slump-hit by a recession.

The Amman Bond Market is still less well developed than the AFM. It falls under the jurisdiction of the AFM. The bonds traded in this market are government bonds (development bonds). So far, no private issues or syndicated bonds have been listed in the AFM. Table II.19 below shows development of the Amman Bond Market.

Table II.19 Development of Trading in Bonds in the
Amman Bond Market, 1981-1985.

	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Number of traded bonds (thousand)	218	185	43	128	337
Value of traded bonds (JD mn.)	2.32	1.94	0.61	1.68	3.60

Source: Central Bank of Jordan, Annual Report, 1985.

Jordan's relative success in the promotion of its capital market lies in its well thought-out regulatory system, encouragement and support of the Central Bank of Jordan, the attractiveness of the market to the private sector as a medium of investment and raising capital, and the relative diversity of the country's national economy. While the AFM currently focuses on promoting growth and vitality, it has the potential to develop into a regional financial market attracting buyers and sellers from the region, especially since the country has had political stability and has been introducing advanced telecommunications systems and a liberal policy toward foreign investment promotion.

Kuwait

The Kuwaiti government has actively encouraged the development of a Kuwaiti capital market long before other ESCWA governments have done so in their countries.

Kuwait financial market actually dates back to 1952 when it began operating informally. It was given legal status in 1961 to stop speculation and to establish a basis for an organized future market. In fact, the Kuwaiti government has always intervened when "serious fluctuations" (upwards and downwards) occurred or the market found itself on the verge of a collapse.

Actually, as early as late sixties, the government of Kuwait began buying securities issued by local companies. By doing so, the government aimed at achieving two objectives. The first was buying in equities of some companies considered by the government relevant for the national economic security and thus ought to be either fully controlled by government authorities, or partly controlled by these authorities enabling them to participate in the decision-making process of these companies to safeguard national interests. The second objective was that the government wanted to activate and promote the market by showing confidence in the market business and thus encouraging the private sector to follow suit.

In early seventies, Kuwaiti individuals and institutional investors became strongly involved in market dealings. After the mid-seventies some Kuwaiti banks and financial institutions began issuing KD Bonds for syndicated loans to foreign borrowers seeking or having business in Kuwait and a small KD bond market, though short-living, was born. At the same time, nationals from other Gulf countries became involved in the market, giving it impetus and strength and a viable secondary market was developed. Kuwait, for a time, seemed to be on the verge of becoming a candidate for a regional financial market.

The 1982 crash of the informal Suk El-Manakh was a blow to the capital market. The Suk developed as an alternative to the official and tightly-controlled stock exchange which, ironically enough, was regulated to prevent the type of speculative activities that ultimately took place in the informal market. Saving was abundant and new issues were rare. The result was spiraling prices, bid up by enthusiastic buyers, followed by severe downturns. The Suk crisis was abetted by questionable accounting practices including the use of post-dated cheques, which amounted to the sum of US\$97 bn. at the time of the market collapse.

Immediately after the crash, the government facilitated clearing operations and allowed the cancellation of debts by offsetting post-dated cheques.

The tendency of the Kuwaitis to always look at the government in times of crises, stirs up expectations of government bail-outs in the event of crash. This kind of "business mentality" has undoubtedly affected risk perceptions of buyers and added to the speculative fever. The government, on the other hand, failed to take stronger regulatory action that might have averted the crash.

The effects of Suk El-Manakh crash are still reverberating even though the government has stepped in. Regulations have become tighter on the unofficial market and companies are encouraged to join the official one. The 17 brokers trading in the unofficial market have been merged into 4 brokerage houses and are strictly regulated and supervised. The houses must have a capital of KD 100,000 and put up a bank guarantee of KD 1 mn. The brokers must trade on the floor during official hours and are prohibited from trading to their account. Bids and offers are displayed on a big board for everyone to see. Shares of non-Kuwaiti companies, i.e., Gulf countries' companies which were traded illegally before the crash are now allowed to be traded in the official market and in the now strictly-controlled unofficial one.

Government intervention and the passage of Law 100 of 1983 which eliminated inflation built into post-dated cheques, have cut total debt from KD 19.2 bn. to KD 1 bn. by 1984. Of the 254 people ultimately threatened with bankruptcy in 1984, 3 were able to restore solvency, 88 were declared bankrupt and 163 reached settlements with their creditors. In average, the defaulters made up slightly over 28% of the debt assets. While not eliminating debt entirely, the government has reduced indebtedness considerably and restored confidence in the stock market and ultimately increased activity in this market.

Even though Kuwaiti banks and investment companies refrained from direct lending for stock market operations, they have been facing the effects of the Suk's collapse, due to lending to individuals and companies involved in the El-Manakh business.

Provisions for non-performing loans have increased during the last 3 years. Recently, the Central Bank of Kuwait has asked some banks and concerned financial institutions to transfer the whole of their operating profits to the provision for non-performing or doubtful loans. But the banks have been also faced with falling prices of securities and collaterals given to them by the borrowers as loan guarantees.

The default, for instance, of Kuwait Real Estate Investment Consortium (KREIC) to service two syndicated loans could at least be partly blamed on the Suk El-Manakh crash. The company's 1983 accounts included some KD 100 mn. in post-date cheques of which the "average" debtor could pay only 25%. However, since the government holding in KREIC is over 50%, the loans were arranged on favourable (sovereign risk) terms and the Kuwaiti Government has played a role in the loans' settlement.

Although government involvement in mitigating the effects of Suk El-Manakh has been considerable, the Suk crash has spilled over to the

country's economy. Even the international financial world has been affected by the crash, not just because some of the market participants' syndicated loans were denominated in US dollars, but also because affiliates and subsidiaries of international financial institutions in Kuwait have been likewise affected by the crash. Kuwait, however, remains the big loser. International banks and financial institutions and markets have become rather cautious in dealing with their Kuwaiti counterparts, and the potentials of Kuwait becoming a focal point in a regional financial market and an important financial place in the international financial system have been seriously hampered by the crash of Suk El-Manakh.

Table II.20 below shows development of Kuwaiti Official Securities Market between 1978 and 1985.

Table II.20 Kuwaiti Official Securities Market,
Volume of Traded Shares (0,000), 1978-1985

	<u>Banks</u>	<u>Invest- ment</u>	<u>Insu- rance</u>	<u>Indus- trial</u>	<u>Transport</u>	<u>Services</u>	<u>Real Estates</u>	<u>Total</u>
1978	67,365	43,736	709	26,950	6,340	7,741	20,562	173,404
79	81,824	24,379	3,452	22,619	8,212	5,530	23,118	169,134
80	47,686	24,537	1,048	14,833	23,607	9,382	22,616	143,709
81	30,477	42,778	1,397	40,452	34,027	47,798	49,768	246,698
82	33,637	25,587	3,902	39,025	9,398	10,641	61,790	183,980
83	12,868	10,242	1,849	16,221	3,264	5,088	11,879	61,411
84	8,391	1,289	108	2,345	363	2,794	4,513	19,804
85	18,920	848	189	3,793	5,948	11,246	1,337	42,282

Source: Central Bank of Kuwait, Quarterly Statistical Bulletin, October-December 1985.

UAE

The UAE has no official stock exchange. Plans, however, do exist to establish one. Stocks are traded on unofficial and private basis. In 1983, the UAE had a total of 834 "shareholding" companies with a total paid-up capital of around 16.4 billion dirham. The plans of the end seventies to establish an "Emirates Wall-Street" in Sharjah failed due to disinterest of addressed companies.

(4) Other Financial Institutions

There are other financial institutions in ESCWA region that have the potential to mobilize savings for development finance. These include insurance companies, investment companies, social insurance and pension funds.

(4.1) Insurance Companies

Insurance companies are well-established in the region. In some countries they are privately-owned, and in others they are state-owned and operated.

ESCWA insurance markets have expanded rapidly in the last few years. The expansion is reflected in the rise of indigenous insurance companies. Today, there are more than hundred national insurance and six reinsurance companies. Total gross direct premium income of the insurers has reached about US\$8.3 bn. in 1984.

ESCWA insurance markets have developed in various ways, and can be divided into four groups.

- (a) Monopoly markets, where the state owns one or more companies, and in some cases, one central reinsurance organization; the private sector is excluded. Such markets include Iraq, Syria and South Yemen.
- (b) Markets which include both national and foreign companies, but in which the state requires its business to be insured by the former. This is the practice in Bahrain, Jordan, Kuwait, Lebanon, Oman, Qatar and the UAE. National companies must be registered locally and have a local majority holding. In Abu Dhabi (UAE), Kuwait, Oman and Qatar, they must be 100% locally-owned.
- (c) Markets in which only national companies are allowed to operate. They can be owned by the state and/or the private sector. Foreign ownership of private companies is restricted to a majority holding. This is the practice in Egypt and North Yemen.
- (d) Markets where there are no insurance regulations and where national companies do not exist as such. They act as agencies to foreign concerns or joint-venture firms registered abroad. The only example of this type of market is Saudi-Arabia, where insurance in its commercial form is not officially recognized.

ESCWA insurance business exhibits the following features:

- (1) A significant imbalance between premiums and claims (Table II.21);
- (2) Excessive competition in non-monopoly markets; however, there are signs of improvement;
- (3) An increasing tendency to insure imports through national companies; this is a requirement in some ESCWA countries;
- (4) A growth in contractors all-risk insurance, although this has slowed down with the decline in large-scale infrastructure projects;
- (5) Serious shortage of suitably qualified nationals - a major obstacle to the development of the local insurance industry.

However, various trends can be discerned in ESCWA insurance markets:

- (a) Political insurance: the importance of this will increase as commercial contracts with the rest of the world expand;
- (b) Reinsurance: ESCWA insurers will have to diversify their sources of reinsurance. This is because of increasing demand at a time when world reinsurance capacity is contracting for both facultative and

treaty business; in addition there is some concern in the markets about the quality of reinsurers' security. To reduce their dependence on non-Arab markets, ESCWA Arab insurance companies are trying to maximize retention at national and regional levels, and create additional reinsurance capacity within local markets. The emergence of more national reinsurance companies - and joint ventures - is a strong possibility;

- (c) Policy conditions: these are likely to become more standardised as common legislation is introduced;
- (d) Banking: insurance and banking services may be combined in the same institutions, where laws allow, to provide a wider range of services - from guarantees and securities to straightforward motor policies;
- (e) Islamic insurance: demand for insurance to conform to Islamic business principles is growing in ESCWA countries. Islamic insurance and reinsurance companies - known as cooperatives - are expected to expand in number and importance.

Table II.21 Insurance Companies Activities in Selected ESCWA Countries
(in million of national currencies)

	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
<u>Jordan</u>					
Premiums	19.64	21.71	23.97	23.35	24.57
Claims	9.36	12.49	12.57	11.50	10.92
<u>Kuwait</u>					
Premiums	52.40	56.90	57.70	...	...
Claims	30.10	33.00	30.30	...	...
<u>Syria</u>					
Premiums	307.2	376.7	381.2	423.0	
Claims	107.4	132.0	151.5	130.8	
<u>UAE</u>					
Premiums	742.7	840.0	...	...	...
Claims	390.2	471.4	...	...	...

Source: ESCWA calculations based on various national and international sources.

(4.2) Investment Companies

Investment companies are a new scheme in the financial system in ESCWA region. Most of them were established in mid-seventies and early eighties. In some ESCWA countries such as Bahrain, Jordan and Kuwait, investment companies have developed to perform investment and merchant banking business. The range of their activities covers securities dealing, underwriting in syndicated loans, new issues, portfolio management, foreign exchange trading, investment and financial advisory services, project evaluation and management and fund raising. Some of these companies, particularly in Jordan and Kuwait are permitted to do a limited amount of banking such as loans and advances, but not overdrafts. The idea behind permitting establishment of investment companies particularly in Jordan and Kuwait was to allow these companies - without large balance sheets - to perform business that commercial banks cannot do due to their articles of association and nature of business.

In fact, investment companies in mid-seventies and early eighties in both Jordan and Kuwait had participated strongly in development finance of projects of the private sector, and to a degree of the government sector, either by managing and/or underwriting syndicated loans and other forms of lending, or by raising funds or by becoming involved in establishing financing facilities for businesses of both sectors.

On the other hand, investment companies in both countries -especially in Kuwait-, have also been involved in dealing with speculative business in the share markets of both countries with the result of material losses and losing some of the trust put in them by the public and their business partners.

However, a fair portion of the decline in profits of these companies, particularly the well-known three K's (Kuwait International Investment Company, Kuwait Investment Company and Kuwait Foreign Trade, Contracting and Investment Company) which have been strongly involved in international lending and now find themselves plunged into the turmoil of the international financial and banking markets, can be attributed to the increased provision for non-performing or doubtful loans. Under the present gloomy economic conditions, good lending and other local investment opportunities have become rare and there exists the problem of collateral as well as good projects.

Nevertheless, despite some obvious management problems, the investment companies are still considered as one of the most appropriate vehicles for development finance, provided they start thinking strategically and be imaginative in looking for particular market niches.

(4.3) Social Insurance and Pension Funds

Also social insurance and pension funds are a relatively new scheme in ESCWA region. They began taking shape in mid-seventies. In only two countries of ESCWA, namely in Jordan and Bahrain, both institutions enjoy an independent legal personality guaranteed by law and encouraged by the government in both countries. In Syria, social insurance as well as pension funds are government organs. The Syrian pension fund is designed to serve government employees and members of the army and security forces, while social insurance is designed to serve other employees of state and public organizations and establishments. Since there is almost no private sector in Syria, both social insurance and pension fund are considered as one and the

same organization whose guidelines for its mainly public investment activities are determined by the state.

In Kuwait and the UAE, institutions for social insurance and pension fund do not exist as such, but respective activities which are normally assigned to such institutions are carried out by concerned departments at the Ministry of Work and Social Affairs. In the YAR, social insurance and pension fund are still non-existent.

In Jordan and Bahrain the system of social insurance and pension fund has developed not just to secure as much as possible social welfare and payment claims of as many segments as possible of the population, but also to become a vehicle of mobilizing, managing and allocating financial resources for development finance.

In fact, investments of the Jordanian Social Security Corporation have increased from J.D. 6.64 million in 1981 to J.D. 79.72 million in 1985, or from 1.6% of total investment of the country in 1981 to the remarkable margin of 18% in 1985.

The increase in investments of the Jordanian Pension Fund, though relatively not as high and remained rather unchanged during the same period, has been making up since 1981 a considerable share of the country's total investments. In 1981, investments of the Jordanian Pension Fund were around 10.7% of total investment, and in 1985 the share decreased just slightly to 10.5%. Table II 22 and Table II.23 below show development of main positions of balance sheet of both the Social Security Corporation and Pension Fund from 1981 to 1985.

Table II. 22 Summary Balance Sheet of the Jordanian Social Security Corporation, 1981-1985 (in million JD dinar)

	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Current Assets	10.34	29.06	41.30	45.31	54.82
Cash and Money at Banks	8.30	22.46	33.22	35.64	41.68
Advances	0.17	0.39	1.39	4.73	8.42
Other Current Assets	1.87	6.21	6.69	4.94	4.72
Loans	0.79	2.17	6.35	12.85	23.62
Investments in Stocks & Bonds	5.67	10.05	17.99	43.11	56.10
Other Assets	0.41	0.69	0.88	1.12	1.14
Assets = Liabilities	17.21	41.97	66.52	102.39	135.68
Forwarded Surplus	15.81	39.41	66.25	102.11	135.41
Other Liabilities	1.40	2.56	0.27	0.28	0.27

Source: Central Bank of Jordan, Annual Report, 1985.

Table II.23 Summary Balance Sheet of the Jordanian Pension Fund, 1981-1985
(In JD million)

	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Cash and Due from Banks	2.21	6.69	7.42	6.17	8.35
Government and Public	1.00	1.00	1.00	1.00	1.00
Bonds					
Other Bonds	0.05	0.25	0.44	0.74	0.73
Stocks	42.38	44.76	48.46	48.44	44.85
Other Assets	1.63	2.08	2.10	2.13	2.12
<hr/> Assets = Liabilities	<hr/> 47.27	<hr/> 54.78	<hr/> 59.42	<hr/> 58.48	<hr/> 57.05
Paid-up Capital	29.40	36.40	41.40	41.40	41.40
General Reserves	3.26	4.95	8.36	8.01	9.68
Other Liabilities	14.61	13.43	9.66	9.07	5.97

Source: Central Bank of Jordan, Annual Report, 1985.

Both tables indicate that the major portion of investments of both institutions has been in buying equities of public shareholding companies.

In Bahrain, on the other hand, investments of the social insurance system (represented by the General Organization for Social Insurance - GOSI) and the pension fund have increased also considerably during the last few years. It is worth mentioning, however, that by law, at least 90% of investment of GOSI should be undertaken in Bahrain in Bahraini projects while only up to 10% can be placed abroad. However, most of the investments of GOSI in Bahrain have been in fixed deposits with banks and investment companies or founder-member shareholdings of new companies or in real estates, especially acquisition of land for development, or extending credit to enterprises needing financial assistance. Up to the end of 1983, GOSI accumulated reserves have totaled around BD. 99.5 million, equivalent to around US \$300 million.

Investments of the pension fund have been in almost the same business areas of those of GOSI. They increased from BD 12.5 mn. in 1978 to BD. 71.6 mn. in 1983, (Table II.24), i.e., advancing at an annual rate of about 42%.

It is obvious that the system of social insurance and pension fund is an adequate medium of mobilization, management and allocation of resources for development finance, in that it not just initiates and forces into being "obligatory" savings, but also can activate these savings for development finance. As an institutional investor with considerable financial resources and regular cash flow, the system is in a privileged market position where it can invest where it chooses. Since the system as such can only be government-sponsored, its investments would most probably be not necessarily motivated just by profit making, but also by promotion of the country's development.

Table II.24 Summary Balance Sheet of the Bahraini Pension Fund,
from 1978 to 1983 (in BD thousand)

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
1. Fixed Assets	3	13	16	13	14	29
2. Investments	12,500	22,500	31,725	41,793	58,246	71,584
3. Current Assets	7,532	3,672	2,879	3,536	2,591	3,936
4. Current Liabilities	210	179	275	275	1,613	1,217
5. Net Current Assets (3-4)	7,322	3,493	2,604	3,288	978	2,719
6. Total Net Assets (1+2+5)	19,825	26,006	34,345	45,095	59,238	73,231
7. Contribution under the present scheme	12,460	18,681	27,246	38,286	52,497	66,258
8. Contribution under the previous scheme	7,365	7,325	7,099	6,809	6,741	6,973
(a) benefits scheme	4,962	4,918	2,734	4,628	4,565	4,605
(b) provident fund	2,387	2,394	4,353	2,169	2,165	2,358
(c) past service plan	16	13	12	11	11	11
Total Contributions (7+8)	19,825	26,006	34,345	45,095	59,238	73,231

Source: Bahrain Monetary Agency; Bahrain: An International Financial Centre, Second Edition, 1984.

(5) Oil Revenue Surpluses and Financial Markets in ESCWA Region

Creation and evolution of financial markets take place to serve and accomodate multilateral and simultaneous exchange of goods and services.

The four principal ways that a financial market may evolve into are:

- (1) remaining self-sufficient, serving domestic lenders and borrowers;
- (2) remaining overly self-sufficient in regard to the supply of funds and seeking outward growth beyond national boundaries in so far as the use of funds is concerned;
- (3) encountering heavy demands for funds without being able to meet them from internally generated funds, in which case the market is characterized by an inflow of funds from surrounding areas; and finally,
- (4) drawing wholly on external funds and meeting external demands.

Syria, Iraq, Oman and possibly North Yemen can be cited as countries which would establish self-sufficient types of financial markets, although the centrally-planned nature of the economy of both Syria and Iraq is not conducive to the development of such a market.

Kuwait may be the striking example of the second type, with Saudi Arabia, the UAE and Qatar as potential candidates.

Egypt and Jordan represent the third type, and Bahrain exemplifies the fourth. Bahrain has become prominent in wholesale short term transactions, primarily in US dollar but also in some other currencies. It has been active as a conduit of funds for the international financial markets more than servicing either regional or local financial needs, while Kuwait has emerged, though only for a short while, as a supplier of long-term financing in Kuwaiti Dinars (KD - Bonds).

On the other hand, the local activity of financial institutions and individuals in ESCWA oil-exporting countries has allowed for a limited efficient use of investment capital available. From financial intermediation point of view, limited participation in capital accumulation and limited availability of financial instruments for investment purposes result in reduced efficiency of capital available in the market, which reduces capital mobility and flexibility.

The development of financial markets in ESCWA region during the last few years indicates that improvement in functioning of domestic financial markets has been considered essential in ESCWA non-oil exporting countries (deficit countries) to achieve mobilization of local savings and to finance local development with local resources to the extent possible.

In the "surplus countries" that possess only rudimentary financial structures, the development of the domestic market has also been considered a first step towards the expansion of the market beyond the national boundaries. The main challenge for the financial markets in ESCWA region, however, has been (and still is) the matching of supply and demand of funds within the region as a whole.

It does not seem, however, that the region's financial markets have been very successful beyond national boundaries as they have not been able to achieve sufficient flow of savings (surpluses) from ESCWA oil-exporting countries to ESCWA non oil-exporting countries and to allocate balance of payments surpluses of the first group to the most efficient economic sectors within the region.

Some complications and obstacles have led to this result.

One of them peculiar to ESCWA oil-exporting countries arises from the fact that oil revenue surpluses accrue almost exclusively in the first instance to governments. This has created challenges in sharing the benefits with the public at large. In addition, government decisions with regard to the placement and use of these surpluses heavily dominates the markets involved. It is often difficult for governments to see their projects as competing for resources with the private sector, especially when these governments already possess the funds. However, the objective of growth of the national economy requires a fair compensation of the returns from alternative uses of the resources represented by surplus funds. This objective is made somewhat hard to realize because of the difficulties in imputing the non-pecuniary or social return on some investments.

Development motivated investments in infrastructure pose such a problem, but if resources are to be used efficiently, an effort must be used to compare imputed returns with alternative uses of the available resources. The hard choice whether to invest surpluses at home or abroad has been made simply and correctly (from a growth maximizing point of view) by a properly functioning financial market which simply supplies the available funds to the highest bidder (risk adjusted), foreign or domestic.

Until now, the existing financial markets in the region have been unsuccessful in attracting government-held reserves. The part of government savings which could be invested through the regional financial markets will continue to be limited by the importance of government-to-government transactions in the form of direct grants or credits on concessionary terms, as well as by the need for a geographical division of risks and for a wide diversification of assets. The amounts involved, however, are of such a magnitude that channelling only a small percentage of the government investments through the region's financial markets would represent a considerable boost for these markets. Achieving this objective will require not only the good will of the governments involved but also the establishment of a more appropriate mechanism - such as the use of an auction system similar in reverse to the system used to auction off treasury bills in some countries, for instance, the USA, - to introduce government savings into the market.

The financial cycle in ESCWA region is largely limited to government capital expenditures generating financial liquidity into the local financial institutions. This liquidity has been largely expended on land and shares speculation and on consumption of rather imported goods, three attributes that have been major indicators of inflationary pressures. The balance of remaining liquidity has been either provided to local business enterprises on short-term line of credit arrangements or has been channelled into the international financial markets for investment purposes.

Consequently, the capital infusions through government expenditures has passed through the economic cycle only one rather than the four or five times experienced by financially developed economies. This has been the result of the absence of organized intermediary mechanisms for the individual and business saving that has constituted the excess liquidity in most of the economies of the region.

Until such intermediation functions are created, there is little hope for the stimulation of locally or regionally financial economic programmes that are not supported by government expenditures. Thus the regional nature of many economic programs will suffer greatly if these programs do not find the needed regional financing to support them. And unless securities and instruments of a regional standing and acceptability are provided, such regional economic programs and projects will have to depend mainly on government support, a prospect that ushers in the many political stumbling blocks so common to this region. The form and efficiency of developing financial markets depend also on the legal and regulatory framework of the countries in which they are located. The establishment and development of such markets require a supportive legal infrastructure defining the nature and interpretation of commercial contracts, collateral and property ownership forms and rights, as well as a system of courts to settle justly and without undue delay differences between borrowers and lenders. This legal aspect of financial transactions does not seem to have been clear enough to the

officials and administrators of some countries in the region. There exists great doubt in the minds of issuers of financial instruments and investors in these financial assets as to whether the transfer of titles, ownership rights and forms, inheritance rights, taxability and mobility, all in a regional context, maintain the original legal contractual arrangements of the securities in question.

Another complication that has not assisted in developing financial markets in ESCWA region beyond their national borders, has been the not-very liberal official attitude towards flows of banking business and capital in the region, as reflected in interest rates that have been prevailing in these markets thus distorting performing financial intermediation and other financial services in response to the profit potential of satisfying demand. No other single factor is as important in attracting the highest possible voluntary savings, and in putting it to the most productive use, as market-determined interest rates. Regulating interest rates in financial markets in ESCWA region has stifled the use and marketability of the regulated instruments. It has also artificially stimulated the emergency of new and less efficient financial instruments and discouraged savings in addition to misallocating what has been saved. In other words, the regulation has thwarted the evolution of financial markets appropriate to the region.

However, despite these complications and obstacles, development in the ESCWA region's financial markets during the last few years indicates a strong trend towards creation of new financial services and programs directed at meeting economic demands of the region. In general, these services have been to a large extent created by the public sector with minimal co-ordination with privately owned financial institutions. In this regard, development funds and organizations have been organized and capitalized by various countries in the region with little, if any, participation by the private sector in the organization or administration of these newly created units.

This trend towards setting up of new funding organizations became much more pronounced after the oil price increase of 1973/74, which - as known - resulted in the accumulation of financial resources on a stupendous scale (by previous Arab standards) by ESCWA (and other) oil-exporting countries. Their good fortune seemed to bring about a change in thinking regarding the priorities of regional co-operation and a moral commitment to the reduction of disparities between the countries of the region. The establishment of development finance institutions, and the formation of supporting institutions and legislation aimed at promoting the investment of Arab capital within the region soon followed, and the systematic identification and preparation of regional projects began. Today, it can justly be said that co-operation in the field of finance has been a major area of interest and concern that has translated itself into the establishment of several types of multinational, national and private institutions.

Contrary to multinational and national institutions which do not seem to have sprung from practical aspects and developments of the financial environment, but rather from the abstract designs and programs of governments and governments-owned bodies, the private financial institutions have emerged from the bottom of the economic superstructure of the countries of the region. These institutions, and not the multinational or national ones, have responded to the increased demand for financial services which resulted from the economic expansion witnessed in the region. While it can be ascertained

that their commercial banking operations and services did rise to the challenge of the occasion, it is not certain whether they also were able to promote and/or encourage a regional role for these financial services. Only one financial institution operates actively on a regional basis in ESCWA countries, namely the Arab Bank, headquartered in Jordan, that has been truly taking on the leadership role in providing regional financial services. The role of the Arab Bank at present is evidenced by the asset portfolio management of the bank on a regional basis rather on the classical national basis common to all domestic Arab financial institutions.

This has been made possible by the strong competitive position of the off-shore unit of the Arab Bank in Bahrain in terms of size, maturity and nationality of the deposits it has been able to attract. This has enabled the Arab Bank to assure a regional assets management policy that is balanced by a portfolio mix of its liabilities. Simply stated, the Arab Bank attempts to lend funds on a regional basis in the currencies of the countries of the region in a manner that balances the deposits in currencies of the region channelled to its off-shore unit in Bahrain.

Another financial institutions that has played a leading role in regional financial development is the Arab Company for Trading Securities (ACTS), which is based in Kuwait and is a privately owned finance house that provides the type of financial services needed by the financial markets in ESCWA region.

ACTS is basically a market maker with a capacity for spot rather than future transactions in Kuwaiti Dinar Bonds (KD-Bonds), KD-Certificates of Deposits (DK-CDs) and Branch Accounts (B/A). This house also provides brokerage and investment (advisory) services to many private customers and institutions within and outside Kuwait.

In an attempt to provide greater depth for and breadth in the financial services offered, ACTS in consultations with the Amman Financial Market (AFM) arranged to provide over-the-counter listing and trading services for securities that are listed in the AFM. This kind of association with the AFM securities has been found to be workable within the Jordanian and Kuwaiti laws, and within the rules and regulations of AFM and ACTS. While all arrangements in principle have been finalized, to date not a single transaction has taken place.

There are many practical factors that work against the start of such an association between AFM and ACTS, among which are the following:

1. Investors in AFM-listed stocks are hesitant to trade through ACTS because of limitations and delays on the transfer of stock certificates in Jordanian companies;
2. The number of interested investors in Jordan-based companies is very small, and very little information is available to the public on these companies that would generate broader public interest outside Jordan;
3. There exists a substantial communications problem between Jordan and Kuwait. While ACTS is capable of quoting up-to-the minute price for securities traded in Hong Kong, Tokyo, London or New York, etc., it

has to wait at least one day for information on stock transaction from the AFM.

Reflecting on these factors which limit more efficient intermediation of financial services in the private sector, similar cases can be cited for the Kuwait Stock Exchange, and to a degree for the over-the-counter securities market in Bahrain. Of major consequence, especially in markets for long term funds, is the limited flexibility available to Arab investors in raising investment capital on a regional basis.

While international borrowers have been able to arrange for the floating of KD-Bonds in the Kuwaiti capital market and assure the marketability of these bonds by ACTS, Arab enterprises in ESCWA countries have been finding it difficult, if not impossible, to have their debt or equity securities listed, traded or demanded in financial markets other than those of their region. Moreover, non-Kuwaiti companies can be listed on the Kuwaiti Stock Exchange, while non-Kuwaiti nationals cannot trade in Kuwaiti securities. This kind of limitation, common to most other financial institutions in the region, is a clear evidence of the level of disintermediation that exists in the operation of the local financial institutions.

Despite all the efforts of the various financial institutions and organizations and the blessing and support of many well-meaning government officials, the flow of investment funds both private and public, towards regional investment opportunities has been very small compared to the funds invested outside the region. Moreover, compared to the financial needs of the region, what has materialized can only be considered as minimal.

Several factors have inhibited regional financial growth besides shaky political relationships between the countries of the region. Among these factors are:

1. Lack of adequate information on investment opportunities;
2. Independently studied or badly conceived business ventures;
3. Lack of proper communications between financial institutions in the region;
4. Restrictions on capital transfer;
5. Cumbersome procedures and regulations regarding financial transactions;
6. Absence of financial instruments that can attract available liquidity in various financial institutions of the region.

III. LOCAL DEVELOPMENT BANKS AND INSTITUTIONS

A. Goals and Objectives

Development banks' goals are typically broadly defined and subject to interpretation which differs according to institutions. A mandate to "promote economic growth" can result in different types of activities depending on the structure of the economy, the level of government's influence and the bank's management perception of economic development needs. Development banks in ESCWA region engage in the allocation of resources unlike typical financial institutions which mobilize resources and allocate them to their most efficient use. ESCWA development banks' funding originates mainly from governments. Their lending is usually on soft-terms to industries given priority by the governments in their economic development plans.

While their primary objective is the well-being and growth of the economy, development banks and institutions generally are interested in, if not profit-making, at least avoiding losses. The degree of financial viability of the bank itself affects present and future resources and its overall reputation as a development finance institution. But still, a conflict between financial viability of the bank and its role in promoting economic development exists, thus causing some development banks to react by restricting long-term development finance loans and/or loans on marginally productive projects. Such policy reduces the effectiveness of development finance. While productive enterprises are normally capable of obtaining loans from conventional banking sources, the objective of development banks is considered to provide mid- and long-term financing for projects that contribute to economic development but are unable to obtain necessary financing from conventional banking sources.

The "medium" that is supposed to play an important role in resource allocation of development banks and institutions is the project evaluation. Since terms of loans of these banks and institutions are usually soft, development banks, particularly the local ones, are faced with too many loan applications that cause them to be restrictive in their project evaluation to ensure long-term financial viability and adherence to the goal of promoting economic development. Role of development banks in economic development can be either passive or active. It is passive when the DB simply reacts to the projects brought to its attention, and fails to respond to changes in the economic and financial structure that inevitably take place as the economy develops. The role is active, when the DB takes initiative in economic development by identifying economic sectors and industries that possess growth potential, and by actively encouraging them. Such banks evolve with the changing environment and become an active component in the financial system that develops as the economy grows. Changes in development strategy, the need for new resources and opportunities for local businesses can also necessitate a flexible response from development banks. A development bank that perceives its role as flexible and adapts to economic development is more likely to be a viable institution capable of influencing long-term economic development. But a DB which takes a narrow view of its role and grants loans in a passive manner might influence the economy in one stage of its development but becomes ineffective as needs of the economy and individual enterprises mature.

Table III. 1 lists local development banks and institutions in selected ESCWA countries. These DBs and institutions are entities that devote attention to development in agriculture, industry and housing. National governments usually hold relatively large equities in these institutions. However, some of them are completely owned by governments, while some others are a mixed ownership of public and private sector.

The explicitly stated goals of these DBs and institutions refer to development, promotion and strengthening of relevant economic sectors, and stimulation of national output. Some DBs, however, are more specific. For example, the Industrial Bank of Kuwait and the Emirates Industrial Bank are committed to the support and development of their local capital markets as an integral part of their development - promotion activity. The IBK is the only local development bank that has taken steps towards promotion of regional economic development. It is authorized to finance projects outside Kuwait, especially in the GCC-countries, and has provided funding for an aluminium project in Bahrain.

Table III.1 Local Development Banks and Institutions in Selected ESCWA Countries, classified according to Sectors of Activity

Country	<u>Number of DBs and Institutions</u>	<u>Agriculture</u>	<u>Industry</u>	<u>Housing</u>	<u>DBs</u>	<u>Saving Banks</u>	<u>Co-operative Banks</u>
Bahrain	1			Housing Bank			
Jordan	6	Agricultural Credit Corp.	Industrial DB	Housing Bank; Housing Corp.	Cities & Villages DB		Jordan Co-operative Corp.
Kuwait	3		Industrial Bank of Kuwait	Kuwait Real Estate Bank		Credit & Saving Bank	
Syria	4	Agricultural Co-operative Bank	Industrial Bank	Real Estate Bank		Popular Credit Bank	
UAE	1		Emirates Industrial Bank				
YAR	3	Co-operative & Agricultural Credit Bank	Industrial Bank of Yemen	Housing Credit Bank			

Source: Arab Fund for Economic and Social Development, Documents of the Second meeting on Arab Development Institutions, 1984.

The Cities and Villages Development Bank in Jordan is unique in ESCWA region in that it focuses on the development of the non-metropolitan areas of the country. Funds are channelled to local councils for infrastructure and commercial projects rather than to pre-determined or specified projects by the bank. This has the effect of decentralizing decision-making and thus giving the rural authorities a greater voice in the development process underway in their areas.

Other development banks in ESCWA region concentrate on promoting economic growth in certain sectors of the economy, particularly in agriculture, industry and housing. But since an important portion of the funds of these banks are government-originated or government-sponsored (guaranteed), their role has in this regard become allocation rather than mobilization of resources.

B. Sources and Use of Funds of Development Banks and Institutions

To perform assigned activities, development banks and institutions rely on a combination of paid-up capital, government and foreign loans, as well as private and public deposits and other sources. Table III. 2. shows sources and use of funds of local development banks and institutions in three selected ESCWA countries, namely Jordan, Kuwait and the YAR. The table shows the important role these banks and institutions play in mobilizing domestic savings and their increasing independence from government sources.

In Jordan, deposit of the private sector with these banks and institutions made in 1983 more than 57% of their total sources, while the rest of around 43% consisted mostly of "official" (i.e, government and central bank) loans followed by foreign loans and grants and other sources, mostly from ESCWA oil-exporting countries. Official but still unpublished estimates for 1985 indicate that deposits of the private sector with these banks and institutions have further increased to almost 68% of their total sources.

The negative development of oil revenue surpluses of ESCWA oil exporting countries during the last few years suggests that development banks and institutions in Jordan (and other ESCWA deficit countries, as well) would have to make further efforts to increase mobilization of domestic savings and funding.

Around two thirds of funds use, namely 65--67%, have taken place in the housing and building sector, expended mainly by the housing bank and the housing corporation. The share of agriculture in funds use was 14% and of industry and mining 10%. The remained 10% were disbursed mainly among small artisans private industrial companies (Table III.2).

In Kuwait, although government share of funding Kuwaiti development banks has been substantial, namely around 32%, due mainly to the government being either a major or the sole shareholder in these banks^{1/}, Kuwaiti development banks depend heavily on the private sector as a source of

^{1/} The government holds 49% equity in the Industrial Bank of Kuwait, and 100% equity in Savings and Credit Bank. The Kuwaiti third development bank, the Real Estates Bank is a private sector bank.

funding. Share of this sector's deposits in total funding of these banks was around 56% in 1982, and has remained almost unchanged since then. But in contrast to Jordanian development banks of which the Housing Bank acts also as a commercial bank, i.e. a deposit-taker bank, and in this capacity makes the bulk, namely around 80% of total private sector deposits with these DBs, the Kuwaiti development banks, particularly the Industrial Bank of Kuwait, raise most of their private sector funds, namely around 35% (out of 56% total private sector deposits in total sourcing) through financial market instruments such as Certificate of Deposits (CDs) and other securities. Actually, Kuwaiti development banks, especially the IBK, have been playing since 1978, when the first Kuwaiti Dinar CD was launched, a major role in developing Kuwait capital market, by issuing financial instruments either to their accounts or to the accounts of other Kuwaiti and foreign corporations. Use of funds by Kuwaiti development banks which in 1982 amounted to about KD 1300 mn. (equal to about US \$ 4.2 bn.) has been concentrated mostly on the housing sector in favour of low-income Kuwaiti nationals through soft term (or cost-less) loans. While local investments of these banks, especially the IBK and the Real Estate Bank, have been minor, namely less than 3% of total funds available, due mainly to the limited local business opportunities, foreign investments have made up more than a quarter of funds available.

In contrast to Jordanian and Kuwaiti development banks, the three Yemeni development banks, namely the Co-operative and Agriculture Credit Bank, the Industrial Bank and the Housing Credit Bank, do not accept deposits from the private sector and therefore do not play any role in private savings mobilization, management and allocation. Major source of funding YAR development banks has been official sources, with Central Bank loans making up 42%, and government's deposits 37% of total funding. Foreign funding in form of foreign loans and grants has been about 23% and has come mostly from ESCWA oil-exporting countries and Arab as well as international finance and development organizations.

In Syria, all four development banks are government owned and controlled, and their development finance activities are concentrated mainly on public projects. In the last few years, however, the Syrian Real Estate Bank and the Popular Credit Bank, have given more attention to introducing ways of attracting deposits from the private sector and to the development finance needs of this sector. The Real Estate Bank, for example, has introduced savings plans that give lending preference to the saver (depositor) for purposes of house building. The Popular Credit Bank has established itself as a representative to the Syrian Commercial Bank in rural areas in deposit taking and lending, as well.

Development banks in some ESCWA countries such as Jordan have been playing a major role in mobilizing, managing and allocating private sector savings and in meeting development needs of this sector. However, they still depend largely on official funds, be it deposits or loans from the government or the Central Bank, and on foreign funds to meet these needs. The negative development of ESCWA oil-exporting countries oil revenues during the last few years which have been an important source of funding for these institutions, be it directly through loans and grants or indirectly through government channels, suggests that dependence of these institutions on official funding may increase or that they would have to look for raising funds in capital markets. By doing so, development banks would have a chance to actively participate in development of these markets.

Table III.2 Sources and Use of Funds of Local Development Banks and Institutions in selected ESCWA Countries

JORDAN (1983)

<u>Source of Funds</u>	<u>Total</u>	US\$ 993.09mn.	=	100.00%
	(1) Private sector deposits	US\$ 572.46mn.	=	57.46%
	(2) Loans	US\$ 420.63mn.	=	42.32%
	of which:			
	(a) government loans	US\$ 6.00mn.	=	0.60%
	(b) central bank loans	US\$ 202.26mn.	=	20.37%
	(c) foreign loans	US\$ 67.62mn.	=	6.81%
	(d) other sources	US\$ 144.75mn.	=	14.58%
 <u>Use of Funds</u>	 <u>Total</u>	 US\$ 833.34mn.	 =	 100.00%
	(1) Building and housing	US\$ 547.28mn.	=	65.67%
	(2) Agriculture	US\$ 118.28mn.	=	14.19%
	(3) Industry and mining	US\$ 83.62mn.	=	10.03%
	(4) Other sectors	US\$ 84.16mn.	=	10.11%

KUWAIT (1982)

<u>Sources of funds</u>	<u>Total</u>	KD 827.7mn.	=	100.00%
	(1) Private sector deposits,	KD 465.8mn.	=	56.27%
	(2) Government loans and			
	deposits	KD 260.7mn.	=	31.50%
	(3) Foreign loans	KD 101.2mn.	=	12.23%
 <u>Use of funds</u>	 <u>Total</u>	 KD 1302.0mn.	 =	 100.00%
	(1) Credits	KD 993.9mn.	=	70.89%
	(2) Local investments	KD 41.1mn.	=	2.93%
	(3) Foreign investments	KD 267.0mn.	=	26.18%

YAR (1982)

<u>Sources of Funds</u>	<u>Total</u>	YR 230.02mn.	=	100.00%
	(1) Central bank loans	YR 112.00mn.	=	42.09%
	(2) Deposits (government)	YR 98.00mn.	=	37.09%
	(3) Foreign loans and	YR 20.82mn.	=	20.82%
	grants			
 <u>Use of Funds</u>	 <u>Total</u>	 YR 434.80mn.	 =	 100.00%
	(1) Local investments	YR 33.90mn.	=	8.99%
	(2) Credits.....	YR 395.90mn.	=	91.06%
	of which:			
	(a) agriculture,	YR 235.08mn.	=	59.38%
	(b) housing.....	YR 88.00mn.	=	22.33%
	(c) industry.....	YR 72.80mn.	=	18.39%

Source: Arab Fund for Economic and Social Development.

C. Financing Activity of Local Development Banks and Institutions

(1) Financing Activity

The Industrial Development Bank of Jordan (IDBJ) provided 85 new soft-term loans in 1985 totalling JD 7.122 mn., thus bringing total amount of industrial loans to JD 68 mn. granted since 1965. Lending to 188 projects in small-scale industries amounted to JD 4.914 mn. In 1984, equity investments of the bank totalled JD 2.2 mn. for fully paid-up shares in Jordanian corporations and JD 2.4 mn. for partially paid-up shares. The IDBJ offers other financial services to customers including arranging syndicated loans.

The Agricultural Credit Corporation of Jordan provides soft-terms loans to the agri-sector. The loans are usually, small-scaled and mostly seasonal with maturities ranging from short- to medium- and long-term with loan payments of up to 80 percent of projet cost. Interest rates are normally 4 to 5 points lower than the market rates for these types of loans.

The bulk of the Industrial Bank of Kuwait's lending is soft-term. In 1983 (latest available data), when the economy was hit by the preceding year's Suk El-Marakh crash and was also beginning to feel the recession, IBK approved financing of 37 new projects with KD 25.2 mn. in loans and KD 4.3 mn. in equities. This represents a slight fall in the bank's loan activity but a substantital drop in equity financing which had amounted to KD 5.31 mn. in the year before.

In its first two years of operation (1983 and 1984) the Emirates Industrial Bank (EIB) granted loans totalling Dh 132.4 mn. to 24 inudustrial projects with interest rate of 4 per cent plus an administration fee of 0.05 per cent and a maximum maturity of 7 years. But many of the granted loans were used instead to repay high interest commercial loans granted during the boom period of mid-seventies and early eighties. By tolerating this unforeseen use of the loans, the EIB shareholders, who are the Federal Government with 51 percent equity and domestic banks and insurance companies with the remaining 49 percent equity, were hoping to soften economic downturn in the UAE by easing debt burden on the borrowers.

The Industrial Bank of Yemen (IBY) financing activities are either providing soft-term loans to industries or buying equities in these industries. In 1983 (latest available data), the bank approved 22 new project loans totalling YR 42.5 mn. along with four supplementary loans to existing projects totalling YR 6.4 mn. These financial facilities were 20% over the preceding year. The IBY, concerned with its long-term viability, hesitates granting loans of long-term maturity. Loans are granted for maturities of up to six years only with one-year grace period, at most, and an interest rate of 4 to 5 points below the market rate. Equity participation by the IBY totalled YR 9.82 mn. by 1983 including the YR 3.42 mn for the Yemen Company for Salt Refining and Packing owned by both the Yemen Bank for Reconstruction and Development and the Yemen Mineral Resources Corporation.

The Co-operative and Agriculture Credit Bank which is wholly owned by the government and was established in 1981 by merging the Agriculture Credit Bank and the Co-operative Credit Bank caters of agricultural development throughout YAR. Many small farmers receive funding on seasonal basis. Loans are given to rural handicraft co-operatives as well as to rural infrastructure

development. Interest rates are 5 and 6 points below market rates for seasonal lending and mid- to long-term loans, respectively. Loans in the last two years, however, seem to have been extended beyond aforementioned areas to financing purchase of agro-machinery and equipment, poultry, land reclamation and irrigation.

While ESCWA countries recognize the importance of developing agriculture for food and thus national security and political independence, they have also stressed industrial development in their development plans. They consider specific types of industries and the long-term growth potential of the industrial sector. There has been criticism, however, regarding some major projects, in some ESCWA countries, in that these projects are considered to be merely prestigious and turn-key ones and do not stand up for a macro-economic feasibility, i.e. for testing their integration potential in the national economy, since major production factors such as management, raw materials, machinery and equipment can neither be supplied locally, nor can they be produced by domestic supplementary industries. Nor can these projects stand up for a micro-economic feasibility, for they would stop production, or produce below full capacity, in case production factors become rare.

A development bank that takes a broad view of its mandate provides additional services to its customers. In doing so, it assists in promoting further economic activities. The IDBJ, for instance, which does not dispose of abundant sources like its counterparts in ESCWA oil-exporting countries is forced to follow a rational lending policy and scrutinize carefully the feasibility of projects presented for financing. In general, a rational evaluation of proposed projects increases the efficiency of the national economy since more or less efficient projects would be financed and technically assisted. Rational evaluation would also expose entrepreneurs to unfamiliar methods of projects evaluation. The entrepreneur, in other words, may find even the application process for a loan a learning experience and may be inspired to apply newly-learned tools in performing his own business and/or later projects. The IDBJ is also involved in on-going evaluation of current projects as well as follow-up reports on past projects. Other ESCWA development banks which have proposed the application of project evaluation in lending have met with resistance from potential customers. In the UAE and YAR, entrepreneurs used to relying on their names and personal connections rather than on their balance sheets hesitate to divulge information necessary for loan processing.

(2) Uncollected Loans and Debt Relief Activities

In general, uncollected loans tend to increase with downturn in the business cycle. Their level is a significant indicator to the financial viability of each individual bank, as future loans to a large extent depend on cashing past loans. Moreover, level of uncollected loans provides an indication of the success of the bank's management in forecasting cashflow of the financed projects. Collection rates for the IDBJ, the only development bank in ESCWA region for which such data are available, are shown in table III.3. A decrease in collection rate occurred in 1984 as Jordanian economic downturn worsened and payment morale of borrowers lowered.

Table III.3 Collection Rate of the Industrial Development Bank of Jordan
from 1979 to 1984

Year	Collection from due sums (JD mn.)	Collection rate (%)	Collection from arrears (JD mn.)
1979	2.66	74.63	0.29
1980	3.27	75.66	0.72
1981	4.42	83.21	0.61
1982	5.58	83.96	1.23
1983	6.60	84.23	0.48
1984	8.49	79.64	1.03

Source: Industrial Development Bank of Jordan, Annual Reports.

The data also show that the IDBJ makes an effort to collect lapsed payments. In this regard, the bank provides financial advisory services to customers. Rescheduling loans helps customers avoid outright default. The IDBJ can exercise the right of seizure of property and securities used as loan collateral, but it tries to avoid such harsh measures. Uncollected loans so far have not seriously affected the financial viability of the bank which has been profitable in most of the last few years. Pre-tax profits amounted to 13 percent and to 17 percent of paid-up capital in 1983 and 1984, respectively.

The Jordanian Agriculture Credit Corporation has also been profitable in most of the last few years. In 1984, pre-tax profits of this organization amounted to around 5.1 percent of paid-up capital despite a relatively low rate of loan recovery of around 63 percent for principal and 68 percent for interest payments. Slightly lower rates are expected for 1985 as a significant portion of its loans has been made to small farmers. Foreclosure of farms is an action available to the ACC, but likewise the IDBJ, it tries to avoid such a step. The Jordanian government has recognized the farmers' difficulties and stepped in with a debt relief program. It has agreed to make interest payments if the rest of the loan is paid at maturity and supplemental collateral on new loans is provided.

The current economic recession in Kuwait is supposed to have affected loan collection in the country. Although loan collection data for Kuwaiti development banks are not available, the intensive financial advisory services provided nowadays by these banks to their customers suggest a deteriorating moral of these customers.

The Emirates Industrial Bank is still new to experience loan collection difficulties. Its current activity, however, endeavors to help customers in avoiding financial troubles thus stemming potential loan collection problems.

The Industrial Bank of Yemen, which is a government bank, still does not consider uncollected loans a serious problem, since it would (in the final analysis) be bailed out by the government.

(3) Technical Competence

Technical competence is usually associated with professionalism, enthusiasm, imagination and strategic thinking of management. But it is also determined by the quality of the staff and the absence of high rates of staff turn-over. As development banks are involved in performing project evaluation and doing feasibility studies and (often) in providing technical assistance to the customers, they are forced to establish (or recruit) highly qualified professionals. Being "development" banks in "developing" (ESCWA) countries, these banks, logically, have experienced problems of attracting and retaining qualified staff. In recent years, however, they have undertaken measures aiming at improving quality and professionalism of staff, and establishing attractive work conditions.

In this regard, the IDBJ has been further ahead of other development banks in ESCWA region. More than 55% of its employees in 1985 were local university graduates, and its salary scale, health insurance and social security plans and housing loan programs compare favorably with those of similar banks and institutions in some developed countries. Its staff turn-over rate in 1985 was less than 3 per cent.

Also the IBK has highly qualified staff, whose members are mostly foreigners. The IBK, however, actively encourages development of Kuwaiti skills to become professionals by dispatching them to training and educational courses and programs in- and outside Kuwait. Staffing problems represent real issues in the YAR, where a shortage of trained professionals largely exists, due mainly to a complete and centuries-old absence of adequate educational facilities. Yemeni development banks, however, try to fill the gap by training nationals with the assistance of foreign professionals sent to the YAR within the framework of development assistance programs of Arab and international development organizations.

IV. REGIONAL DEVELOPMENT FINANCE INSTITUTIONS

A. External Financing and Regional Development Finance Institutions

Development finance in ESCWA countries is also served by regional development finance institutions primarily designed to assist Arab economic development and integration.

The present ~~source~~ project funding of these institutions is sourced partly by loan repayment and partly by returns on investments from surplus funds of past years.

The generous endowment of these institutions in the past made it unnecessary for them to become involved in any major activity aiming at raising funds in financial markets or from other sources.

Table IV.1. below lists the regional development finance institutions serving ESCWA countries (and other developing countries, as well). Most of these institutions were established in the seventies during the oil boom period. They were designed as a medium of facilitating regional and channelling international development finance assistance rather than serving the investment needs of oil-exporting countries.

Table IV.1 Regional Development Finance Institutions serving ESCWA Countries

	<u>Institution</u>	<u>Headquarters</u>	<u>Date of Establishment</u>
1.	Abu Dhabi fund for Arab Economic Development.	Abu Dhabi	1971
2.	Arab Fund for Economic and Social Development.	Kuwait	1971
3.	Arab Monetary Fund ^{1/}	Abu Dhabi	1976
4.	Islamic Development Bank	Jeddah	1974
5.	Iraq Fund for External Development.	Baghdad	1974
6.	Kuwait Fund for Arab Economic Development.	Kuwait	1962
7.	OPEC Fund for International Development.	Vienna	1976
8.	Saudi Fund for Development.	Riyadh	1974

^{1/} Activities of Arab Monetary Fund are designed to mainly serve financing deficit balance of payments of member countries, which are all countries of the Arab League.

Oldest among these institutions is the Kuwait Fund for Arab Economic Development which was established in 1962 and served as a model for most of them. Apart from the Arab Monetary Fund whose activities are designed to mainly serve financing balance of payment deficits of member countries, activities of these institutions are largely diversified and cover almost all areas of economic development, be it infrastructure (telecommunications, education, health, power, irrigation, sewage, etc.) or agriculture or industry or services.

Some national development funds among these institutions, such as the Kuwait or the Abu Dhabi Fund for Arab Economic Development, channel part of their financial assistance through local development finance institutions of the receiving countries, either directly, or indirectly through opening lines of credit or undertaking guarantees for credits given to these local institutions by development finance organizations.

B. Regional Development Finance Institutions and Regional Economic Co-operation and Integration

Institutional arrangements have been established in the Arab World for the purpose of promoting regional economic co-operation and integration. The Council of Arab Economic Unity pursues the goal of regional co-operation and intergation among Arab states. Other pan-Arab agreements have focused on the establishment of a "Supreme Trade Authority" and on proceeding with the "Unified Agreement for Investment of Arab Capital in Arab Countries", and futher on founding an "Arab Investment Court" to settle legal issues concerning Arab investments in Arab countries. The most successful integrative agreement, however, has been the establishment of the "Gulf Co-operation Council" in 1981. The member states of GCC have since agreed on many issues among which liberalization of trade among member countries, freedom of travel and residence, launching joint-venture projects, and others. In 1984, the GCC established the "Gulf Standard Authority to standardise specifications and norms of goods and services in the Gulf region. The Gulf Investment Corporation, with an authorized capital of US \$ 2.1 bn. was established to invest in Gulf joint-venture projects. The current recession, however, has showed its pace. Other joint-venture projects have been postponed or cancelled due to the drop in oil revenues.

The regional development finance institutions -by their very act of providing project finance in the region- add to regional co-operation efforts. However, the motivations of some of them tend to be that of promoting economic development in the developing countries, in general. As countries of oil revenue surpluses, ESCWA oil-exporting countries -in solidarity with other oil-importing developing countries- felt a moral obligation to aid these countries whom the high oil import bills were causing considerable economic stress. The regional development finance institutions aimed at facilitating this process. The benefits of regional economic and financial co-operation are more of a welcomed side-effect to their major purpose of acting as "Third World" benefactors. However, regional co-operation could be furhter promoted to the benefit of the region where regional development finance institutions are used (or make use of themselves) as financial markets' vehicles for channelling funds from ESCWA surplus countries to ESCWA deficit countries.

However, regional development finance institutions created by the Arab League or any of its suborganizations to operate on regional basis, such as the Arab Fund for Economic and Social Development and the organization of Arab Petroleum-Exporting Countries' (OAPEC's) "Special Account" to ease the financial burdens of the Arab petroleum-importing countries, are important examples of regional institutions that make available development aid in impressive amounts. The Arab Fund encourages private investments that emphasizes the development of joint-ventures. The Arab Authority for Agricultural Investment and Development was a result of the Arab Fund equity financing and its first project. OAPEC's "special Account" began as an "institute" for emergency aid to the poorest countries of the region and offered interest-free loans with a 20-year maturity and 10 year grace period. The OPEC "Special Fund" established in 1976 functions in a similar manner but on a larger scale. Another important institution is the Arab Monetary Fund established in 1977 whose goals are expanding inter-regional trade and furthering economic development of member countries, but whose activities are designed to mainly serve financing of balance of payments deficits of member countries.

The Islamic Development Bank (1974) should also be mentioned as it provides a wide range of services such as equity financing, lending to private as well as public sector development projects, and providing technical assistance and feasibility studies to Islamic countries. Regional investment companies such as the Arab Investment Company, the Arab Bank for Investment and Foreign Trade and the Arab Petroleum Company and others, were established to promote the investment of Arab capital in economic development of the countries of the region, by carrying out projects in agricultural, industrial, commercial and services sectors. Other institutions of regional ownership are the Bahrain-Kuwait Bank and the Oman-Bahrain Bank. These and other similar institutions provide services similar to those of other regional investment companies.

V. SUMMARY AND CONCLUSIONS

Development finance institutions play an important role in promoting economic development in ESCWA region. National development finance institutions, usually funded by their national governments grant soft-term loans for project financing. They co-ordinate respective activities regarding these loans with concerned officials of local governments in order to ensure efficient use of funds and to establish development priorities of projects financed. The regional development finance institutions, usually funded by ESCWA and non-ESCWA governments, as well, contribute to efficient allocation of funds at their disposal for investment financing, by providing, as the case with the former, soft-term loans and technical advice and other related services.

Contrary to lending of national development finance institutions, lending of regional development finance institutions is not limited to the public sector; it extends also to the private sector, whereby the host government guarantees the lending (sovereign risk).

Most national as well as regional development finance institutions have exhausted their usual funding sources and are becoming increasingly dependent on repayment of past loans for new ones. The current economic recession in ESCWA region, caused, inter alia, by lower oil prices, has changed the dynamics of both types of institutions as well as that of local development finance institutions. Many of these institutions consider their situation as one of static or no-growth in the foreseen future.

As most of these institutions except some of the local ones such as the Industrial Development Bank of Jordan, and the Industrial Bank of Kuwait have not become involved in the past in any noteworthy activity in the region's financial markets to raise funds and establish themselves as market participants while they still enjoyed a high leverage and credit rating, they do not seem to be able to do this at present or in the foreseen future with their current low leverage and credit rating, and with the absence of any impetus in these markets. Instead of using the unfavourable current state of affairs of finance in ESCWA region as an incentive to rethink development finance policies and enact changes in line with the changing development finance needs of the region, they have continued performing same loan policies that have not proved very feasible in the past, and have led to exhausting their funding sources which at present can hardly be compensated, neither by the funding governments which are suffering a high savings gap and deep economic recession, nor by the region's financial markets, which neither possess the necessary "financial technology" and impetus, nor have the sufficient liquidity.

The deficit countries are confronted with severe problems of lack of funds for development finance. Starting early eighties all selected ESCWA countries have been experiencing deteriorating (i.e., an increase in) savings gaps. This situation is expected to continue through the second half of the decade.

To achieve the International Development Strategy for the UN-Development Decade goal of a 7% annual growth rate, which, however, can no longer be considered valid, due to the "troubled" world economic conditions, (selected) ESCWA countries would most probably have to look for external financial sources.

However, there is still a potential for savings mobilization in the region. A large portion of total savings is still accrued to governments. Savings of the private sector are at relatively low levels. The potential to increase savings remains therefore with this sector, as government savings are declining due to the problems associated with decreased oil revenues and spillovers.

But there are many factors contributing to the present low saving rates of the private sector. They include, inter alia, absence of saving motives and habits, underdeveloped banking habits, complications of saving procedures with banks, absence of nearby and sufficient banking facilities, religious objections by some segments of the population, low rates of return on saving deposits and absence of other and more rewarding saving alternatives such as investing in financial market instruments. In addition to this, the banks have not shown great imagination as to introduce other savings forms of saving instruments, such as "investment saving accounts" or "saving bonds" and others, to mobilize savings.

Use of the financial system by individuals does not seem to have been greatly encouraged in some (selected) ESCWA countries. Banking facilities are available in urban areas, but only with a minimum presence in the country side. Except for Kuwait (which is a city-state) whose banks were pioneers in introducing automated and conventional banking in the region, conventional banking even in urban areas of most ESCWA countries does not exist. Access to banking in some ESCWA countries is still associated with the well-known government bureaucracies backed by complexities of procedures and red tape. Alone, among ESCWA deficit countries, Jordan which has recently begun introducing automated banking services has been the most successful country in attracting savings through postal savings schemes and easier access to banking through the so-called mobile-bank of the Jordan Housing Bank moving on regular weekly basis from one village to another in the country-side. Moreover, all banks in most of ESCWA countries have been addressing only specific segments of the population, especially the middle-income class, and neglecting the others. On the other hand, no efforts have been made by most of these banks to cultivate and encourage saving habits by the younger generation and school children who are the customers of tomorrow.

The market-determined interest rate which, like no other single factor is very important to attract voluntary deposits, has been made artificial in most of (selected) ESCWA countries and has therefore not been very encouraging to save.

In addition to the limited investment opportunities at the beginning of, and actually during, the period of abundant financial surpluses, the non-market determined interest rates have been a reason for the outflow of savings' capital from ESCWA countries to the international financial markets, where interest rates were higher and investment opportunities more rewarding.

Non-market determined interest rates result in a paucity of savings and an over-abundance of projects to be financed. Without the interest rate acting to ration investment funds, non-economic criteria would be used and would result in less-than-efficient use of investment funds.

Islamic banking system has been relatively successful in ESCWA region in attracting deposits. There seems to exist a large potential for this system in attracting saving deposits among devoted and would be devoted Moslems, considering the rising wave of Islam. While problems still exist in allocating deposits in more efficient ways, since these Islamic Banks are still experimenting with their "new" financing techniques, and are facing a tough competition from the long-established conventional banks and financial institutions, encouraging development of Islamic banks deserves a try. Individuals, unfamiliar with typical banking might be more attracted to facilities with religious affiliation. Development finance institutions suffering from stressing funding problems may find it feasible to make use of resources mobilized by Islamic banks, through special arrangements specifying proper use of these resources by these institutions according to Islamic principles.

Such co-operation would benefit the two branches of the financial system. On the one hand, the Islamic banks and institutions would establish, in the development finance institutions, an experienced, able and far-reaching investment vehicle for their liquidity excess, and on the other hand, the development finance institutions would have, in the Islamic banks, a reliable source of funding.

By examining the development process of financial markets in ESCWA region during the last decade, it can be said that this process has made substantial strides, particularly in Amman and Kuwait. However, it should be borne in mind, that developing financial markets is a gradual and time-consuming process. If financial operations in these markets are not at the level of sophistication of those in developed countries, this does not imply that these markets have failed, but rather that the level of efficiency of the institutions operating in them still needs improvement.

The problem of using some ESCWA countries' currencies in the region's financial markets has not been considered sufficiently in the last few years although it is one of the most important issues that should have been looked at by developing and integrating these markets. Beyond the development of a satisfactory legal and regulatory framework and the creation of an adequate institutional infrastructure, no positive step is likely to be as important as protecting the domestic value of the domestic currency. This is vital not only in encouraging the expansion of banking habit but also for rational financial planning at all levels of economic activity.

The return on financial assets must be attractive relative to alternative forms of savings, such as land and other durable goods, but that return must be attractive in real terms, as well. Insuring the value of financial assets means ensuring the stability of the purchasing power of money. This is because money is an important financial asset itself and because the principal and interest on other financial assets are usually fixed in money terms. The denomination of financial assets in local currency implies the use of that currency as a reserve currency to a certain extent. Therefore if an ESCWA (and Arab) financial market is to develop in its own right, as something more than offspring of the Euromarkets, such as the Bahraini offshore market that has developed to a rather "external" market than a regional one, serving as a vehicle for resources transfer from the region to the international financial markets, then it is imperative that, for instance, ESCWA surplus countries accept the sharing of the responsibilities for reserve

currencies, albeit modestly. Certainly, there are ways to divide the burden, either by creation of a monetary union, as has been discussed for several years in the Gulf region, or by agreeing to use a basket of the strongest currencies of the region. Alternatively, consideration might also be given to denominating claims in SDRs or in ECUs.

Any further developing of financial markets in ESCWA depends on the governments' approach to banking regulation and on the availability of the needed expertise. The ESCWA countries have many of the ingredients required for financial markets development integration. Cultural and linguistic unity are positive factors while the lack of a widely held Arab currency is a main obstacle. Barring the establishment of a common currency, which is still a long way off, efforts should be made to achieve an integration of the available financial markets. This requires harmonization of banking regulations, and removing restrictions on lending and a good communication and transportation system.

The development of financial markets in ESCWA region during the last decade indicates that these market have not been very successful beyond national boundaries as they have not been able to achieve efficient as well as sufficient flow of savings from ESCWA surplus countries to ESCWA deficit countries. There have been some obstacles that have led to this result, among which are the objective inability of these markets to attract government-held reserves and further the limiting of government savings that could be invested in these markets due to the government-to-government transactions in form of direct grants or credits on concessionary terms. The amounts involved here are of such magnitude that channelling only a small percentage of them through the region's financial markets would represent a considerable boost for these markets.

However, no blueprint solutions to the issue of boosting and integrating ESCWA financial markets should be expected in this study. The process of financial markets development and integration is a result of functional behavior of the intermediary role of the many financial institutions on a regional level. Therefore, if any recommendation is to be worthy of consideration, it should first and foremost attempt to expand and strengthen this role as well as to provide for the practical aspects of adequate and efficient financial services which can be made available by financial institutions of the region.

In this regard, the following recommendation is made: A market-making financial institution should be created for regional risk-taking similar to the market-making function of ACTS in Kuwait which was established to lubricate the wheels of the secondary market of the Euro-Kuwaiti Dinar sector, which, however, is effectively closed at present.

As such a market-maker requires substantial commitments of capital, the capitalization should be made possible through an association of the existing commercial banks and development finance institutions in the region. The risk-taking will be on the marketing of securities issued for the financing of regional economic programs, or securities issued by enterprises operating on a regional basis. These securities should be made available to the public as well as to the private sector and development banks and organizations on a subscription basis. By the creation of such a market-maker, financial institutions in the region would change from the traditional liquidity

oriented investment and asset management to financial services management where financial assets creation and syndication would be encouraged as is the case with the Arab Bank in Bahrain. The ability of these financial institutions to secure a market-making environment for their portfolios would release substantial funds to the regional equity market which, presently, is either held in liquid form or placed in the international financial markets.