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# ARAB CAPITAL MARKET INTEGRATION:

# PROBLEMS AND PROSPECTS

A THESIS SUBMITTED FOR THE DEGREE OF

DOCTOR OF PHILOSOPHY IN ECONOMICS.

by

SULEIMAN ABU-SABHA

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# ABSTRACT

## ABSTRACT

The Arab region comprises a group of developing countries which sought further socio-economic development through institutionalizing their cooperation. Within this context intensified efforts have been made toward their economic integration. The oil boom of the 1970s and the subsequent enormous wealth accruing to the region increased the pressures on the Arab States to institutionalize their financial cooperation and to integrate their financial markets.

The main objectives of this study are to examine the problems and prospects of the integrated Arab Financial Markets. We hold the view that the development of the national financial markets is the first step toward creating integrated Arab Financial Markets. And we assume that the primary objective of the Arabs in integrating their financial markets is to finance economic development and to achieve financial equilibrium for the region as a whole.

Accordingly, this study investigates three main areas of interest which are (a) the structure and performance of the region's emerging financial markets, (b) their role in economic development and the flow of funds from the high savings countries to low savings ones, (c) desirable policies and procedural changes to improve efficiency and create or strengthen the links between the national financial institutions in order to enlarge their contribution to national and regional development.

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| | |
|---|---|
| AFAED | Abu Dhabi Fund for Arab Economic Development |
| AFM | Amman Financial Market |
| AAD | Arab Accounting Dinar |
| (BADEA) | Arab Bank for Economic Development in Africa |
| AFSED | Arab Fund for Social and Economic Development |
| AMF | Arab Monetary Fund |
| EP | Egyptian Pound |
| EEC | European Economic Community |
| GCC | Gulf Corporation Council |
| IBCD | International Bank for Construction and Development (World Bank) |
| IMF | International Monetary Fund |
| IFED | Iraqi Fund for External Development |
| IDB | Islamic Development Bank |
| JD | Jordanian Dinar |
| KFAED | Kuwait Fund for Arab Economic Development |
| LP | Lebanese Pound |
| LABF | Libyan Arab Foreign Bank |
| MD | Moroccan Dirham |
| OAPEC | Organization of Arab Petroleum Exporting Countries |
| SAMA | Saudi Arabia Monetary Agency |
| YPDR | The People's Democratic Republic of Yemen |
| TD | Tunisian Dinar |
| UBAF | Union de Banques Arabes et Francaises |
| UAEs | United Arab Emirates |
| UNCTAD | United Nations Conference on Trade and Development |
| YAR | Yemen Arab Republic |

# INTRODUCTION

# INTRODUCTION

In recent years, the Arab countries have shown some interest in the integration of their financial markets as one of the major instruments for developing the Arab region.(1) This interest has been consolidated by the growing interdependence of the Arab countries' economies. This is evident both in the significant movement of people and of capital within the region on an unprecedented scale; in the growth of regional investment and trade; in the desire to establish a real industrial base in the region; and in the unnecessarily large proportion of the region's savings held abroad.(2)

The backwardness of the region's financial systems in the early 1970s prevented it from playing any significant role in recycling the capital surplus of the oil-exporting countries and passed this opportunity to the international banks which recycled most of this surplus outside the region.(3) The development of the Arab financial markets was seen as a precondition for correcting those conditions and channelling more funds for domestic development.(4) The integration of the Arab markets was seen by some writers in the region as the appropriate channel to transfer funds from the high saving Arab countries to the low saving countries.(5) The popular appeal of the integrated Arab financial markets induced the twenty Governors of the Arab Central Banks to examine this issue in 1978 and to agree to make greater efforts towards its realization.(6) Consequently new financial institutions were set up: new commercial banks, development banks Islamic banks, investment companies, securities markets and other types of financial institution and arrangements required to fulfil specific functions relating to the transfer of funds within and outside the region.(7). As a result the financial scene of the region began to change rapidly.

In spite of its importance, this development has not been investigated thoroughly on the regional level before. It would appear that the Arab states have emphasized the integration of Arab capital markets as an instrument for economic growth, without giving much consideration to the existing socio-economic factors which would hinder its realization and without recognizing the expected inefficiencies and dangers associated with them.

In this study we shall examine the problems and prospects of integrating Arab capital markets through an examination of the financial institutions and markets of the region. We will assume that the development of the national Arab capital markets is the first step towards their integration, and that the primary objective of the Arab countries in developing and integrating their markets is to facilitate the financing of economic development. In order to meet these objectives this study is presented in eight chapters:-

Chapter one will review the financial and economic literature available for dealing with questions related to financial growth, the size and nature of the markets, the emergence and development of various types of financial intermediaries and markets, economic and financial integration, and the impact of the markets on economic development. This review will serve as a theoretical background to an analysis of the nature and development of the financial institutions and markets in the region, and will enable us to pass judgement as to the degree of their efficiency, their impact on the process of economic development and the way in which improvement in their operation may be made.

The second chapter is concerned with the analysis of the socio-economic characteristics of the countries in the Arab region. It will focus on the distribution of the human and natural resources, the level of socio-economic development achieved, the availability and methods of financial utilization, and the existing economic co-operation within the region. This chapter is designed to serve as a necessary background to the proper understanding of the problems and prospects of integrating Arab capital markets, as the recent focus on Arab capital markets has been encouraged by the structural differences in the region. We shall argue here that the resources available in the region are poorly utilized due to their uneven distribution, and that the integration of the Arab financial market can particularly facilitate the achievement of a regional financial equilibrium. But overall economic integration is the road to comprehensive economic and social development on the regional level.

Chapters three to six will examine the evolution and operation of the main constituents of the financial markets in the region: namely the banking system, the development banks, the Islamic banks and the stock markets. This analysis will show their organizational characteristics, the legal framework within which they operate, and their impact on the economic development of the national and regional level.

This examination will enable us to judge their effectiveness with reference to the theoretical discussion in chapter one and within the framework of the regional economy presented in chapter two, and will enable us to identify any structural and operational faults in their function. We will then suggest measures which may be undertaken to improve their efficiency. Each chapter will be concluded with a short remark regarding the position of each type of institution within the region's financial structure and its importance in the provision of capital for productive investment.

Chapter three is devoted to the analysis of the banking systems. Here we shall provide a detailed and extended analysis of the structure and function of the banking systems and emphasise more essential criteria of economic development and performance in relation to the Arab economy as a whole. This chapter can roughly be divided into five separate yet inter-related sections each section focuses upon distinct features of the banking system.

The Introduction provides an introductory overview of the nature of the banking system. Here we shall indicate how the banking system has a dual function the first of which provides an adequate supply of an "acceptable money", the second function transfers capital between lenders and borrowers. The effective performance of this dual function played by the banking system is fundamental in the overall development of the economy.

The first section deals with the structural and organizational nature of the banking system. Here it will become evident that the systems performance capacity is dependant on these organizational and structural factors. In order to have an adequate grasp of the structural nature of the banking systems within the region as a whole, we need to examine the structural change according to the historical events which influence growth of the system. During the colonial period the Europeans introduced the conventional banks for the first time, mainly as a means of facilitating trade with the centres and to serve the colonial administrations. At this period of time indigenous banks were few and far between. After each Arab countries independence greater concern was placed on the establishment of national banks For the first time the banks were subjected to new regulations and the free era came to an end. Central banks or equivalent institutions were introduced to improve and overcome the previously existing deficient monetary systems. A second major role of these newly established central banks was to encourage and promote economic development. At this stage the more socialist oriented Arab countries for example Egypt, Syria and Algeria re-organised their banking system and brought it firmly under state control, while at the same time standardizing their financial systems.

In third period pertinent to structural change in the banking system which coincided with the oil boom in the early 1970s. The increase in oil prices created enormous liquid wealth which attracted the establishment of new banks both national and foreign. Additionally the new found wealth allowed Arab financial institutions and other wealthy people to establish banks abroad in such places as London, Paris and New York. Obviously, this led to an increase in the number of banks in the region and a further increase in the number of branches and their financial assets

In the second section we shall examine the banking systems role in economic development. The introduction of the central banks improved the monetary system and helped create a more effective set of organizational principles, for example the central system played a prominent role in the supervision of the financial sector and aimed to promote its growth Equally the central system in many Arab countries undertook the duties of managing government national debt. This section will also examine the commercial banks and their role in monetizing the economy, mobilising saving and extending credit to trade and other productive sector. The findings of this examination of the commercial banks reveals a poor performance in all of the three above functions. Most of the Arab countries depict a low monetizing ratio, low saving ratio and the sectoral distribution of finance showed bias toward short-term finance mainly for financing trade and construction. The productive sector which needs long-term credit was neglected.

The third section provides a more critical analysis and draws out a number of possibilities which might improve the banking system. The growth of the Arab banking system expanded without any co-ordination between the various Arab countries which meant that organizational structure was heterogenous rather than homogenous. An example of this multifarious nature can be seen in the contrast beween the United Arab Emirates who have a population of less than one million people but over 52 banks and Iraq with 13 million people and only one commercial bank. The national financial legislation and particularly banking regulations placed some barriers on the expansion of banks between countries, and like-wise, the imposition of ceiling limits on the interest rate structure placed constraints on the effective operations of the banks Another critical factor which hindered the effectiveness of the banks was their concentration on urban areas at the expense of rural areas. The banks were reluctant to spread to rural areas because they were cost ineffective.

In conclusion, in this chapter we will find that the overall development of the banks leaves much to be desired, there are a very few large banks with a regional base, the majority of the banks are small concentrating their operation to the urban centres in the countries of their origin. The expansion of some banks abroad diverted part of their efforts to serve their national countries. That is, they diverted part of their efforts elsewhere at the expense of economic development in Arab countries. Furthermore, unless the banks up-grade their resources, expand in the region and abandon their conservative lending policy they will continue to be fragmented and of little value for economic development in the region.

Many economists would argue that the development banks are not an integral part of the capital market. These economists suggest that development banks have a distinct function which essentially aims to channel the public sector funds to special economic activity, as opposed to other financial institutions which explicitly work in channelling funds according to the market forces. However, I would argue that this is not the true state of affairs in the Arab region. Indeed, the development banks are the second most important sector in the Arab financial system and they perform a crucial role in the flow of capital at the regional level. What must be remembered is that the development banks have a special position in the developing countries, and in the first part of this chapter we shall examine this crucial rule and the rationality which underlines their establishment in the developing countries. Here will be presented the three main theoretical interpretations for the creation of such banks. Due to the weak forces in the developing countries it is unlikely for the financial institution to specialise in providing risky long-term finance. The next interpretation highlights the problems and deficiencies inbuilt within the banking model which is based on the British banking system. The final interpretation stresses the importance of technical assistance preformed by development banks.

In the second section we shall examine the evolution of development banks in the Arab region. There are two separate kinds of development banks, national banks and regional banks. The former is responsible to the country of origin and the latter concerns itself with the regional and sometimes international banking activities. Here we shall present an overview of the banks' development in terms of their number their spread, areas of activities and growth in their financial assets.

Section three concentrates on the manner in which the banking charters define the operational rules and particularly how these regulation obligate the national development banks to the followng criteria they are limited in their operations to specific economic activites within the countries of origin; they are expected to extend long-term finance on concessionary terms and they are not allowed to solicit savings and if a certain few are allowed it is under limited conditions. With regard to the regional banks, in total there are nine of them, each of these banks have a separate and distinct set of responsibilites. The two of special interest in this section are the Arab Fund for Social and Economic Development and the Arab Monetary Funds which are respectively modelled on the World Bank and the International Monetary Fund, although the Arab Banking institutions have a more widespread set of objectives. These objectives are primarily to promote economic and financial integration of Arab countries.

Section four provides a critical exposition of the development banks both regional and national with regard to the national institutions we shall examine their performance efficiency through their effectiveness in utilizing the capital on their disposal. To explore the adequacy of their capital we shall focus on a comparison of the finance extended by them to the total investment made by the Arab countries in each economic activity. With regard to the regional institution we shall also examine the way in which they utilize their available resources and the recipient countries and the economic activities pursued by these recipients.

Section five provides a number of concluding comments: here we shall argue that both national and regional development banks are of a central importance to the development of the Arab region as a whole, and development would be less had not these banks extended the long-term finance and technical assistance to the productive sectors. However, there are number of drawbacks and problems in their ability to step-up such development. For instance, the majority of the national banks, particularly in the poor Arab countries have inadequate financial resources. They are dependent for their capital on their particular governments which lack any wealth. Obviously the solution here is to free them from the constraints imposed upon their operation, and allow them to solicit savings and raise the lending charge rate. With regard to the regional banks, they have been one of the main channels in which the savings of the Arab capital surplus countries transfered to other Arab countries. However, the main discrepancies arise from their inability to accurately indentify feasible projects over a wide area. With regard to the two Pan-Arab institutions they have achieved a limited success, the success is undermined by the bureaucratic restrictions and their lack of economic power. Increasing the regional economic power and reducing the shackles of bureaucracy could pave the way toward a more effective operation and Arab economic integration.

In chapter five I shall focus on the distinct role played by the Islamic bank. This role is important both in terms of cultural and economic principles, although the Islamic Bank operates by a co-ordination of these latter two principles, whilst the more modern financial institutions and commercial banking systems often neglect the intimate interplay between cultural and economic factors. That is, the Islamic bank according to Islamic tradition reinforces the disapproval of the 'usury system' whilst the more conventional systems impose a set of economic practices upon the Islamic people which are foreign and disagreable to their way of life. Chapter five can be appropriately divided into six sections which dealing with a specific set of pertinent factors related to the Islamic Bank. In the first section I shall provide a detailed account of the economic principles of Islam. The 'spirit' of Islam it seems, places greater emphasis on the collective needs of the community, and while allowing the individual to prosper economically the individual must always pay heed to the principle of shared benefit. An example of this ethos is the prohibiting of paying fixed interest rates on money loans. Therefore the economic contract between two participating parties is based on a shared profit and loss making criteria. All these principles are derived from a number of passages in the Holy Koran.
Section two will trace the historical evolution of the Islamic banks. There will be a focus on the circumstances of their emergence, the

manner in which they have gradually embedded themselves within both the local region and abroad. Here I shall illustrate how the simple economic life style had no need for a banking institution. However the arrival of colonialism meant an imposition of the conventional bank upon the Islamic nations. Of course, after independance it was difficult to uproot these now established banking systems. A set of superficial principles of objections to such colonial systems manifested itself in the introduction of nationalised banks and the imposition of ceilings on the interest rate structure. These latter two developments did not fully embody the symbol of Islam and were partial solutions. However, the new found wealth of the early 1970's meant that people could institutionalise their own banking systems which corresponded more closely with the principles of Islam, hence the emergence of the Islamic bank. Many countries went on to establish one or two banks, a few countries attempted to introduce radical changes and implement a banking system in total accordance with the ideas of Islam.

Section three, attempts to explain the way in which the Islamic financial institutions generate their funds and how the financial instruments developed were in compliance with the principles of Islam. A focus is placed on how they built their financial liabilities and how they deployed their financial assets. Section four a comprehensive case study is made of the experience of the Jordanian Islamic Banks. Section five looks at the impact of the Islamic institutions in the Arab region as a whole. The new instruments based on Islamic principles allowed the devout people to be able to utilise the banking systems whereas, previously they refrained from using such systems.

The second major impact was that because the Islamic Banks participated in the shared risk notion of profit and loss with the entrepeneur this allowed for an extension of long-term finance and the development of the economy. Finally, the operation of the Islamic bank is the concept of profit-loss sharing avoided the artificial ceiling of interest rates imposed in the region and allowed people to deposit money at home.

In conclusion, section six illustrates how the Islamic Banks, even though they are of recent origin, are essential for development and enrich the diversity of the financial system. One discrepancy is however, their lack of growth at present and their operations have yet to become finalised. That is, perhaps they need to incorporate at some future time, a more flexible and all encompasing set of financial instruments.

Stock markets are often regarded as a feature of the more developed countries as they provide long term finance and confidence in holding long-term security. That is to say, the development of the British Banks specialise in one type of business, namely in providing short-term finance for stock goods, while the security markets and other financial institutions provide long-term finance for housing, plant equipment and so on. Many Arab countries in the late 1970's began to improve their financial system and the financial security shares and government bonds began to be more frequently circulated in the market. These markets were created to organise trade in these securites. Chapter six provides a thorough examination of the Arab security markets, their development and structural operation. This chapter can be appropriately divided into six sections.

In section one there will be a detailed account of the structure and function of the stock market, followed by an analysis of its significance and value in economic development. Here I shall introduce the concept of primary and secondary markets as well as organised and unorganised markets,

Their significance will be examined through their function in the saving investment process. For instance, the primary market is the site where the funds are raised initially by governments or the corporations, the secondary market is the site where the investors can sell the outstanding securities in their possession and restore liquidity.

Section two focuses on the historical grounds for the emergence of the stock market. In the earlier period of this century the French introduced the practice of stock marketing to such countries as Lebanon, Morocco and Tunisia. In the absence of any national security and due to the low per capita income at this time the markets were thoroughly a foreign enclave. Even though the operation of such markets was terminated when the French departed, these earlier institutions provided the framework for contemporary stock market institutions. In the 1970's some Arab countries, such as Jordan and Kuwait, established such markets for the first time, whereas, the countries which had previously been exposed to a colonial stock market system, revived these financial institutions in the hope of increasing long-term finance for economic development.

The contemporary structure of the Arab stock markets reveals a decisive and common factor, that is, all of them are public institutions governed by committees heavily represented by the public sector. The characteristics of the dealers, however, differ substantially. In Kuwait and Jordan the process is similar to that of London, whereas in Morocco and Saudi Arabia the banks play a major role in these markets, similar to that of the German stock market system. The discussion then moves on to examine the development of the two main active markets, separately, namely Jordan and Kuwait. I shall then go onto discuss in a general fashion the securities markets in other countries and conclude that the markets in both Jordan and Kuwait attracted the listing of share-holding companies, as they regarded the market as a means to facilitate escalation and expansion of capital. With regard to operation, the Amman Financial market has grown in trade shares but has failed to expand in government securities. The Kuwait stock exchange has become large, but speculative activities hindered and interrupted trade on many occasions. In Morocco and Tunisia the markets have had no substantial growth, as very few companies are officially listed and there is little trade there.

In section three, I shall examine the relationship between stock markets and their importance in economic development. Here I compare the trading activities of these markets with the banks outstanding lending activities. Their role in attracting foreign capital is discussed as well as their role in creating confidence in the financial securities and their influence on the rate of savings.

Section four analyses factors adversely affecting the growth of Arab stock exchanges, these include; the relatively cheap borrowing from development banks and commercial banks, (this has prevented the company from resorting to market activity); the narrow base of the economy hinders the establishment and growth of corporations, i.e. share holding companies; family enterprises continue to dominate the economic arean, again, at the exclusion of corporations; additionally the enormous wealth of a many governments precluded them from any borrowing.

These factors among others limited the supply of security. On the demand side I shall examine those factors limiting this demand for securities such as, the rigidity of the traditional bureaucratic institutions and the information published about share-holding companies not being sufficient enough. The low per capita income in some countries and the skewed wealth in others altogether reduces the demand.

Section five, will suggest ways in which Arab countries can move toward development and integration of the current stock exchanges. Although the circumstances in each country differ, the problems faced by these markets are common, it is suggested that a number of measures be introduced to increase the supply and demand for securities. These measures include, some incentive through direct allowances, such as tax concessions for the companies and the share-holders. It would be preferable if the central bank performed the role of creating these more favourable conditions, by attempting to curb inflation and to liberalise the interest rate structure.

In conclusion, in section six, a recapitulation of the overall development will be presented. It can be observed that the present stock exchanges are few and small, and indeed, of minor importance for economic development, and for the purpose of integration of the Arab capital market a regional stock exchange is essential.

Chapter seven examines the effect of the Offshore Banking business on the Arab economy and market. If the Arab countries are to achieve any effective integration of any kind they have to adopt a common economic strategy with the outside world. The introduction of an offshore banking system works directly against such integration by systematically increasing the connections with the outside world, whilst neglecting and reducing the inter-relations between Arab countries. Again this chapter can be divided into seven separate sections. In section one, I shall discuss exactly what the offshore banking business entails. The restricted financial environments of many countries induced the financial institutions and other enterprises to tax haven territories, in order to operate freely in what could be described as a relatively 'free financial zone', that is, a zone not subject to the type of regulations imposed on domestic banks. This allows the offshore banking business to compete effectively for business from the surrounding countries.

In section two, the introduction of these banks to the region is traced and drawn out and then their emergence and growth is discussed. These banks were primarily established in Bahrain. The United Arab Emirates, Egypt and Tunisia, also have such banking facilities but only on a limited scale. The offshore banking institutions in Bahrain grew rapidly and led to Bahrain establishing itself as a financial centre, additionally enabling it to host other kinds of financial institutions, for example the Exempt Companies, which allowed the establishment of many Arab companies, especially Kuwait companies, as shown earlier. In section three I shall examine both the impact and the advantages for the international banks in establishing themselves in Bahrain.

Initially the international banks used Beirut as the main banking headquarters in the region, the civil war in Lebanon and the rapid increase of wealth in the Gulf area were the two main factors which caused the international banks to shift their headquarters to Bahrain. I shall examine in detail the decline of Beirut as a financial centre.

There are two other main advantages for the international bank in establishing themselves in Bahrain, and both derive from the geographical location of Bahrain. First, it is located on the door-step of the most wealthy countries in the Gulf region. This allowed the international banks to mobilise in a very short time an enormous amount of capital. Secondly, the geographical position of Bahrain is mid-way between the Far East and Europe, which allows for a global money market which could operate continuously.

Section four focuses on the impact of offshore banking business in the Arab region. Their progressive and constructive impacts were the development of the money market and the narrowing of the rate of currency exchange. However, the speculative activities of the offshore banking business in the currency of the neighbouring countries and the mobilising of saving and lending dramatically harmed the countries involved. These surrounding countries were adverse to international-ising their currency, the offshore banking business also mobilised more savings out of the region than was ultimately reinvested within the region. Next, they impeded the development of the local banks, due to their operations under the liberal system, whilst the local banks were constrained by strict regulations, particularly with regard to interest rates.

Section five examines the impact of the offshore banking business on the host country (i.e. Bahrain, Egypt, Tunisia). The aims of establishing the offshore banking business in Egypt and Tunisia was to increase the finance of economic development, whilst in Bahrain the main intentions were to diversify their economy by the promotion of the service sectors. The offshore banking business, equally, has an adverse effect on the socio-economic nature of these countries. In Egypt, they attracted the most competent and qualified bank staff from the local banks, in Bahrain, the incorporations of this system and its lucrative financial rewards created an atmosphere of both superficial needs and high cost of living.

In Section six, I shall explore the prospects of the offshore banking system, I shall argue that their growth and development enabled them to compete and to resist other competition because of their established nature, and effectivity.

The previous discussion, the analytical insights and the issues raised from this examination of the evolution and operations of the Arab financial institutions and markets will provide a foundation to extrapolate in chapter eight on a number of concluding remarks as to the existing financial structure and function in the Arab world. At the same time, it will enable us to constructively recommend the adoption of certain policies as a means of integrating the Arab capital market, this would undoubtedly have the effect of creating financial equilibrium at the regional level. In general, however, the conclusion of this chapter would seem to imply that the various problems of integration are sufficiently great to make the implementation of such a development extremely unlikely in the near future.

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# CHAPTER ONE

## THE DEVELOPMENT AND INTEGRATION OF THE FINANCIAL MARKETS AND THEIR ROLE IN ECONOMIC DEVELOPMENT: A THEORETICAL DISCUSSION

# The Development and Integration of the Financial Markets and their Role in Economic Development. A Theoretical Discussion

## Introduction

The objective of this chapter is to provide the theoretical setting on questions related to market development, market integration and their significance in the saving - investment process as a basis for discussion in the subsequent chapters.

The chapter is presented in three main sections. In the first section we will examine the nature, evolution and expansion of financial markets. Section two will present the concept of economic integration and review the best known forms of economic and financial integration. Section three will examine the importance of capital accumulation in the technologically backward economies, the sources of investment finance, then review the generalizations reached by certain economists concerning the role of the financial markets in development and finally examine the contribution of integrated financial markets to the countries intending to integrate their markets.

## 1.1. The nature, evolution and expansion of financial markets

### 1.1.1 Definition of a financial market

Financial markets like other markets grew to provide a focus for the activities of sellers and buyers of a particular commodity, in this case money. The importance of money in economic life has necessitated the creation of a variety of financial instruments which can be exchanged for money. This in turn has resulted in the complexity of the present financial markets.

The financial literature provides no standard definition of the term financial market; on the contrary one encounters notable variations between writers. For instance Silber defines financial markets as a transmission mechanism and describes them as follows:

> "Financial markets are basically the same as other kinds of markets. People buy and sell, bargain and hassle, win and lose ... in the financial markets. They buy and sell securities or I.O.U's."(1)

This shows that the market is easy to describe but more difficult to define. Smith's definition of the market is similar to the first. He says that,

> "the market in financial terms, is a place to borrow and lend money in the broadest sense, all borrowing and lending is part of one big financial market."(2)

Mason is more specific in her definition of the market. She describes the market as a market in particular instruments, consisting of all those who are involved with that instrument either as a holder or as specialist agents or consultants.(3)

From the above discussion we have to accept with Revell that the word 'market' is used somewhat loosely in discussing the financial system.(4) Smith suggests that the definition of a market usually depends upon the purpose of the discussion. Once the definition is extended beyond identical securities issued by a single institution or corporation, the concept necessarily includes instruments that are not perfect substitutes.(5)

In the financial literature financial markets are usually classified according to the financial instruments maturities, to the status of the market (organised or unorganised) and to the type of financial securities (primary or secondary).

With regard to the financial instruments' maturities, the financial markets are divided into money markets and capital markets.

The money market may be defined as a network of borrowers and lenders for short-term securities. But what constitutes short term securities varies from one country to another, although most participants in the financial markets define the short-term as up to one year maturity.(6) Within this definition, the treasury bills, commercial papers, bankers' acceptance and bank accounts of less than one year maturity are the main financial instruments issued and traded on such markets. The main participants in the money markets are commercial banks, discount houses (in Britain) and the monetary authorities.

The capital market is a term used to mean all the financial markets dealing in medium and long-term securities.(7) The best known financial instruments issued and traded in such markets are shares, bonds, mortgages and long-term loans. The participants of capital markets are among others, unit trusts, investment trusts, insurance companies, issuing houses, saving banks.

The money markets and the capital markets are not necessarily formal organisations where buyers and sellers meet regularly in a particular place to conduct business. The majority are merely a collection of institutions dealing in financial instruments with similar features, and, within each market there is a high degree of specialisation. In special cases a capital market may have a specific location such as a stock exchange.

The classification of financial markets by economists is usually based on the financial role of these markets in the economic process. Since economists are more concerned with the link between financial activities and the real sector of the economy.

They have divided financial markets into primary and secondary markets.(8) The first market includes all financial instruments regardless of their maturities issued for the first time. The second market includes all markets in the outstanding financial instruments regardless of their maturities. So it is possible to find money markets and capital markets in both the primary and secondary securities.

The classification of the financial markets into organised and un-organised markets depends on the status of the markets. The majority of financial markets have no location and no restriction on their participants others have some regulations and rules which determine the financial instruments traded on the market and the participants of the market. The organised stock exchange is the best example of an organised market.

### 1.1.2 <u>The process of financial development</u>

In parallel with Rostow's stages of economic development(9) Revell distinguishes four main stages of development of a financial system. These stages are associated with some devices introduced to overcome the constraints on economic development. According to Revell the introduction of commodity money was the first device in the process of financial development. It ended the practice of barter and separated the acts of sale and purchase. Consequently the store of purchasing power was introduced for the first time. However, at this stage the rudimentary financial system did not allow a deficit unit's expenditure to exceed its share of income accruing to it. There was no deficit finance and the only development was the emergence of the partnership form of business which allows a few people to pool their savings but this device was not sufficient to overcome constraints on development.

The second stage of financial development came through the development of borrowing. At first the deficit units which were prepared to run business risks for profit issued interest-bearing financial claims direct to the surplus units in the form of bonds and loans. This allowed the deficit units to expand their business and to control physical assets greater than their net worth. Concomitantly it allowed the surplus units to earn some income on their savings if they were held in such instruments without sharing in the risk of the business. Then with the appearance of joint-stock companies, surplus units had a further opportunity. They were able to obtain a title to a share of profits of the business with their liability limited to the amount of money which they had subscribed. With the introduction of borrowing techniques, the financial markets emerged to facilitate transactions in these securities.

During the course of development direct finance became inefficient as the savers and borrowers grew larger in number, so the third stage of financial development began with the introduction of a new mechanism of indirect finance via the financial institutions.(10) The commercial banks were the first to emerge within the financial institutions because people in the early stage of development showed a preference for holding their savings in money and bank deposits. But when the economy became complex the performance of savers and borrowers also changed. The former showed a greater preference for holding their savings in financial instruments earning more income or giving more security, while the latter showed more interest in borrowing long to start a more risky business.

These demands were satisfied by the emergence of the non-bank institutions. The new institutions usually specialise in financing particular economic activities and secure their funds by issuing their own financial instruments with certain features to suit savers and borrowers alike.

The effective standing of the financial institutions between savers and borrowers in their different capacities (11) left very little chance of direct contact between them. Hence the direct channelling of funds from savers to borrowers declined and indirect finance via the financial institutions grew. (12)

The fourth stage of development came with the operation of the financial institutions; they began to depend on switching their liabilities and assets for relatively small differentials in the expectation of profits. This switching is very important to the smooth running of a complex financial system at the present time. (13)

The growth and sophistication of the financial markets in different countries depends on the requirement of the governments, the corporations and others. In countries where the government borrows on a large scale through the issue of treasury bills and debentures and where corporations are numerous and obtain most of their capital needs through the issue of equity shares.

bonds or borrowing from the financial institutions, the markets become more complex and richer in financial instruments. In other countries where the government borrows little and the corporation sector is very weak with most of its finance being achieved by ploughing back profits, the market would be very small with a narrow range of financial instruments.(14) Thus the advanced countries with a market economy system, where the government and corporations are large borrowers, have developed more sophisticated financial markets than the socialist or the less developed countries.

### 1.1.3 Measurement of financial development and the difference between markets

The size of a financial market can be measured by the amount of financial instruments outstanding at any given time, or the increase in their total over a period of time.(15) The pervasiveness of financing activities in the economic life of any country may be indicated by relating the above measurement of market size to real variables. Economists have developed several ratios. The best known are the ratios which measure the current flows of funds against gross domestic product and gross capital formation as well as the ratios which measure the outstanding financial instruments against national wealth at any given time.

Economists have observed that during economic development countries usually experience more rapid growth in financial assets than in national wealth. This phenomenon was examined by many economists for a group of countries over a long period of time. They found the ratio of the total outstanding financial assets to national wealth was about 0.36 and 0.1 in 1880 for Britain and Japan respectively but it rose to

1.04 and 0.4 in 1913 then rose again to 1.7 and 1.5 in the early 1960's.

This indicates that financial assets have grown faster than gross domestic product in these countries. In the socialist countries and the developing countries, the ratio was also on the rise but at a very slow rate. For instance this ratio was found to be around 10 per cent in 1928 in the Soviet Union rising to about 0.35 in the 1960's. Likewise in the developing countries, the ratio was low and until now perhaps less than 0.5 in such countries.(16)

In a study of the financial structures of 35 developed as well as developing countries over a long period time(17). Goldsmith introduced the above ratio as the principal indicator of financial development and he termed it Financial Interrelation Ratio (FIR).

From the difference in financial structure among countries he found that as a country progresses up the scale of wealth and income, its financial structure usually becomes increasingly rich in financial assets and institutions. This common path of financial progress is marked by a uniform behaviour of the FIR, which implies the existence of stages and cycles of financial development and is reflected in the size of their financial structure, and caused by the fact that the financial structure of western Europe countries served as a prototype for the modern financial system. And from this study he observed a striking regularity in financial development over a long time and around the world. Some of these observations are:-

1. The financial assets of a country increases faster than its

national wealth (and than national product) in the course of development, then they level off at a value of about 1½ times the national wealth.

2. The share of the financial institutions in the ownership of financial assets increases with a country's economic growth.

3. The value of the FIR reflects the degree of specialisation in production and finance of each country.

4. The financial institutions are the predominant holders of financial assets bearing a fixed rate of interest while the individuals are the predominant holders of equities.

5. The banking system is the first to emerge followed by the non-banking institution so the share of banking in the ownership or financial assets declines.

6. Foreign financial links are helpful at some stage as they provide the necessary finance or provide an outlet for surplus to be invested abroad.

7. The financial innovations of the advanced countries are transferred to other countries.

8. The cost of finance is cheaper in countries with a developed financial growth.(18)

From these observations he identified the existence of three types of financial structure in the course of financial development.

The first type prevails at the early stage of financial development and its main characteristic is the limited number and variety of financial instruments with a FIR of less than one half. The commercial banks constitute the most important financial institutions among other types of financial institutions. He cited the financial structure of the European countries from the early eighteenth to the middle of the nineteenth century as an example of this type.

The second type of financial structure is similar to the first type except for the greater role of the governments financial institutions in this type. He cited the financial structure in the present developing countries as an example of this type.

The third type of financial structure is characterised by increased diversification among financial institutions and a FIR ratio of over one. The diversification of institutions in this type led to decline in the importance of the banking system and a corresponding increase in the importance of the non-bank financial institutions.(19)

Despite the importance of the above findings about the process of financial development, the financial structure does not lend itself to measurement in a way helpful in deciding on the optimal size of a single financial market for any country. To quote Goldsmith:

> "we have not succeeded in developing reliable methods to measure the extent and the result of facilitating function of finance to determine the optimal size of the financial super structure in relation to the real infrastructure of the economy and to distinguish effectively the contribution of different forms of financial structure to economic growth."(20)

## 1.2. Economic and Financial Integration

Capital market integration is a part of overall economic integration and can only be achieved within economic integration. We begin this section by examining the concept of economic integration before presenting a brief review of the forms of co-operation in economic and financial field in general.

### 1.2.1 The concept of economic integration

A survey of the conceptual approach to economic integration reveals that the term has a very broad meaning in its aggregative sense and rather diversified emphasis. The economic literature on integration emphasises three approaches, namely, the classical, the institutional and empirical approaches.(21)

The classical or the functional approach is an extention of the classical economic doctrine of free international trade. This approach to economic integration stresses the removal of artifical trade barriers and in finance it perhaps stresses the removal of exchange controls on capital. The institutional approach for economic integration stresses the socio-economic factors and envisages economic integration as the realization of equality of opportunity. This approach rejects the classical concept of achieving integration through equalisation of commodity - factor prices through trade regardless of social factors. Its alternative to the free flow of goods and factors is an exclusive standard of equality of opportunity, social as well as economic.(22)

The empirical approach is a mixture of the two previous approaches. It seeks the removal of artificial barriers and attempts to bridge the social and economic disparities between countries to be integrated. Within this context Balassa defines economic integration as "a process and state of affairs. Regarded as a process, it encompasses measures designed to abolish discrimination between economic units belonging to different national states. As a state of affairs it can be represented by the absence of various forms of discrimination between national economies".(23)

Thus economic integration in any form is a two-pronged process of abolishing discriminatory barriers among participating states and the deliberate introduction of co-ordination with the objective of establishing a level of economic co-operation whereby optimal development may be achieved for equal partners. The experience of many regions which have embarked on a policy of economic integration shows the difficulties in implementing immediately all measures for full economic integration. This has led to the emergence of several forms of partial integration, namely the free trade area, the customs union, and the Common Market.

In the first two forms of co-operation quantitative restrictions and tariffs on trade between member states are abolished. In the third form of co-operation a further step is taken to allow for more integration through the abolition of discriminating and restrictive measures against factor mobility. In the final stage of total economic integration a regional decision making authority is usually established to supervise and unify monetary, fiscal and other policies within the integrated area as one entity.(24)

### 1.2.2. Capital Market Integration

Capital Market Integration on the other hand is concerned with the financial aspects of economic integration. The removal of all kinds of restriction on the movement of capital within the integrated area is essential for financial integration.(25)

To achieve full freedom for capital movement within the integrated area the most effective measures in this direction are:

1. The creation of a single currency to end all the uncertainty inherent in the exchange of many different currencies. This would facilitate the movement of capital and bring the national economic and monetary policies of the users of the same currency in line.(26)
2. Development of the financial systems of the member countries the establishment of a unified network of financial services in the banking stock exchange and other finance fields.(27) The permission of securities and borrowing by the residents of other member countries is essential to encourage individuals and institutions to put their savings and raise money across boundaries.

3. The establishment of the same type of strategy towards the outside world. This would create equal protection to the member countries from the rest of the world and open the member countries on each other for the movement of capital.(28)

In cases of less than full integration there have been a wide range of arrangements used for financial co-operation. These forms depend on the stage of economic development of the member states and what they intend to accomplish through their co-operation. Serious efforts in this direction usually start with monetary co-operation. The co-operating countries may create among themselves one of the following forms: payments unions, reserve pooling, exchange rate co-ordination monetary co-ordination and parallel currency. Each of these is a partial form of monetary integration, as their names imply, and each serves a specific purpose. The first two forms provide the participating countries with a direct source of reserve saving and promote trade. The first form is usually a clearing system agreed upon by a group of countries to settle current account payments which arise from trade among their countries. The best known of such arrangements is the European payments union which operated from 1950-1958.(29) This form is recommended for countries with unconvertible national currencies. Through the payment's union they can agree to settle credit and debit arising from trade among their countries with their national currencies. This will reduce the need for hard currency and create smooth trading relations between them.

In the second form the participants pool part of their central monetary authority reserves to be used for the settlement of payments for any country in difficulty. These reserves are usually used in financing the overall balance of payments deficit's by providing short and medium-term loans. The loans may be automatic loans or subject to some condition specified in the agreement. This type of arrangement was first introduced by Triffin to help countries, particulaly the weak ones, to benefit from the pool.(30)

The remaining forms are more advanced and meant to create stability in the currency exchange rates of the participating countries through exchange rate co-ordination. Progress towards the creation of the European Monetary System (EMS) started in this form. In the community's drive for further integration of it called for co-ordination of member states domestic monetary policies in particular the development of bank liquidity, the terms for allocating credit and the level of interest rates.

The last form of parallel currency is the creation of new currency to be used within the integrated area in parallel to the national currencies. The parallel currency usually start as a unit of account within the integrated area, then gradually it is promoted as means o of exchange and reserves and then eventually will be granted the status of a currency.(31)

## 1.3 Theoretical Considerations concering the relevance of the financial markets in economic development

The role of the financial markets in the process of economic develepment has been a controversial subject among economists.

To understand the impact of the financial markets on economic development we have to enlarge the area of our investigation to include capital accumulation and development then review the theoretical, empirical and historical studies about the role of the financial markets and finally present what the integrated financial markets may contribute to the participating countries.

### 1.3.1 Capital accumulation and development

There is one central problem, that of capital accumulation, which is common to the vast majority of the developing countries. The essence of economic development is the building up of capital equipment in industry, mining, agriculture, schools and laboratories. In the present backward developing economies, Johnson views capital accumulation in its widest sense as the distinguishing characteristic of development and the structural transformation of economies as a generalized process of capital accumulation:

> "The condition of being "developed" consists of having accumulated and having established, efficient social and economic mechanisms for maintaining and increasing stocks of capital per head in the various forms. Similarly the condition of being "underdeveloped" is characterised by the possession of relatively small stocks of the various kinds of capital.(32)

The notion of capital accumulation as a source of growth has its roots in economic history.(33) The writings of the contemporary development economists emphasise the need for capital accumulation, whether they approach the subject historically to explain how the industrial revolution took off two centuries ago or so in Britain and other advanced countries or analytically through introducing various models in which precise ratios of investment to national income are calculated so as to achieve a particular rate of growth.(34) Contemporary writing on capital theory ascribes the productivity of capital to the existence of a wide range of production techniques. The accumulation of capital enables producers to introduce the best technology and permit more innovative production methods, in order to increase productivity.(35) It is generally accepted that technological change itself depends on accretion to investment-capital formation.(36)

However, production function studies mainly in the advanced countries, cast some doubt on the importance of capital accumulation for development. Solow's investigation into the role of capital in the economies of the advanced countries had shown that capital was of minor importance in the growth of the non-farm sector of the U.S. economy for the period 1919-57.(37) This is so because these countries attained long ago a very high scientific and technological level, and these findings did not account for the embodied technological changes caused by capital investment.

Nevertheless Solow's evidence is concerned with advanced economies. Thus conclusions may not be drawn on development strategy for countries - developing countries - with different economic and social structures. The present developing countries need capital far more than it is needed in the developed countries. Developing countries need investment in capital goods if fundamental changes in the structure of their economies are to be achieved. Developing countries need to build their industrial bease and increase the importance of industrial as opposed to agricultural activity. This structural change is recommended to lessen their heavy dependence on imports of all sorts of goods and to lessen their heavy reliance on agricultural and mineral products as main exports. They need further investment in social capital such as housing, transport facilities, electricity etc., which are a precondition for the smooth operation of the productive sectors. As capital stock of a country increases through the process of net investment, we therefore now turn to the question of sources of investment and the way to mobilize them.

### 1.3.2 The Sources of Investment

A country may obtain resources needed for investment by saving part of its national income. But in various studies made by the Department of Economic and Social Affairs of the United Nations, the ratio of gross domestic savings to the gross domestic product of the developing countries has been found to be less than 15 percent in the period 1955-68.(38) This ratio may not adequately achieve the desired rate of growth in such countries. Thus a country with an open economy and an ambitious target of economic growth usually augments its domestic resources by an inflow of foreign resources. Such inflows may come in widely varied ways be it outright grants, technical and economic assistance or in the form of loans and direct foriegn investment.

The experience of recent years has shown that the inflow of foreign aid merely amounted to a very small proportion of the needed investment in the developing countries and more importantly investment in countries which received foreign capital was not the sum of domestic and foreign savings as previously thought.(39)

Many economists have investigated the effect of foreign capital inflow on domestic savings and found it to have a highly significant effect. Haavelmo suggested that domestic savings is not a function of local income alone, but it is also related, inversely, to the inflow of foreign capital.(40) Haavelmo's hypothesis was tested and supported by Rahman in the late 1960's using cross country data for thirty one developing countries/(41) These pioneer studies were followed by other studies made by many economists all of which support the hypothesis that foreign capital had been substituted for domestic saving.(42)

The other impact of private foreign investment on local enterprises was investigated by Bos, Sanders and Secchi.(43) They found that finance obtained from the financial institutions of the host countries to finance the expansion required by foreign enterprises reduces the amount available for the rest of the economy.(44)

In addition Dacy had drawn attention to two important consequences of dependence on foreign resources to accelerate the attainment of self-sustaining growth. The first consequence observed is that countries which have been fed with foreign resources find it difficult to make the necessary economic adjustment when the aid dries up. The second consequence of dispensing with foreign finance is the emergence of trade contraints, as a result of the combination of three factors namely:-

1. Structural change in the economy.
2. Remission of the profit of foreign investment.
3. Amortization of the existing debt.(45)

The above discussion suggests that developing countries should be very selective in allowing direct foreign investment to operate in their economies and should pay more atention to maximizing their domestic savings. But for them to do so they have to identify who the savers are and why they save. Newlyn suggests that the ultimate source of all saving are the individuals, but saving can be accumulated in three ways:

1. Individuals may save part of their income to the extent they consume and pay taxes less than their income.
2. The government may save when its taxes revenues are less than its expenditure on consumption.

3. The producers save when the total sales receipts is greater than the sum of production costs plus direct taxation plus dividends.

On the question of what determines the level of saving, the saving function differs between these sectors. For instance, the government to an extent can raise its saving by collecting more taxes and other revenues and cutting its expenditure. However, its ability to do so is restricted by the tax effort and tax capacity. Meanwhile corporate saving is the function of business activities, government tax policy and the form of ownership. Business activities are positively related to the rate of growth of national income.(46) And the tax policy and ownership greatly influence the distribution of profit between dividend and retained earnings. Finally the function of personal savings is complex and dependant on many variables. A considerable amount of research has been directed to the assessment of various incentives for personal saving.

Economists have introduced many theories with regard to personal saving. These theories have been classified as relating to:

1. The ability to save.
2. The willingness to save.
3. The opportunity to save.(47)

The first is a necessary condition relating to income. Within this group of theories came the absolute income hypothesis of Keynes and others (48) the permanent income hypothesis of Friedman, (49) and the relative income hypothesis which was developed by many economists but gained wide attention through Duesenbery's writings.(50) The first theory implies that a higher rate of savings is expected at a higher level of income. The second theory is an expansion of the Keynesian assumption that saving is a function of income. The modification of Friedman on the previous hypothesis of the Keynesians is that saving is a function of income in the long run - while the relative income theory introduced some social and cultural values as determinants on saving. The empirical studies of individual household behaviour have supported the hypothesis that income is an important determinant of saving; as it is now an accepted fact that the largest proportion of saving is done by upper income families.(51).

Within the theories of willingness to save, perhaps comes the claim by classical economists that interest rates have a significant influence on the volume of saving. They claim that an increase in interest rate increases the volume of saving and vice versa. But as regards the willingness to save, given that the ability to save depends on the balance between present and future consumption, modern economist have come to question the effect of interest rates on aggregate saving.

They introduced the notions of substitution, income and wealth effects and argue that the influence of these variables on saving is not in the same direction. For instance when the interest rate falls, the substitution effect would influence the rational individual to consume more and save less, because his utility of saving is less than his utility of consumption. In this sense, the substitution effect implies a direct relation between saving and interest rates. The income effect would curb present consumption and increase saving, because a rational individual would keep his level of income through saving more at the time of a fall in interest rates. Thus, the income effect implies an inverse relation, while the wealth effect has different tendancies depending on the wealth status of the individual. A fall in interest rate would make an individual feel more wealthy if he has more financial assets than liabilities and in this case he has less need for more saving. But if he has more financial liabilities than financial assets he feels less wealthy and expects to save more. Thus the wealth effect works in either direction depending on the status of an individual.(52) For these off setting effects, economists are unsure as to the net effect of interest rates on saving.(53) Empirical investigations show that saving of the household sector is mainly a function of income and wealth, but the connection between savings and interest rates in not unequivocally proven.(54)

Within the opportunity to save comes the theory relating to the development of the financial market, because the opportunity to save depends on the availability of approapriate assets in which savings can be held, which in turn depends on the efficiency of the financial system and within this context come the recent economists writings on the development of the financial markets as instruments to mobilize savings.

### 1.3.3 The role of financial market in development

The role of financial market in the process of economic development has been a contraversial subject among economist. This controversy emanated partly from the institutional differences between the developing countries and advanced countries. On the positive side there is a reputable body of opinion to the effect that financial markets are crucial for development and it cannot be denied that they have been the link between savers and lenders in the market oriented economies.

In contrast to the positive view expressed by many economists, there is a negative view expressed by other economists. This group states their scepticism about the usefulness of the policy of developing financial markets in the developing countries. Gurley's scepticism about such a policy emanated from his doubts about the universal desirability of financial techniques for mobilizing and allocating resources in developing countries.(55) He argues that other possible alternative techniques for finance could be better for the developing countries, as the financial markets there are undeveloped and the habit of holding financial assets is not established or not widely accepted.(56) Furthermore, he argues that the development of financial markets is not necessary and would be inhibited by certain factors such as:

a. Inflation which would reduce real demand for financial assets in such countries.

b. The narrow economic base would be reflected in the narrow range of financial instruments on such markets particularly the primary securities.

c. The high average cost of the operation of the financial markets.

d. The criteria of the markets would not work in favour of equality in income distribution which is a very important objective in these countries.(57)

The weakness of such a view stems from the fact that it does not question the efficiency of the development of financial markets per se but it introduces the alternative techniques which only proves more feasible in countries with a comprehensive aggregate planning approach.

The more important challenge to financial markets came from Minsky who questions the indirect finance through the financial institutions and the concomitant growth of financial superstructures is questioned on practical grounds. He argues that financial institutions amplify cycles in expectations, retarding real economic development. He wrote "the potential for seriously disruptive domino effects is implicit in the hierarchical pattern which has developed. The introduction of additional layering in finance, together with the invention of new instruments designed to create credit by tapping pools of liquidity is evidence, beyond that revealed by the data on financial stocks and flows, of increasing fragility of the financial system. In a fragile financial structure, feedbacks from the rising interest rates of a boom lead to financial crunches and crashes".(58) This arguments shows that too much development in the financial markets with a tendancy toward speculative finance can be a destabilizing force.

The economists who hold a positive view on financial development are many. Some have investigated the relationship between financial development and economic development, and developed a number of argument relating to the broad inter-relationships between them.

Gerschenkron, Cameron and Tilly (59) examined the historical experience of banking institutions in financing early European industrialization. The former explored the positive role of the Crédit Mobilier in stimulating industrial expansion in France in the eighteenth century, and in the second work he examined the industrial capital needs and their source of finance in England, Germany and Russia. From these investigations, he found banking functions were different from one country to another.

The German banks were the most helpful to industrial finance and management. They were in essence the prime source of capital and entepreneurship for industry there. He wrote

> "German banks, as the saying went, accompanied the industrial enterprise from cradle to grave, from establishment to liquidation throughout all the vicissitude of its existence".(60)

The British banks and the Russian banks were found passive in their relations with industry. The finance of industry in both countries was mainly achieved from sources outside the banking system. So he attributed to the German banks a greater influence on industrialization than the British and the Russian banks had.

He concluded that the difference in the function of these banks was mainly shaped by the pattern of industrialization and the economic environment in each country. In the German case, the relatively backward German economy influenced banks to take the lead in financing the country's industrialization, while the more advanced British economy was able to generate internal saving for its own finance and expansion, so the banks were passive. In contrast, the extremely backward economy of Russia in those days made the Russian banks themselves weak. He wrote,

> "The scarcity of capital in Russia was such that no banking system could conceivably succeed in attracting sufficient funds to finance a large scale industrialization ... no bank could have successfully engaged in long term credit policies in an economy".(61)

In such an environment it was natural for the state to take over the responsibility of financing industry in Russia and from these experiences he concluded that the banking system can be growth inducing in moderately backward economies as the German banks' experience has shown.(62)

This work was followed up and developed by Tilly, Cameron and others. The former examined the financial institutions and industrialization in the Rhineland. His study shows that the financial institutions have been successfully used for development purposes in Britain and Germany.(63) He argued that the economic conditions in each country influenced the structure and operation of the banks. The relative absence of joint stock-companies and the emphasis on railway investment in Germany encouraged banks to extend short-term and long-term finance, as well as advice to industry.

In Germany there was scarcity of joint-stock companies, founded in the Rhineland between 1830-1870, that did not have one or more bankers in a key managerial position - either on the direction which handled day-to-day decisions or on the administrative council, which handled less frequent and more important decisions such as the awarding of large contracts.(64)

Likewise the development of the financial system in England reflected the characteristic of early English industrialization with its emphasis on the textile industry.(65) The long-term requirements of such industries were comparatively small relative to working capital needs and more over were adequately met from the accumulated profit of that industry. This left the working capital to be provided by the banks.

The arguments presented by Tilly in his interpretation of the operations of banks in Germany and Britain point to the existence of a variety of successful types of banks (i.e. those designed specifically to serve the particular context in which they operate). Along this line of thought Cameron in his comparative study of the evolutions of the banking system in eight developed countries pointed to the absence of a single model of the banking system appropriate for all economies.(66)

But on the bank contribution to economic development (from the case studies which he edited), he concluded from the experience of the banking system particularly in Austria, Italy and Spain that banking may or may not make a positive contribution to economic development. Much depends on the structural characteristics of the system, laws, regulations and customs more than on the personal quality of bankers.(67) Consequently he concluded that the structure of the financial system and the way the system reacts and responds to the special needs of its economy may well hasten or retard the process of economic development.(68) Likewise, after reviewing the historical evidence assembled by Cameron etal., Gurley concludes that

> "recent experience strongly suggests that banking systems as intermediaries are not highly essential to the growth process."(69)

The analytical works of Shaw, McKinnon, Patrick and others and the empirical studies of Goldsmith and Wallich(70) give further insights into the role of financial markets on development.

Through their analytical work these economists appeal for financial development as a means of creating growth - inducing instruments. The theoretical postulates of their approach rests on the following assumptions.

1. A preponderant objective of economic policy in the developing countries is to raise the domestic saving rate in order to finance the investment expenditure needed to sustain a per capita income.(71)

2. The firms and the households in the developing countries are isolated from each other under the prevailing fragmented economic conditions, so they face different effective prices for land, labour and capital.(72)

Within this context these economists view money and other financial instruments as playing an important role in improving the quantity and increasing the quality of capital formation. Along this line Patrick advocated a policy strategy for financial development in the developing countries based on his view that financial development will promote real growth.

He believes that much of real wealth in developing countries held by individuals in unproductive assets. The financial development would lead to the introduction of a wide variety of financial claims to serve as assets for them. As for the financial claims offered to investors differentiated by liquidity, yield, maturity, divisibility, risk of default or change in value and other services they are suitable to capture the unproductive assets in gold, jewelery and such like and turn them into productive assets thus helping economic growth.(73) Patrick goes further to suggest deliberate creation of the supply of financial services by governments when the private entrepreneurial response in the financial sector may not be adequate or possibilities of external economies may exist as a way to promote real growth in the developing countries.(74)

Similarly, Mckinnon and Shaw contend that the financial institutions are invariably growth-inducing and only when they are repressed, which in their view is often the case, would they fail to make positive contribution. Both of them call for the development of the financial markets through finance deepening and liberalization. Shaw equates 'deep' with liberalized finance which opens the way for increased savings and superior allocation of capital. According to Shaw by deepening the finance

> "the market for savings is extended ... local capital markets can be integrated into a common market and new opportunities for pooling savings and specializing investments are created."(75)

Similarly, Mcknnon advocates financial liberalization and condemns what he terms 'financial repression'. He calls for raising the rate of interest on the financial claims to match the range of that on real assets and calls for freeing the financial markets of all types of control. In his view this will make the market efficient and would lead to economic growth. The high interest rate will make people restructure their portfolio wealth in favour of financial assets.

External finance would help the entrepreneur to go beyond the confines of his own savings and undertake those large scale investments that embody technological improvement and give rise to increased productivity.(76)

In a cross-section analysis of many developed and developing countries financial assets and gross national product, Wallich found the degree of financial intermediation was significantly and positively related to real economic growth.(77) Similarly, Goldsmith found the financial structure of the countries he studied is closely related to their real infrastructure.(78)

Both of these studies are of special importance because they provide quantitative supporting evidence for the relationship between financial growth and real economic growth. But these findings can only indicate that an increase in financial intermediation, as denoted by the ratio of financial assets to gross national product (GNP), accompanies growth.

Goldsmith points out that the development of financial institutions

> "accelerates economic growth and improves economic performance to the extent that it facilitates the migration of funds to the best users .... to the place in the economic system where the funds will find the highest social return.(79) This indicates that financial development does actively promote real growth."

But Goldsmith later qualified this judgement and took a neutral stand on financial development,(80) because he saw the determinant factors as the effects of the legal and economic environment, rather than those of the financial structure alone.(81)

### 1.3.4 Casual relationship between financial development and economic growth

The previous investigation into financial development points to the fact that there is an interconnection between the financial structure, capital accumulation and the growth of the economy. But the direction of causation in the relationship between financial development and the real rate of economic growth is not at all clear. It seems from the previous discussion that financial development has proceeded as if it was the result of demands upon it. These demands arose from the deficit units' needs for finance from the surplus units within this context, real economic development causes financial development. But also we may conclude that financial development can allow greater or lesser rates of increase in income depending on the form it takes. To identify causation, it is the introduction of money and financial institutions and their combined effect which count in favour of financial development. Monetization and financial institutions, led to specialization in production and finance. It is in this way that the financial system may influence real development.

It is a known fact in today's economies that not all savers are willing to invest the full amount of their savings directly nor are they efficient investors. Under these circumstances financial development augments the savings. According to Porter it allows savings to occur without the need for a concomtant act of investment. (82) Similarly Goldsmith agreed to the possibilities of promoting higher saving as a direct effect of institutional development.(83) And finally financial development increases savings as it deters the flight of capital.(84) In addition, financial development increases the productivity of investments as the financial intermediaries provide the mechanism for the transfer of claims on real resources from savers to the most efficient investors. They also allow investors to make large scale lump investments in technological improvement which gives rise to increased productivity. Thus financial development is growth promoting to the extent that it encourages saving and improves the allocation of resources.

This explanation is further delineated in Patrick's analysis. Historical evidence of financial development reveals the existence of two distinct patterns of financial institution. The first type of institution has played a leading role in the economic development of their respective countries. The second type of institution has merely responded to the demand made for their services. Patrick calls institutions of the first type,'supply leading' institutions and those of the second type 'demand following' institutions.(85)

Economists quote the German and Japanese financial institutions, particularly banks, as paradigms of the first type. These institutions had provided long-term loans to their countries' industries in the early stages of industialization. By so doing, they led and influenced economic development.

However, the financial institutions in Britain and the United States (mainly banks) are merely a 'demand - following' phenomenon. As the economies grow they generate additional and new demand for their services. Thus their role in inducing economic growth was passive and permissive, although some writers have suggested that circumstances could have compelled them to do so at that time.

However, the classification into supply leading or demand following institutions does not conclusively explain the direction of the causality.

### 1.4 The importance of integrating financial markets for development

The advantage of an integrated capital market can be understood from the function expected from such market. A strong large market is capable of providing a better service to savers and borrowers alike, through the economies of scale and wider diversification of risk it permits. The success of the international markets is mainly attributed _inter alia_ because they operate on a world scale. A well integrated capital market which permits and promotes the flow of capital among the member countries is bound to contribute to their economic development in two ways.

1. A well-integrated capital market equilibrates capital flow and cancels the balance-of-payments difficulties among the member countries. This is clear from the experience of the States within the United States of America, which have no balance of payment problems amongst themselves.

2. A well integrated capital market allows capital to be allocated among member countries on a commercial basis, consequently eliminating regional differences in prospective yields which means a better allocation of capital in the integrated area.

However, the second advantage mentioned above concerning the integrated capital market is not accepted by every commentator as integration is in favour of the strong members. It has been argued that if capital were free to move in quest of higher profit, it might not reflect the interest of the community as a whole. Along this line of thought Lomax wrote:

> "The ultimate free-market doctrine might go as far as to assert that all economic problems should be left to the market economy, and they would be resolved satisfactorily. This view, however, seems completely false in modern conditions. There is no reason to believe that life in a society in which everything was left to market forces would be satisfactory or even tolerable. The ill-balance of power between particular producers or sectors would almost certainly lead to the weak going to the wall, and for many people life would be intolerable. In addition patterns of expenditure would be far from ideal".(86)

This argument does not represent an isolated view, and one need not conclude from it that the pricing system ought to be thrown out as a guide to the allocation of investment funds. The fact that the pricing system may pull in the wrong direction is probably due to the unequal availability of educational opportunities, transportation facilities and public facilities among regions.(87) So the integrated countries may carry out public investment projects in such areas in order to bring about a degree of equilibrium in terms of profitability in different regions which would correct the operation of the profit motive in the private sector and force private investment into socially desirable directions.

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26. The creation of the European Monetary System and the drive to achieve monetary union among the European countries is evidence for the importance of creating a single currency for the integrated countries. See: Com (84) 125 final.

27. In the European Community there have been considerable efforts to increase the movement of capital within the community and to achieve financial integration. The EEC has introduced several measures, namely;

1. The first Directive 1960 accorded varying degrees of freedom to capital chiefly related to commercial transaction.
2. The second Directive of December 18, 1962 extended the same freedom to the supply of service.
3. The third Directive of April 14, 1964 provides for the elimination of legal and administrative obstacles which hinder.

a. The introduction of the securities of one country on the stock exchange's of another country.
b. The purchase by the financial institutions of one country of the securities issued by residents of another country and denominated in other country's currency.
c. The issuing of securities by the residents of one country in the capital market of another and denominated in the other country's currency.

4. Code of conduct relating to transactions in transferable securities, it is a set of general principles valid for a transaction in transferable securities.

   See:

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# CHAPTER TWO

# ANALYSIS OF STRUCTURAL CHARACTERISTICS OF THE ARAB REGION ECONOMIES

## Analysis of Structural Characteristics of the Arab Region Economies

### Introduction

The Arab region during its history passed through periods of advancement and prosperity, rendering it the most advanced region of its time. The prosperity of the Arab region was based among other things on the region's integrity.

The region has maintained its hegemony, first under the Arab rule then under the Ottoman dominance for many centuries, but it began to disintegrate in the nineteenth century. During that century Egypt and the Ottoman Empire began borrowing from the European banks to finance development and to build up their arsenal. The need of these countries for more capital allowed the European states and banks to put pressure on them to grant some concessions which they did. Then the competing European Imperialism took advantage of the bankruptcy of both regimes' at the end of that century(1) and began direct political control over Egypt and other territories in the region.

This trend of disintegration culminated in the collapse of the Ottoman Empire in the First World War, when Imperialism took control over the remaining part of the Arab region. Consequently the region was divided in compromise between the rival European powers.(2)

The rivalry between the new occupiers and the new arbitrarily drawn boundaries, isolated the Arab countries from one another, and haulted the free movement of goods and people between the Arab countries, while such movement between the Arab countries and the metropolitan centres was permitted and encouraged. It follows that no branch of economic production was able to complete with the goods of the advanced countries. This made the Arab countries' dependency absolute on the metropolitan countries. In the middle of this centry, the colonizer left the region in a piecemeal fashion. In so doing they conceded political independence to those who were under their tutalage and domination. As a result they left behind twenty two sovereign states many of them are the creation of this century.(3) The result of the whole process was the creation of fragile economies dependent on the production of primary product, and the introduction of a large array of systems of government and political control ranging from revolutionary republics to patriarchal monarches.

In the post-independence period, the Arab countries began working toward integration. The few independent countries in 1945 set up the Arab league as a central body to coordinate their efforts in all fields in the common interest of the Arab.(4) The Arab league established many committees each responsible for specific activities. In the field of economy the Economic Council of the Arab leage has advanced several agreements covering uniform policies in many areas to include trade, petroleum, transportation, capital movements and others. The most important agreement among these is the Arab Economic Unity Agreement which was introduced in 1964. The Agreement envisages total economic integration to be achieved in stages. The agreement calls for the establishment of a permanent Board known as the "Arab Economic Unity Council" to execute this Agreement and to assist in the drive toward economic integration of the region. Consequently the Arab Common Market was established by five Arab states namely, Jordan, Syria, Iraq, Egypt and Kuwait. This was followed by several measures and arragements for coordination of the Arab policies in various fields.(5)

However, the Arab countries have taken many measures aiming at pooling their resources and coordinating their policies, implementation of many measures to reach these objectives has lagged behind. Coherent common policies among the Arab countries were thwarted by the interest of some groups in maintaining national sovereignty. As a result of Arab achievements in this direction have been very modest.

As the essential function of the Arab capital market is to increase and channel the flow of long-term funds for development between the Arab countries, it is necessary to examine the socio-economic characteristics of the Arab region in order to provide background information on the present twenty two sovereign states in the region, and know who the savers are, why they save, how their savings are used and why the development of the Arab capital markets in necessary. To answer these questions this chapter is presented in five sections. Section one will examine the natural and human resources of individual Arab countries. This will show the competence and the deficiencies of human resources and their economic activities. Section two examines the economic growth and structural changes in the individual Arab countries to show the stage of economic development and structure. Section three assesses the level of the region's industrial activities to show how far it has developed its productive sectors and where capital is needed. Section four examines the mobilisation and uses of the region's resources to show how the Arab countries finance their socio-economic development. Section five examines the emergence of the concept of an Arab capital market. This will show why some countries have encouraged the establishment to new financial institutions, and show the collective financial measures undertaken to increase the flow of capital within the region. Finally in the concluding remarks, we shall relate all these issues to our main theme of the integrated Arab capital market.

## 2.1 NATURAL AND HUMAN RESOURCES

### 2.1.1 Population and labour force and their characteristics

The importance of human resources is not limited to the fact that their activity determines economic development in any country, but more important is the fact that there can be no development without people and development itself is created for them. Thus a brief summary of the major characteristics of the Arab population is provided to acquaint the reader with the participants of the Arab financial market and to indicate the potential that the region possesses for economic development.

The Arab region had a dynamic population of about 163 million inhabitants in 1980 (see Table 2.1). With an average rate of growth exceeding 3 percent, the region's population could double in less than 25 years. The population structure is similar to that in other developing countries. A large part of the population is under the age of 15. Thus the proportion of population in the economically productive age group (16-64) is relatively lower than that of their counterparts in advanced countries. This phenomenon is clearly demonstrated in the region, where the economically active population was estimated at 86 million persons. This figure is slightly over 50 per cent of the total Arab population and very low compared to its counterparts in the middle income countries or industrial market economies which averaged 55 per cent for the former group and 66 percent for the latter group of countries in 1979. (6)

At the national level the Arab region displays a wide difference in the size of population and the rate of growth. The distribution of people among the Arab countries is very skewed. In 1980 the population of Egypt alone accounted for about one quarter of the Arab population.

TABLE 2.1 Arab Countries: Some Indicators of Population

| Country | Population in millions 1980 | % Urban 1980 | Average annual growth rate for 1975-80 | Labour force in thousands 1980 | Percentage of population of working age 1979 | Percentage of Labour force in economic sectors | | | Average annual growth of Labour Force % 1970-80 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Agri | Ind | Serv | |
| Algeria | 18.67 | 44 | 3.3 | 4.397 | 49 | 32 | 24 | 44 | 3.4 |
| Iraq | 13.07 | 72 | 3.3 | 3.232 | 51 | 43 | 26 | 31 | 2.4 |
| U.A.E. | 0.73 | 48 | 2.8 | .313 | | | | | |
| Qatar | 0.24 | 88 | 8.9 | .096 | | | | | |
| Kuwait | 1.37 | 88 | 6.1 | .378 | 52 | 2 | 34 | 64 | 4.5 |
| Saudi Arabia | 8.96 | 67 | 2.9 | 2.691 | 52 | 62 | 14 | 24 | 4.5 |
| Libya | 2.97 | 52 | 4.3 | .662 | 51 | 20 | 27 | 53 | 3.7 |
| Jordan | 3.24 | 56 | 3.2 | .765 | 51 | 21 | 19 | 60 | 3.1 |
| Bahrain | 0.31 | 80 | 5.4 | .085 | | | | | |
| Tunisia | 6.37 | 52 | 2.3 | 1.574 | 55 | 35 | 32 | 33 | 3.0 |
| Syria | 8.98 | 50 | 3.3 | 2.183 | 48 | 32 | 31 | 37 | 3.3 |
| Oman | 0.89 | 5 | 3.5 | .268 | | | | | |
| Lebanon | 2.66 | 76 | 2.0 | .872 | 55 | 12 | 26 | 62 | 1.3 |
| Egypt | 42.20 | 45 | 3.0 | 11.865 | 57 | 50 | 29 | 21 | 2.0 |
| Morocco | 20.05 | 41 | 3.0 | 5.378 | 50 | 53 | 21 | 26 | 3.0 |
| Sudan | 18.68 | 25 | 2.5 | 6.641 | 53 | 78 | 10 | 12 | 2.4 |
| Somalia | 4.64 | 30 | 2.6 | 1.402 | 54 | 84 | 8 | 8 | 2.2 |
| Mauritania | 1.63 | 23 | 2.2 | .436 | 52 | 85 | 5 | 10 | 2.4 |
| Yemen A.R. | 5.81 | 10 | 1.8 | 2.140 | 51 | 76 | 11 | 13 | 0.7 |
| Yemen P.D.R. | 1.97 | 37 | 3.1 | .497 | 51 | 47 | 15 | 38 | 1.6 |
| Djibouti | 0.31 | 65 | 2.5 | | | | | | |
| TOTAL | 163.75 | 40 | 3.1 | 45.866 | | | | | |

SOURCE: United Nations Demographic Year Book, 1981.
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Morocco, Sudan, Algeria and Iraq are other countries with a sizeable population. With the exception of Yemen Arab Republic and probably Saudi Arabia, the population of the Gulf States - Kuwait, Qatar, United Arab Emirates, Bahrain and Oman reached about 3.5 million persons or about 2 per cent of the Arab population.

Fortunately, the sparsely populated Arab countries have experienced a higher rate of growth in their population than the populous ones. For instance, the average annual growth rate of population of Qatar and Kuwait was about 8.9 per cent and 6.1 per cent respectively in the period 1975-1980. On the other hand, the average annual growth rate of the population of Mauritania and Yemen Arab Republic was about 2 per cent.

The second characteristic of the region is the large proportion of its people who live in rural areas. The urban population of the region accounted for about 40 per cent of the total population in 1980. However, there has been a considerable difference among Arab countries in the proportion of urbanised population to the total population. For instance, the population of Kuwait and Qatar are totally urbanised with 88 per cent of their population living in urban areas. This ratio falls to just 5 per cent in Oman, 10 per cent in the Yemen Arab Republic, 25 in Sudan and less than 50 per cent in the majority of the remaining countries.

The third characteristic of the Arab population is the high rate of illiteracy. An average of 42.2 per cent of the total Arab population was classified as illiterate in 1980. (7) But there is a difference in the extent of illiteracy between males and females, where the former had a much lower illiteracy rate, averaging about 27.7 per cent while the latter had an average of 51.5 per cent in 1980. (8) At the country level, the Arab countries diplay a wide difference in illiteracy rates. For instance in 1978, Jordan displayed the lowest rate of 25 per cent, while Yemen Arab Republic displayed the highest rate of about 77 per cent. The other Arab countries displayed a ratio between these two extreme poles. A decade earlier these ratios were higher for every Arab country, and again Jordan had the lowest ratio of about 45 per cent and Yemen had the highest ratio of about 92 per cent. (see Appendix 2.1) This is an indication of considerable progress.

Although there has been a great drive forwards in the expansion of public health and education facilities in the Arab region, the persistence of illiteracy among the population indicates that these facilities have not been sufficient for a rapidly growing population. Moreover, the distribution of these facilities is concentrated in large urban areas. That is to say the rural population are totally excluded from these services and to some extent poor urban residents are deprived of these services.

However, there is a distinct difference between the countries in the region. The rich oil-producing countries have provided these services for larger proportions of their population and invest heavily in the welfare of their people while in other non-oil Arab countries, the level of these services is extremely low. For example, Saudi Arabia, one of the first group, allocated £28,818 million investment in health and education in the 1970's. This is in contrast with Yemen Arab Republic with almost the same size of population which devoted about $427 m for the same purpose and during the same period. (9 )

Lack of medical care and facilities in poor Arab countries in particular is responsible for a high mortality rate in the region. The fact that 1.2 million Arab children die each year without reaching adulthood points to the fact that health facilities are not tailored to the region's needs.(10)

The lack of access to health care and education for the majority of the people in the region has far reaching implications for economic development. On the one hand a high rate of illiteracy has tended to reduce the potential economic use of the existing manpower available to the region. On the other hand poor health tend to affect the productivity of employed workers manifested in long-leave for hospitalization and absenteeism. It is worth mentioning that a large part of education in the region is directed towards the social services and the humanities which bear very little relation to the actual needs of the region. The essential training and vocational, technical and scientific studies comprises a small part of overall education in the region.

Consequently, the region as a whole suffers from a shortage of skilled labour particularly professional, technical administrative and managerial. The demand on these categories of labour from both the private and public sectors has been high and surpasses over supply in the majority of the Arab countries. This shortage of skilled labour has impeded the pace of development in the region. According to Show who has recently studied this problem, the quality of the labour force is going to be one of the most serious bottlenecks for growth in the region. (11)

The region's labour force was estimated at 46 million, slightly over half of the economically productive age group. This is so, because the participation of women in paid employment is limited. In addition there are large numbers of the Arab population of working age who are continuing their education at schools, colleges, universities, vocational training centres and other educational institutions.

The distribution of the labour force in the economic sectors shows, that the traditional sector provided employment for one half of the Arab labour force. The service sector is the second in terms of providing jobs for workers. The industrial sector provided jobs for about 9 million persons (see Appendix 2.2). This accounted for less than 20 per cent of the Arab labour force. On the individual country level the situation considerably differs from one country to another. The labour force in the traditional sectors of Saudi Arabia, Morocco, Sudan, Somalia, Mauritania and the Yemen Arab Republic was in the range of 60-85 per cent of the total labour force in these countries. The second sector of special importance in offering jobs is the service sector. This sector provided jobs for over 50 per cent of the labour force in Kuwait, Libya, Lebanon and Jordan. The industrial sector's share in employment was modest in all Arab countries. Accounting for approximately one third of active labour force in Kuwait, about one quarter in Syria, Lebanon, Egypt and Tunisia and less than one quarter in the remaining Arab countries.

This will explain later why the per capita income of many Arab countries is very low.

The variation in the pace of economic development as will be shown later in this chapter, the uneven distribution of population, and the very low level of skill and indigenous technology in the region caused a great movement of labourers from Arab countries with relatively large labour forces such as Egypt, Yemen A.R., Jordan, Lebanon, Tunisia, Morocco Algeria to scarely populated countries such as the Gulf States, Saudi Arabia and Libya.

The Arab migration to America began in the early years of the century particularly from Syria, Palestine and Lebanon. In the 1960s many Arabs of North African countries, namely Tunisia, Morocco and Algeria migrated to Europe and in particular to France. Today several millions Arabs are living in Europe and America. The Arab migrant workers within the region were estimated at 6 million persons in 1982. (12) The foreign migrant workers perhaps exceeded the Arab migrant. The influx of foreign labour on a large scale makes the national citizens in the Gulf States a minority in their own countries. This has created some social problems, particularly in the lower Gulf States where the foreign expatriates from outside the region outnumbered the Arab expatriate and local citizens. (13) Kuwait has no such problem because it has long given preferential treatment to other Arabs to come and work there. However, the lower Gulf States from the time of British domination have imported much of their labour needs from outside the region. Today, foreign workers make up over 90 per cent of the labour force in the United Arab Emirates, while the migrant work forces of Saudi Arabia and Libya are 30 to 40 per cent of the host countries total population. (14)

TABLE 2.2

Irrigation Waters and Irrigated Cultivated Land and their Potential in the Region (area in millions of hectares and water in billion cubic metres)

| Country | 1975 | | | Future Potential | | |
|---|---|---|---|---|---|---|
| | Water used for Irrigation | Cultivated area | Cropped area | Irrigation water | Cultivated area | Cropped area |
| Egypt | 55 | 2.9 | 5.1 | 65 | 4.4 | 8.7 |
| Sudan | 16 | 1.5 | 1.2 | 35 | 4.2 | 4.7 |
| Iraq | 25 | 3.7 | 1.6 | 55 | 4.4 | 7.3 |
| Syria | 6 | 0.6 | 0.4 | 14 | 1.3 | 1.9 |
| Morocco | 10 | 0.8 | 1.0 | 13 | 1.1 | 1.7 |
| TOTAL | 112 | 9.5 | 9.3 | 182 | 15.4 | 24.3 |
| Other Arab Countries | 13 | 1.3 | 1.2 | 18 | 1.5 | 2.4 |
| All Arab Countries | 125 | 10.8 | 10.5 | 200 | 16.9 | 26.7 |
| Percentage of the five Countries to the rest of the Arab World | 90 | 88.00 | 89.00 | 91 | 91.00 | 91.00 |

SOURCE: Source and Problems of Arab Development, p.78-9 (Kuwait: 1980)

2.1.2 Land and Water

The Arab region covers a wide area of over 13 million square kilometers of Western Asia and North Africa. From the geographical perspective, it occupies a strategic position at the meeting point of the three continents. Climatically it mostly lies in the arid zone with a rainfall of less than five inches a year. Rainfall is sufficient and climate is moderate in a narrow area close to the Mediterranean Sea. Other parts like North Yemen and South Sudan also receive sufficient rainfall.

In the global context the Arab region represents about 10 per cent of the world's total land, but the regions arable land is less than 4 per cent. The pasture and forest land covers about 28 per cent and the irrigated land less than one per cent (see Appendix 2.3).

This leaves over two thirds of Arab land of little use as compared with world level of 35.1 per cent. (15) This points to the scarcity of arable land.

However, the region has a great potential to expand its irrigated land area particularly in Egypt, Sudan, Syria and Iraq where two of the world's greatest rivers (the Nile and the Euphrates) run through their land. These countries can exploit their water resources more effectively instead of allowing part of this resource to reach the sea unused. Table 2.2 shows the region has utilized water for irrigation at about 125 billion $m^3$/year while its surface water is estimated at 200 billions $m^3$/year. Rationalising the use of water for irrigation from the present level of 12000 $m^3$ per hectare

to 7500 $m^3$ per hectare could, according to experts, increase the Arab irrigated area to about 21 million crop hectacres. (16)
On the country level the cultivated land of potential expansion is mainly located in five Arab countries namely, Egypt, Sudan, Iraq, Syria and Morocco. Sudan and Iraq have a great potential for doubling their cultivated land. It is worth noticing here that the distribution of land and water correlates with the distribution of the population.

### 2.1.3 Mineral Resources

The scarcity of arable land in the sparcely populated Arab countries seems to be compensated by the considerable subsoil minerals particularly petroleum. The region as a whole had over 51 per cent of the world's proven oil reserves and about 14 per cent of proven gas reserves as seen in Table 2.3. However, the region may be rich in oil and phosphate but poor in other minerals such as coal, uranium and copper which are very important for economic growth and modernization. This indicates the heavy dependence of the region on the oil industry. The minerals are concentrated in a few countries, for instance the distribution of oil reserves among the Arab countries shows that Saudi Arabia accounted for about 47 per cent, with about 19 per cent for Kuwait, 10 per cent for United Arab Emirates, 12 per cent for Iraq, 6 per cent for Libya with the remaining Arab countries such as Algeria, Bahrain, Tunisia, Syria, Egypt and Oman sharing the remaining six per cent of which Algeria

TABLE 2.3

Gas and Oil Reserves, Production and Depletion Period

| Country | Gas Reserve | Reserve in billion barrels | Oil: Production billion barrels per day 1979 | 1982 | Depletion Period of Oil according to Production 1978 | 1982 |
|---|---|---|---|---|---|---|
| U.A.E. | 810 | 32.4 | 1,829 | 1,229 | | 72 |
| Bahrain | 223 | 0.2 | 51 | 45 | | 12 |
| Tunisia | 122 | 1.9 | 115 | 106 | | 49 |
| Algeria | 3,152 | 9.4 | 1,217 | 670 | | 38 |
| Saudi Arabia | 3,433 | 165.3 | 9,533 | 6,697 | | 68 |
| Syria | 36 | 1.5 | 166 | 175 | | 23 |
| Iraq | 816 | 41.0 | 3,700 | 987 | | 114 |
| Qatar | 1,756 | 3.4 | 508 | 330 | | 28 |
| Kuwait | 966 | 67.1 | 2,496 | 833 | | 221 |
| Libya | 609 | 21.5 | 2,029 | 1,017 | | 58 |
| Egypt | 203 | 3.3 | 497 | 667 | | 14 |
| Oman | 76 | 2.7 | 295 | 322 | | 23 |
| 1. TOTAL | 12,202 | 349.7 | 22,499 | 13,078 | | |
| 2. Th. World | 85,652 | 670.2 | 63,185 | 54,572 | | |
| World | 14.2% | 51.2% | 35.6% | 24% | | |

SOURCE: O.P.E.C. Annual Statistical Bulletin, 1981
Petroleum Economist, January 1983
Oil and Gas Journal Various Issues

accounted for one half. The distribution of gas among Arab countries is almost always associated with the distribution of oil, but Algeria has a considerable gas reserve greater than its share in oil. The region's production of oil has varied over the years. It was estimated at about 18 million barrels a day in 1973, (17) steadily climbed to about 22 billion in 1979, then dropped in recent years to about 13 million barrels a day. This occurred partly because new countries have entered the oil market such, as the U.K. and Mexico which have increased their oil sales and partly because oil demand was down in the early 1980's from a peak in the early 1970's as can be seen from Table 2.3.

The importance of the region's oil industry emanates from its large proven reserves and from the fact that almost all its production goes to export. Its heavy dependence on the international demand for energy explains the considerable variation in its production.

Phosphate is the second mineral with considerable proven reserves in the region. It had an estimated 51 per cent of the proven world reserve in 1975 as seen in Table 2.4. The distribution of phosphate among the Arab countries shows that Morocco had over 85 per cent and the remaining 15 per cent was shared by Iraq, Egypt, Jordan, Syria, Tunisia, Algeria and Saudi Arabia. The regions production was about one-quarter of the world's production of which Morocco accounted for about two-thirds in 1979. Jordan and Tunisia were the other Arab countries with a relatively large production.

Iron ore is the third mineral with large reserves in the region. The estimated proven reserve was about 4 billion tons and the possible

TABLE 2.4

Phosphate Reserve and Production and Iron Ore Reserve in the Region

| | Phosphate | | Iron Ore |
|---|---|---|---|
| Country | Proven Reserve 1975 Ton | Production 1979 m. Ton | Proven Reserves Ton |
| Algeria | 642 | 1.10 | 1102. |
| Egypt | 4,325 | .65 | 338. |
| Iraq | 1,760 | n.a. | _ |
| Jordan | 1,062 | 2.83 | _ |
| Morocco | 57,000 | 20.32 | 55. |
| Saudi Arabia | 912 | n.a. | 56. |
| Syria | 860 | 1.17 | 80. |
| Tunisia | 885 | 4.04 | 12. |
| Mauritania | _ | _ | 515. |
| Libya | _ | _ | 1815. |
| Others | _ | _ | _ |
| 1. TOTAL | 64,446 | 30.2 | 4024. |
| 2. World | 130,000 | 126.79 | |
| 1/2 | 51% | 23.8% | |

SOURCE: A.M.F. Joint Arab Economic Report 1982, 1981
The British Sulphur Corporation Ltd.
Statistical Supplement July/August, 1981.

reserves may be three times as much as the proven ones. Here Algeria, Libya and Mauritania accounted for the most proven and possible reserve (18). In addition to these three important minerals, the region has abundant quantities of glass sand, copper ore, bromine, potash and the potential gains from a geological mapping programme are very large.

## 2.2. Economic growth and structural changes in the post independence period

Economists differ in their explanation of the process of economic development as well as to the criteria they employ in their analysis of development. (19) However, economic development has been defined as the process of whereby a country's real per capita income increases over a substained period of time through continuing increases in per capita productivity. (20)

Accepting this criteria as a measure of growth, the region in general and the major oil exporting countries in particular have achieved significant growth since independence. But the regions great expansion took place between 1973-81. In this period the price of oil increased significantly, and the oil revenues had been very large. Consequently, the growth which had been achieved in the major oil exporting countries was significantly greater than the growth achieved in the other Arab countries.

### 2.2.1 Economic Growth

In analysing the growth in per capita income and the gross domestic product of the Arab countries for the period 1971-82 we observe the striking difference between the non-oil Arab countries and the major oil exporting Arab countries (The major oil exporting countries concerned in this analysis are Algeria, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, Libya and the United Arab Emirates). At the beginning of the period under consideration the major oil-exporting countries had a per capita gross domestic product (GDP) of $707 and the remaining Arab countries $229. In 1982 these had grown to about $6179 and $819, respectively as seen in Table 2.5.

Similarly, the gross domestic product of the major oil exporting countries in absolute terms in 1971 was about $24 billion and of the other group $21 billion. By 1982, these figures had increased to approximately $312 billion and just $100 billion respectively. That means the first group achieved a growth rate of about 30 per cent in their GDP at current prices, while the latter had achieved just 16 per cent as seen in Table 2.6.

The difference is great and striking in the growth of the GDP and per capita income between these groups. However, the great difference is not only between oil and non-oil producing countries, but it also evident within each group. Data on the GDP and per capital income for individual countries Qatar and the United Arab Emirates had some of the highest per capita incomes in the world - over $35000 in the early 1980's. These were followed by Saudi Arabia and Kuwait with GDP per capita of approximately $17000 in 1981 almost one half of the GDP

TABLE 2.5

**Gross Domestic Product Per Capita at Current Prices and its Percentage Year to Year Growth Rates for Arab Countries Divided into Oil and Non-Oil Producers**

| | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | Average |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Non-Oil Countries | | | | | | | | | | | | | |
| G.D.P. per cap $ | 229 | 258 | 298 | 372 | 431 | 483 | 565 | 660 | 642 | 763 | 797 | 819 | |
| Growth Rates | | 12.6 | 15.5 | 24.8 | 15.8 | 12.1 | 16.9 | 16.8 | -2.7 | 18.8 | 4.4 | 2.7 | 12.5 |
| Oil Countries $ | 707 | 839 | 1129 | 2337 | 2675 | 3084 | 3559 | 3887 | 4799 | 6381 | 6727 | 6179 | |
| Growth Rates | | 18.6 | 34.5 | 107.0 | 14.5 | 15.5 | 15.4 | 9.2 | 23.5 | 32.9 | 5.4 | -8.4 | 24.3 |
| All Countries | | | | | | | | | | | | | |
| G.D.P. per cap $ | 360 | 420 | 530 | 930 | 1070 | 1230 | 1430 | 1590 | 1850 | 2400 | 2530 | 2390 | |
| Growth Rate | | 16.6 | 26.2 | 75.5 | 15.0 | 14.9 | 16.2 | 17.2 | 16.3 | 29.7 | 5.4 | -5.4 | 20.1 |

Source: Calculated From Data in Arab Monetary Fund.
National Account Country Tables for the Years 1971-1982
(Abu Dhabi, 1983)

TABLE 2.6

Gross Domestic Product at Market Prices of Arab Countries Divided into Oil and Non Oil Producers and its Percentage Year to Year Growth Rates

| | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | Average |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Non-Oil Countries G.D.P. in million$ | 20895 | 24079 | 28545 | 36562 | 43462 | 49767 | 59993 | 71920 | 71897 | 88243 | 94644 | 99783 | |
| % | | 15.2 | 18.5 | 28.1 | 18.8 | 14.5 | 20.3 | 19.9 | 0 | 22.7 | 7.2 | 5.4 | 15.5 |
| Oil Countries G.D.P. in million$ | 24604 | 30295 | 42233 | 89984 | 107027 | 127675 | 153033 | 172591 | 220757 | 303107 | 329623 | 312693 | |
| % | | 23.1 | 39.4 | 113.0 | 18.9 | 19.3 | 19.8 | 12.8 | 27.9 | 37.3 | 8.7 | -5.1 | 28.6 |
| All Countries G.D.P. in million$ | 45502 | 54374 | 70778 | 126546 | 150489 | 177442 | 213027 | 244511 | 292654 | 391350 | 424267 | 412476 | |
| % | | 19.5 | 30.1 | 78.8 | 18.9 | 17.9 | 20.0 | 14.8 | 19.7 | 33.7 | 8.4 | -3.0 | 23.3 |

NOTE: Oil Countries include the O.A.E., Algeria, Saudi Arabia, Iraq, Oman, Qatar, Kuwait, Libya.

Non Oil Countries include Jordan, Bahrain, Tunisia, The Sudan, Syria, Somalia, The Lebanon, Egypt, Morocco, Mauritania, Yemen, Arab Republic, People's Democratic Republic of Yemen.

per capita income in the other two countries. The third sub-group includes Libya and Oman which had a GDP per capita income in the range of $7000 - 10000 in the same period. Finally Iraq and Algeria with a GDP per capita income of about $2000.

Similarly the non-oil Arab countries had different growth rates. The GDP per capita income of this group in 1980 ranged from $390 in the lowest to $1740 in the highest. The lowest sub-group includes the Sudan, Somalia, Mauritania, Yemen, Arab Republic an People's Democratic Republic of Yemen with a per capita income of less than $480. The second sub-group comprises Egypt and Morocco with a per capita income of less than $720. And finally the highest among the non-oil countries are Jordan, Syria and Lebanon with a per capita income of over $1400.

The difference in per captia income within the major oil exporting countries can be attributed to the magnitude of oil revenues received by each country and the size of its population. But the difference in GDP per capita income within Arab non-oil countries can be partially explained by the difference in their stage of development and partically by population density.

### 2.2.2. Structural Change

In the above discussion it was made clear that the oil revenues were the main cause of per capita income increases, particularly in the oil producing countries. Thus the most important change in the 1970's was the decline in the pre-eminence of the agricultural sector as a main contributor to the region's economy leaving the hydrocarbon sector in the lead as can be seen in Table 2.7. In that period, the agricultural sector's contribution to the region's GDP declined from 15 per cent in 1971 to less than 7 per cent in 1980. Likewise the manufacturing sector's contribution dropped from about 10 per cent in 1971 to slightly over 7 per cent in 1980. But the transport sector almost maintained its position of about 5 per cent of the region's GDP. In contrast, the mining sector's contribution rose from about 27 per cent in 1971 to almost 50 per cent in 1980.

The overwhelming dominance of the mining sector dwarfed the contribution of other sectors. This points to the weakness of the region's economy and to the little progress achieved outside the mining activities. On examining the sectoral contribution on the country level as given in Appendices 2.5, 2.6, 2.7 & 2.8 the data show great differences between individual countries, but it is possible to put them into four groups. The first group include Iraq and Algeria. They are both from the major oil exporting countries but differ from other Arab oil exporting countries in having more balanced economies. The mining sector contributed about 22 per cent of their GDP in 1971 and increased to about 47 per cent in 1980. The second group includes the United Arab Emirates, Saudi Arabia, Qatar, Kuwait, Libya and Oman. This group is heavily dependent on oil revenues. The mining activities contributed almost 60 per cent of their GDP in 1971 and increased to about 64 per cent in 1980. The third group includes, Jordan, Bahrain, Tunisia, Syria, Lebanon, Egypt and Morocco. This group has produced oil but on a smaller scale and its economies are more balanced than the economies of other groups. The fourth group includes the least developed countries in the region namely, the Sudan, Mauritania, Somalia and both Yemens. Here the traditional sector has continued to dominate the economic scene.

TABLE 2.7

Arab Countries: Aggregate Gross Domestic Product Sectoral Contribution to G.D.P.at Factor Cost and in Million U.S.$, at Current Prices in Selective Years

| | 1971 | 1972 | 1979 | 1980 |
|---|---|---|---|---|
| Agr., Fishing & Forest | | | | |
| Millions of U.S.$ | 6680 | 7908 | 20355 | 24983 |
| Percentage Ratio to G.D.P. | 15.1 | 15.3 | 7.2 | 6.6 |
| Mining, Quarr. & Fuel | | | | |
| Millions of U.S.$ | 11926 | 14298 | 122734 | 185845 |
| Percentage Ratio to G.D.P. | 27.0 | 27.6 | 43.3 | 48.9 |
| Manufacturing Industry | | | | |
| Millions of U.S.$ | 4695 | 5317 | 22244 | 27310 |
| Percentage Ratio to G.D.P. | 10.6 | 10.2 | 7.8 | 7.2 |
| Elect., Water & Gas | | | | |
| Millions of U.S.$ | 647 | 833 | 2258 | 2712 |
| Percentage Ratio to G.D.P. | 1.5 | 1.6 | 0.8 | 0.7 |
| Contruction | | | | |
| Millions of U.S.$ | 2363 | 3394 | 26695 | 31621 |
| Percentage Ratio to G.D.P. | 5.3 | 6.5 | 9.4 | 8.3 |
| Commerce, Rest. & Hotel | | | | |
| Millions of U.S.$ | 5175 | 6149 | 28271 | 34075 |
| Percentage Raion to G.D.P. | 11.5 | 11.8 | 10.0 | 8.9 |
| Tran., Comm. & Storage | | | | |
| Millions of U.S.$ | 2531 | 2843 | 13884 | 16449 |
| Percentage Ratio to G.D.P. | 5.8 | 5.4 | 5.0 | 4.3 |
| Finance, Insurance & Bank | | | | |
| Millions of U.S.$ | 835 | 782 | 6042 | 7406 |
| Percentage Ration to G.D.P. | 1.8 | 1.5 | 2.1 | 1.9 |
| Service Sector | | | | |
| Millions of U.S.$ | 9347 | 10447 | 40681 | 49757 |
| Percentage Ratio to G.D.P. | 21.2 | 20.1 | 14.4 | 13.2 |
| G.D.P. at Factor Cost | | | | |
| Millions of U.S.$ | 44199 | 51971 | 283164 | 380158 |

SOURCE: Computed from Appendix 5 to 8

## 2.3 The Industrial Activities

### 2.3.1 The industrial level

The early efforts for industrialization began in Egypt, Syria, Lebanon and other Arab countries in the North. These efforts led to the establishment of some small plant industry mainly directed to the domestic market. In the 1970's the oil boom allowed the region to pursue vigorously its industrialisation through increasing imports of capital goods and expertise. The region's total merchandise imports in 1971 amounted to about $9 billion rising to $138 billion in 1981 a large part of which was for the establishment or operations of industries. As the oil exporting countries had very little industry before the oil boom, they embarked on a strategy of import substitution industrialisation. This includes building materials and equipment industries, ship repair, metal engineering and electrical industries, food industries and others. Then it was natural for them to start hydrocarbon related export industries.

They increased their petroleum refineries and established petrochemical industries, liquid petroleum gas and liquid natural gas plants, and aluminum smelting and steel making industries.(21)

In the early 1980's, the region's industrial base has become more diversified, but development has fallen short of the Arab desire to building a real industrial base. The regions production of manufactured goods in 1980 accounted for only 0.5 per cent of the world industrial capacity.(22)

Industrial progress has been of a very limited nature. The Arab efforts in industrialisation to improve sectoral balance and diversification have been confronted with various obstacles, such as the small market size in individual Arab countries, the shortage of skilled labour across all Arab countries, and the shortage of other types of labour in the oil exporting countries and of capital expenditure in the more densely populated Arab countries. As a result, Arab industry today is composed mainly of small plants. The large industrial projects are inadequate in both number and capital and both types of industries have continued dependence for their operation on imported raw materials, foreign technology, expertise and markets.

These deficiencies have been a matter of concern for the Arab planners and decision makers. They have realized that without Arab co-operation none of them is able alone to create a viable industrial base. Industry still has considerable room for expansion on a regional scale. Arab industry's production of manufacturing goods comes to only a small proportion of the imported manufactured goods. These facts were examined in several conferences and all called for joint Arab action.(23)

The joint industrial projects may prove the key to the region's industrialisation. Likewise in the petro-chemical industry with its countless product the region has ample opportunity for specialisation. Metwally suggests that the long-term solution to the economic development problem of most, if not all the Arab countries lies in industrialisation through some form of economic integration between themselves.(24) Ghantus, among others, calls for a common industrialisation strategy because modern industry and in particular the engineering industry can only operate on a large scale and notes that many of the individual Arab markets are too small for scale economies in production to be realized.(25)

### 2.3.2. The performance of agricultural sector

The Arab agricultural performance has been less successful than in industry. The Arabs have paid less attention to the development of their traditional sectors and more to industrialisation. Too much emphasis on industrialisation in fact changed some of them from food exporters into food importers with little gain. In addition to this preferential policy the lack of arable land and water in the capital surplus countries, with the exception of Iraq and the shortage of capital in countries with arable land have been further constraints on agricultural development.

Only Saudi Arabia can claim that significant development has been achieved in this sector. Indeed it has made vigorous efforts to develop its traditional sector, despite the physical limitation on significant progress in this direction. It has made great efforts to improve the standard of living of its rural population and to curb their flow to the urban centres. The government applied all manner of subsidiaries to encourage farmers to grow plants and raise livestock. It bought their out-put at a very high price and extended to them all the credit needed. This policy resulted in a dramatic rise in agricultural product. The country was approaching self-sufficiency in many food stuffs such as milk, eggs and cereals. Indeed wheat production rose from just 3000 tones in the early 1970's to over 1.3 million tons in the early 1980's as impressive achievements (26).

However, the experience of Saudi Arabia is the exception and not the rule and more importantly such policies are not entirely conclusive to the creation of a self-sustaining agricultural sector.

The Arabs have failed to increase their production enough to feed their growing population. The average annual growth rate in the production of wheat, grain and animal products for the period 1970-81 was 1.8 per cent, 4.0 per cent and 0.7 per cent respectively see Table 2.8. This has sharply reduced the per capita rate of domestic food production because the population grew at an average annual rate of 3 per cent. Also the increase in the region per capita income has increased its per capita consumption. As a result, the region's self-sufficiency in food has deteriorated further. Its self-sufficiency in grain dropped from 84 per cent in 1970 to about 60 in the 1980s. For sugar the rate dropped from 40 per cent to 30 per cent during the same period. The region can claim it had self-sufficiency in fruit and cotton while other foodstuffs have to be imported (see Table 2.9), a rapidly rising costs. For instance, the cost of such imports in 1971 was about $100 million, but it soared to $21 billion in 1981.(27)

The food problem continues to haunt the Arabs. The vulnerability of the region is great if it cannot produce its own food. To quote Caplan,

> "As the west fears its energy dependence on the Middle East, so too, the Middle East countries are worried by their dependence on Western food supplies. And if, as the recent Rome Conference concluded, the world is heading for serious food shortages in the 1980's, the Arabs may become really alarmed. This reasoning has promoted the Kuwait based Arab Fund for Economic and Social Development to draw up an imaginative plan, spread over a 25 year time scale, to turn Sudan into an Arab food granary"(28).

The prominent position of agriculture in the economic life of the region has been undisputable for many centuries and agriculture will continue to be the base of the region's economy for the forseeable future. It provides a living and employment for more than one-half of the region's population, and more importantly there can be no

TABLE 2.8

Economic Indicator of the Arab Agricultural Performance for the Period 1970-1981

| | The Yield per hectar to the World Levels % | Production to the World Production % | Labour Productivity to the World Levels % | Average Annual Growth Rates in Land Yield % | Average Annual Growth Rates in Labour Productivity % |
|---|---|---|---|---|---|
| Wheat | 56.7 | 2.3 | 86.2 | 1.8 | 0.5 |
| Grain | 55.1 | 1.7 | 94.8 | 4.0 | -0.6 |
| Animal Product | 31.7 | 1.7 | 64.1 | -0.7 | 0.6 |

SOURCE: Compiled from:-

A. W. H. Rashid, "Aggravation of the Agricultural Food Deficit in the Arab Region",

Oil and Arab Co-operation, Vol.10, No.2, 1984, pp.68-81.

TABLE 2.9

The Regions Self-Sufficiency at the Beginning and at the End of Last Decade in Selected Agricultural Products

| Major Catagories | Self-Sufficiency | |
|---|---|---|
| | 1970 | 1980 |
| Grain | 84 | 60 |
| Sugar | 40 | 30 |
| Fruits & Vegetables | 114 | 101 |
| Animal Products | 81 | 65 |
| Coffee, Tea, Tobacco | 16 | 11 |
| Cotton | 240 | 190 |

SOURCE: The Arab Fund for Social and Economic Development (A.F.E.S.D.) Joint Arab Economic Report 1981. (Sharjah Dar al-Khalij, 1982), p.39

successful industrialisation without a flourishing agriculture. It provides material for processing and it saves the Arabs paying for foreign food stuffs. The solution to the agricultural problem may be achieved through more efficiency. Labour productivity in the 1970's was behind the world level respectively. Table 2.8 shows that the labour productivity for the three products wheat, grain and animal product was about 86 per cent, 94 per cent and 64 per cent of the world level. The average annual growth of labour productivity was very low or negative.

## 2.4 Mobilization and Uses of Resources

### 2.4.1 Mobilization of domestic resources

The great disparities in the distribution of natural and human resources among the Arab countries has resulted in their improper use. The resources available to satisfy the enormous individual and collective needs of the Arab countries are relatively small and unevenly distributed. Table 2.10 shows the total economic resources and their use for the two major groups namely the oil exporting countries and the non-oil countries. In 1971 the total economic resources for both groups were close in volume, but since the oil prices rose in 1973 the total economic resources put at the disposal of the oil exporting countries has risen faster than those resources available to non-oil countries. This has resulted into two distinct patterns of economic growth.

TABLE 2.10

Total Economic Resources and their use

| Arab Countries in group | 1971 | % | 1974 | % | 1979 | % | 1981 | % |
|---|---|---|---|---|---|---|---|---|
| The Oil-Exporting Countries Resources | | | | | | | | |
| GDP | 24604 | 80.0 | 89984 | 80.1 | 2220757 | 72.9 | 329623 | 73.0 |
| Imports of goods and services | 6059 | 20.0 | 22324 | 19.9 | 81748 | 27.1 | 121340 | 27.0 |
| Total Resources | 30663 | | 112308 | | 302505 | | 450963 | |
| Uses | | | | | | | | |
| Consumption | 13124 | 42.0 | 28738 | 25.5 | 103111 | 34.0 | 152963 | 33.9 |
| Investment | 4724 | 15.4 | 17246 | 15.3 | 65695 | 21.7 | 97042 | 21.5 |
| Exports of goods and services | 12813 | 41.7 | 66328 | 59.0 | 133700 | 44.0 | 200957 | 44.5 |
| The Other Arab Countries Resources | | | | | | | | |
| GDP | 20898 | 80.3 | 36562 | 72.0 | 71897 | 69.9 | 94644 | 68.9 |
| Imports of goods and services | 5111 | 19.7 | 13890 | 28.0 | 30872 | 30.1 | 42620 | 31.9 |
| Total Resources | 26009 | | 50452 | | 102769 | | 137264 | |
| Uses | | | | | | | | |
| Consumption | 18994 | 73.0 | 32037 | 63.0 | 64106 | 62.3 | 86739 | 63.1 |
| Investment | 3184 | 12.2 | 7435 | 14.5 | 19678 | 19.1 | 23493 | 17.1 |
| Exports of goods and services | 3831 | 14.8 | 10935 | 21.5 | 8983 | 18.6 | 27031 | 19.8 |

SOURCE: Complied from N.M.F.: Arab countries National Accounts 1971-1982 (U.A.E.: A.M.F., 1983).

The economic growth in the non-oil Arab countries has depended on the increase in average income per inhabitant which was extremely low. To increase per capita income these countries tried to increase the productivity of their workers through adoption of modern techniques and the diversion of persons from less productive activities to more productive ones. They did this by squeezing the consumption of their masses - which generally speaking was very low - and increasing the ratio of economic resources to total resources devoted to the investment. This is evident in the rise of the ratio of resources allocated for investment and the fall in resources devoted to consumption. The former ratio had risen from about 12 per cent of the total economic resources in 1971 to slightly over 19 per cent in 1979 but dropped to 17 per cent in 1981. In contrast private and public consumption declined from 73 per cent in 1971 to about 63 per cent of the total economic resources in 1981.

In contrast, economic growth in the oil-exporting countries depended on the influx of oil revenues. The unique experience of the major oil-exporting countries of receiving enormous liquid wealth in a very short time fostered types of consumption peculiar to countries of high productivity and made planners base their targets on the volume of investment expenditure rather than on production.(29) The total consumption of the oil exporting countries rose more than twelve times in a decade, from about $13 billion in 1971 to about $153 billion in 1981. The sudden increase in consumption and the importing of a variety of luxury goods has been strongly criticised.(30) Sudden riches seem to deter the building of a vigorous society and provide ample opportunities for extravagant expenditure.

However, concurrent with the increase in consumption in the oil exporting countries, investment also increased at a great pace. It had risen about twenty times during that decade from about $5 billion in 1971 to approximately $97 billion in 1981. Thus the oil exporting countries have invested heavily in various economic sectors. The distribution of planned investment in the 1970's among the Arab countries as given in Appendix 2.9, shows that the emphasis in these plans is on the productive sectors. This is clear from the allocation of 55.5 per cent of the total planned investment to these sectors. While the service sectors and the distribution sectors were allocated one-quarter and one fifth of the total planned investment respectively. However, the emphasis on the productive sectors was more pronounced in the development plans of the non-oil countries which allocated two-thirds of their planned investment to these sectors.

The emphasis on other sectors in some oil exporting countries such as Saudi Arabia and the United Arab Emirates was necessary for two reasons.

(a) The physical and social infrastructure of both countries was relatively undeveloped compared to their counterparts in Kuwait and Iraq.(31.) Thus Saudi Arabia and the United Arab Emirates devoted a large proportion of their total investment plans in the early 1970s to building up their physical and social infrastructure, especially housing, roads, ports, electricity and water.

(b) The building of the physical infrastructure is necessary to prepare the ground for the smooth take-off of the development of other sectors.

The uneven distribution of liquid wealth among the Arab countries resulted in large disparities among Arab countries in per capita consumption and capital formation. The figures for 1981 (Table 2.10) show the consumption of the oil exporting countries was twice that of the non-oil countries despite the fact that the majority of the Arab population live in the latter countries. Likewise the investment in the oil exporting countries was four times that in the non-oil producing countries although the investment opportunities are larger in the latter countries. In this context it can safely be assumed that, there has been much room for improving opportunities and reducing wastage in the region had a collective plan been made for deploying the regions surplus among the Arab countries.

The oil exporting countries have pushed the investment ratio in the non-oil economy (over 60 per cent) beyond all historical records (32) through the Governments budget regardless of the productivity of these investments. In contrast some productive investment opportunities were left in the non-oil producing countries due to lack of capital. It is worth noticing here that investment in some of the non-oil countries such as Jordan and North Yemen was only possible through the help received from the oil exporting countries. In solidarity with other Arab countries, the oil exporting countries extended in official aid about $20 billion to the former countries during the 1970s (Appendix 2.10) Concomitant with this, the non-oil producing countries received about $26 billion in remittances from their citizen working in the oil exporting countries (see Appendix 2.11). These payments undoubtedly alleviated the hardship of the non-oil countries and made economic growth possible, but not to such a sufficient extent to finance all the investment opportunities available in these countries.

The great discrepancy between the oil revenues and the planned investment in the major oil exporting countries is striking. Table 2.11 shows that the United Arab Emirates' oil revenues were almost ten times its' planned investment. This in Kuwait corresponds to a 400% ratio and more than 300% in Saudi Arabia. A similar discrepancy can be observed in Qatar and Libya. The other Arab countries like Iraq and Algeria with considerable oil production have invested a larger proportion of their oil revenues (and the latter country has even borrowed to satisfy its development needs). In the former countries with a high discrepancy between oil revenues and planned investment, development was severely constrained by the lack of other complementary factors of production such as labour and poor infrastructure facilities which severely reduced the capital absorptive capacity of these countries. These problems were aptly described by Everett. He wrote,

> "Every economist would agree that in any country there is some limit to the rate of capital formation that can be carried out at any given time with resulting increase in productivity. There are technical and other limitations. Among the technical ones are the size of the construction industry, the availability of materials for capital construction and of workers for construction and subsequent operation, the capacity of the ports and transportation system to carry capital goods, of the communication system to carry messages, of the country's housing to house expatriate or migrant builders and workers, and of the existing productive complex into which or onto which the new enterprises must be fitted and on which they must depend in part for their productivity. Other limitations would include the number of individuals in the society with adequate managerial and technical capabilities, including in the extreme case the capability of making contracts with foreigners to do the capital formation, and the values and motivations of many groups in the society of workers, which affect their availability for new enterprises of government officials, which will determine the degree of waste, corruption and misdirection of investment."(33)

### 2.4.2 The Financial Assets Accumulation

The major oil exporting countries have converted their depleted national wealth in excess of their development needs in the short run,

TABLE 2.11

Arab countries planned investment and value of petroleum exports

(U.S. $ million)

| | Planned investment (1) | Value of oil exports (2) | (1) & (2) |
|---|---|---|---|
| Jordan | 2,853 | - | - |
| Bahrain | 377 | 7,897 | 4.7 |
| Tunisia | 13,553 | 2,354 | 575.0 |
| The Sudan | 10,068 | - | - |
| Syria | 16,028 | 5,290 | 302.0 |
| Somalia | 757 | - | - |
| Lebanon | 2,361 | - | - |
| Egypt | 33,790 | 8,016 | 421.0 |
| Morocco | 13,947 | - | - |
| Mauritania | 999 | - | - |
| Yemen A.R. | 4,498 | - | - |
| Yemen P.D.R. | 323 | - | - |
| U.A.E. | 8,020 | 74,254 | 10.8 |
| Algeria | 31,982 | 45,133 | 70.8 |
| Saudi Arabia | 97,501 | 3,47,724 | 28.1 |
| Iraq | 42,528 | 95,344 | 44.6 |
| Oman | 5,231 | 12,015 | 43.5 |
| Qatar | - | 20,257 | - |
| Kuwait | 19,262 | 86,717 | 22.2 |
| Libya | 33,752 | 87,693 | 38.5 |
| TOTAL | 3 38.130 | 7 92.703 | 42.6 |

SOURCE: Joint Arab Economic Report, 1981.
Table 10/6, p.236.
Table 2/12, p.295.

as a result a great proportion of their oil revenues have been kept in liquid assets abroad. This leads us to investigate where the rest of oil revenues have gone and more importantly how these funds have been deployed. In answering these questions we encounter a scarcity of data and different estimates for Arab capital surpluses. However, the most quoted data are tabulated in Table 2.12. According to figures in the Table the accumulated capital surpluses of the six Arab countries totalled about $275 billion at the end of the first quarter of 1982. Others estimated it at 400 billion at the end of 1982.(34) The wide discrepancy in these estimates is due to the absence of publications about them. The distribution of these financial assets between the holder shows the drastic concentration of the financial assets in the hands of two countries namely Saudi Arabia and Kuwait. The formers foreign assets stood at about $160 billion and the latter's foreign assets at $75 billion. The other two countries which were still holding foreign assets at the end of the period under consideration were the United Arab Emirates (U.A.E.) and Qatar, each of them was possessing a relatively modest amount compared to the holding of the first two countries. While the last two countries on the list, Libya and Iraq, have found their surpluses drastically cut and even becoming negative. This happened for different reasons. Iraq has lost its foreign assets and borrowed what is estimated by some sources at about $35 billion(36) mostly from the Arab rich countries, as a result of the war with Iran which started in September 1980, whilst the reduction in petroleum production in Libya has dried up its foreign assets.

The surpluses of the major oil exporting countries were matched by smaller deficits accumulated by other Arab countries. The latter countries have been unable to generate domestic income sufficient to

TABLE 2.12

Arab Foreign Assets

(U.S. $ billion)

| Country | 1972 (1) | 1977 (2) | 1978 (3) | 1979 (4) | 1980 (5) | 1982 (6) |
|---|---|---|---|---|---|---|
| Saudi Arabia | 2.3 | 64 | 61 | 78 | 125 | 160 |
| Kuwait | 2.4 | 21 | 27 | 49 | 65 | 75 |
| United Arab Emirates | .3 | | 9.3 | 12.7 | - | 30 |
| Qatar | .4 | | 2.9 | 4.2 | - | 10 |
| Iraq | .7 | | 8.6 | 17.5 | - | - |
| Libya | 2.7 | | 4.1 | 6.3 | - | - |
| TOTAL | 8.8 | | 112.8 | 167.7 | | 275 |

SOURCE: For Calculations 1, 2, 3, 4 and 5 for Saudi Arabia and Kuwait quoted by Financial Times Survey, Monday September 28th, 1981 Arab Banking and Finance, p.II.

For Calculations 1, 3 and 4 for U.A.E., Qatar, Iraq and Libya quoted by Zuhayr Mikdashi, Payments Imbalances, O.P.E.C. and Financial Markets in Oil and Arab Co-operation, Vol.7, No.3, 1981, Table 2, p.77.

Calculation 6 for Saudi Arabia, Kuwait and U.A.E. from Odeh Aburdene, U.S. Economic relations with Saudi Arabia, Kuwait and U.A.E. by A. Abourdeineh in Arab Business Magazine, No.40, (August, September, 1982), p.40-43 in Arabic.

their consumption and investment. So in contrast to the first group, they borrowed about $72 billion or about one quarter of the surplus accumulated by the first group. As seen in Table 2.13, the figures show Algeria as the largest borrower among the Arabs with an outstanding debt of approximately $21 billion in 1981. During the 1970s Algeria had raised large sums of money in order to finance its ambitious industrialisation programme. Egypt is the second country in terms of outstanding debt accumulated in 1981, approximately $17 billion. Then comes Morocco with a figure of loans amounting to $10 billion. The other Arab countries borrowed less than the first three did.

On the question of surplus deployment, detailed statistics are not available. However, it is known that the vast bulk of such funds are placed in Euro dollar markets in short term instruments with a much smaller amount finding its way into the Arab region and to other developing countries. This is clear in the portfolio investment of Saudi Arabia, the largest holder of such funds and in the Arab portfolio investment in the United States of America which is the largest recipient of Arab capital surpluses. In the case of Saudi Arabia's surplus, two thirds of it is invested in U.S. dollars primarily U.S. Government treasury bills and notes and the other 20 per cent in D-Mark and Yen denominated securities.(36) In 1982 the Arab investment in the United States was estimated to be nearly $80 billion. The bulk of these investments were in the form of U.S. Government securities (about $46 billion), corporate bonds and stocks($15 billion) and direct investments were just about $4 billion, (see Table 2.14).

TABLE 2.13

Arab countries: Debt indicators 1972-1981

(in million US dollars)

| Country | Total Debt | | | | Total Debt Service | | Disbursed to GNP | | Debt Service to Exports | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Outstanding | | Disbursed | | | | | | | |
| | 1972 | 1981 | 1972 | 1981 | 1972 | 1981 | 1972 | 1981 | 1972 | 1981 |
| Somalia | 251 | 1,316 | 100 | 877 | 2 | 16 | 24 | 71 | - | 6 |
| Sudan | 702 | 6,004 | 396 | 4,595 | 51 | 111 | 17 | 68 | 14 | 24 |
| Algeria | 2,697 | 21,686 | 1,488 | 14,392 | 189 | 3,880 | 21 | 36 | 12 | 26 (1) |
| Egypt | 2,680 | 17,334 | 1,982 | 13,887 | 349 | 2,065 | 25 | 47 | 31 | 23 |
| Iraq | 733 | - | 415 | - | 45 | - | 10 | - | 3 | - |
| Jordan | 339 | 2,277 | 171 | 1,419 | 10 | 182 | 28 | 39 | 7 | 6 |
| Lebanon | 63 | 385 | 62 | 246 | 9 | 54 | 3 | - | - | - |
| Morocco | 1,216 | 10,678 | 919 | 7,879 | 104 | 1,233 | 18 | 51 | 10 | 30 |
| Oman | (2) 343 | 842 | 166 | 556 | 10 | 95 | 14 | 10 | 1 | 2 |
| Syria | 523 | 3,978 | 337 | 2,336 | 42 | 411 | 14 | 15 | 8 | 15 (3) |
| Tunisia | 1,083 | 4,599 | 694 | 3,182 | 95 | 517 | 31 | 39 | 15 | 15 (4) |
| Yemen A.R. | (5) 380 | 1,747 | 230 | 1,094 | 10 | 59 | 30 | 34 | 5 | 5 |
| Yemen P.D.R. | 149 | 1,271 | 20 | 640 | - | 37 | - | 66 | - | 7 (6) |
| TOTAL | 11,159 | 72,117 | 6,980 | 51,103 | 916 | 8,660 | | | | |

NOTES: (1) Exports of G & S 1980
(2) Debt of 1974
(3) Export of G & S 1980
(4) Export of G & S 1980

TABLE 2.14

United States Investments of the Major Arab Oil Exporters (end of 1982)

| | $ Millions | % |
|---|---|---|
| U.S. Government Securities | 46280 | 58.0 |
| Treasury Bills | 7005 | 8.8 |
| Treasury Bonds | 33006 | 41.4 |
| Federal Agency Issues | 6269 | 7.9 |
| Corporate Bonds | 5892 | 7.4 |
| Corporate Stocks | 9570 | 12.0 |
| Commercial Bank Liabilities | 8164 | 10.2 |
| Demand Deposits | 1340 | 1.7 |
| Time Deposits | 1434 | 1.8 |
| Other (mainly CDS) | 5391 | 6.8 |
| TOTAL | 69906 | 87.7 |
| Non Bank Liabilities | 1019 | 1.3 |
| U.S. Government Liabilities | 4884 | 6.1 |
| Direct Investment | 3926 | 4.9 |
| TOTAL Investment in U.S. | 79735 | 100.1 |

NOTE: Statistics cover Algeria, Bahrain, Iraq, Kuwait, Oman, Qatar, Saudi Arabia & U.A.E.

SOURCE: United States Treasury Commerce Department, Publication of Office of Intenational Banking and Portfolio Investment, 1st March 1983, cited in The Arab World, Rodney Wilson An International Directory, (U.K. Wheatsheaf Books Ltd., 1984) Table 22.

The deployment of the region's surplus in short-term financial instruments abroad has not been rewarding. In the period 1974-78 the interest earned in real terms from such investment in the Western countries was low and perhaps even negative.(37) Thus the way the Arabs' money has been deployed has not been compatible with their announced aim of accumulating these funds as a 'pension fund' for the future generation when the oil era comes to an end.

The Arab holders of these surpluses have not been interested in this short term investment. But they encountered two major problems. First, the oil exporting countries were obliged to accomodate the expanding world demand for energy by selling more oil, thus producing more revenue than they could absorb. As a result oil revenues began accumulating in the international banks. Undoubtedly these countries have benefitted from the adjustment in oil prices in parallel with othe sources of energy prices but objectively, they could have managed with a lower production level. In fact, despite the increase in oil prices, many people in the region advocated the policy of leaving the oil in the ground instead of converting it into financial assets which may be eroded by inflation. Within this context an Arab financier said it would be wise for the oil exporting countries to tailor oil production levels to their own needs.(38)

The second problem faced by the Arab countries with large holding of surpluses is that of portfolio selection. In selecting their portfolio investment the Arab were faced with two problems. The first of these problems was the concentration of the revenues in the hand of governments. The latter trusted this task to their Ministry of Finance or Central Bank. The lack of material and human resources in such institutions made it impossible for them to effectively invest huge amount of surpluses in a short time.(39)

The second problem with regard to portfolio selection is the reluctance of all countries to open the door to foreign direct investment on large scale.(40) So the Arabs were left with very little choice apart from accumulating their funds with well known international banks.

## 2.5 The Emerging concept of Arab Capital Markets

### 2.5.1 On the national level

In view of these limitations the Arab countries began questioning their investment strategy. They found that long term rewarding investment, particularly equity investments are not open enough in foreign countries on the scale required. Consequently the call for Arab investment to confine itself to the region was intensified.(41) This policy was reflected in the paper given by Alhamed. He said,

> "we do not regard ourselves in the Arab capital surplus countries as merely providers of funds, mere money lenders or ventures. Our role cannot possibly be confined to such limits as our fundamental aim is the most appropriate coupling of Arab financial resources to the development needs of Arab lands".(42)

This development coincided with the need of the other Arab countries for funds and great opportunities opened up for Arab capital when many Arab countries welcomed the Arab surplus.

Within this context, Kuwait the first Arab capital surplus country has gradually diversified some of its portfolio across a wider spectrum of assets. The Kuwaitis established their own investment companies very early and have been by far the leading institutions in this respect.

In the 1970s in an effort to have more control and direction over their capital surpluses, many Arab countries resorted to the establishment of their own financial institutions. The leading countries in this direction were Kuwait, Libya and U.A.E. These countries have developed their own financial institutions to have direct control over their capital surpluses. Since then such institutions have been instrumental in channelling part of their funds. Other Arab countries, Jordan, Bahrain and Egypt among others also embarked on policies of developing their own financial institutions. In addition, the latter two countries invited foreign banks to operate as offshore enterprises in their territories with the intention of helping to finance projects in the case of Egypt and building a regional service centre in the case of Bahrain. The proliferation of the new financial institutions in many Arab countries was accompanied by the emergence of securities markets and the introduction of new financial legislation and regulations. So the scene of the Arab financial markets began to change rapidly, and some regional financial centres began to emerge. These developments will be the subject of the remaining chapters.

### 2.5.2 On the regional level

Long before the appearance of Arab capital surpluses, Arab countries were active participants in several agreements. The vast increase in the surplus available for investment increased the Arab efforts toward economic integration. The Arab countries collectively established the Arab Fund for Social and Economic Development (A F S E D) in 1972 and the Arab Monetary Fund, AMF in 1977. Since then these institutions have been performing for the region what the international institutions perform for the world, but the Arab institutions have broader aims than the international ones. Both institutions have been active in promoting Arab economic integration by various means. In addition the oil rich countries have established their own development institutions to serve the region in particular and the developing countries in general through the extention of soft loans.

The new wealth also encouraged the establishment of many joint ventures. A survey shows that there are now 750 joint Arab projects with a total capital of about $35 billion.(43) The joint projects allowed the region to benefit from economies of scale, relieved the deficit Arab countries hosting such projects from the burden of borrowing, and provided an opportunity for the capital surplus countries to diversify their investment and to be partners rather lenders of money.

Further co-operation envisaged in the multilateral agreements initiated by the Arab Economic Unity Council namely:

1. Agreement on avoidence of double taxation and elimination of tax evasion.
2. Agreement on co-operation in collection of taxes.
3. Agreement on capital investment and mobility.
4. Agreement on settlement of investment disputes between Arab host countries and citizen of other countries.(44)

Some of these agreements have been approved.

A further co-operation envisaged in the three agreements was approved by the Arab headsof state in 1980. These agreements are the strategy for joint Arab Economic Action. The joint agreement for Investing Arab capital in Arab countries and the plan for joint Arab development during the 1980s, proclaimed as the decade of Arab economic co-operation.

The main aim of these efforts is to speed up economic development by pooling resources. This would alleviate the present constraint on the region's development, and open the way for creating a viable modern economy for the region as a whole. The importance of these efforts emanates from the fact that they were initiated at the offical level and with the approval of those in power. As a result further progress is expected because it is in compliance with the desires of the region's people.(46) It may proceed slowly but the probability of reversal is remote. Progress in this direction would have been greater had not these efforts received a serious setback with the suspension of Egypt - the founder of and the most populous country in Arab League - form membership of the Arab League in 1979.

## Conclusions

The Arab countries have great diversity in population, in economic wealth and in the level of economic development, but their economies still have the feature of developing economies. The high per capita income and the favourable balance of payments in the oil exporting countries are symptoms of a developed economy, but the great reliance of the economics on single products, an inadequate indigenous supply of technical skills and labour and an over dependence on imports of all sorts of goods from abroad put their economics among the under developed economies.

The extensive mining of Arab minerals has undoubtedly facilitated economic growth in the region, but has had implications for the sources and structure of the Arab economies. The oil boom helped the establishment of the urgent social and physical infrastructure especially in the oil exporting countries, but in modernizing the regions traditional sectors and in building a real industrial base its contribution was modest. The non oil Arab countries financed the bulk of their domestic capital needs from domestic saving, and foreign funds most of which come from official sources and workers', remittances. Some of them borrowed on the international markets, but the ones that had restricted access to market financing were forced to slow down their economic growth.

The oil exporting countries had abundant funds and the allocation of resources to domestic investment was dictated by economic and social needs. The lack of the complementary factors of production reduced the capital absorptive capacity of these countries and so some of them were left with enormous liquid funds. Economic development of the sparsely populated countries may require a further large influx of population. Similarly, the other Arab countries are needed for capital.

The Arab countries collectively have the adequate human and natural resources to support a major development programme for the region as a whole. The efforts of the individual Arab countries for development have been constrained by the shortage of either labour or capital.(47) Therefore, the great challenge for Arab planners will continue to be how to rationalize the scarce Arab resources and how to bring about their free movement within the region. The existence of high saving countries and low saving countries - with the former having few if any options to diversify their economies or reduce their almost total dependence on oil and the latter having limited access to the international capital markets provides the basic rationale for enhanced efforts toward the development of Arab capital market. In addition the emphasis on the establishment of viable industries on a large scale one has much in commonwith the emphasis on creating a dynamic and efficient Arab capital market. The type of funds needed, their nature and size requires a new arrangement to allow the operation of Arab financial institutions across boundaries with a minimum of restriction.

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# CHAPTER THREE

## ANALYSIS OF THE DEVELOPMENT AND OPERATION OF THE BANKING SYSTEM

## Analysis of the development and operation of the banking system

### Introduction

The banking systems are the most important financial institutions in every country's financial system. Their importance stems both from their size within the financial sector and from the fact that their liabilities determine the money supply. Thus the banking system plays a key role in the functioning of the economy.

The commercial banking institutions are usually the first to appear in financial development and constitute an important sector within the financial structure. When the economy expands the existing banks either adjust their financial instuments to serve the changes in savers' and borrowers' preferences, or new financial institutions emerge to introduce the newly demanded services. The banks differ from other financial institutions in the degree and complexity of their market relationships. Banks are vested with a public service responsibility. This responsibility is met in three major ways.

1. providing the principal monetary mechanism for the country of operation.
2. providing credit facilities for all sectors of the ecomony.
3. providing safe repositories for savings.

These services are of vital importance to any country, developed or developing. However, the deposit and credit services the banks share with other financial institutions, but the first service is almost limited to commercial banks. In this service, banks create money other financial institutions do not, and for this the banks are usually subjected to specific regulations. The performance of the banking system is closely related to its structure and organisation, and its contribution to development depends on its dual function of carrying a smooth payment system on one hand and extending credit to economic development on the other. In addition the establishment of sound banking systems in the developing countries take priority over the other type of financial institutions, as the demand for money is usually high in the early stage of development, because people prefer their savings in cash or deposit with banks.

The purpose of this chapter is to take a detailed investigation of banking system in the Arab region. As already indicated, the banking system are the region's most important financial institutions. It is therefore natural that we should be concerned with the structure of the Arab banking industry to explore whether it provide banking services in an efficient manner in order to identify the ways on which a possible improvement in their operation and strengthening integration may be achieved. More specifically, in this chapter we shall examine issues like the following: How are the Arab banks born, and how do they expand? Is the banking system safe, efficient, and competitive? Who regulates banks, how they are regulated, and why they are regulated? As we attempt to answer these questions, we shed light on a pressing practical problem namely, financing economic development. For this the present chapter is presented into three main sections. First section will examine the structural changes occurred in the regions banking system during the turn of this century. Section two will examine the impact of central banks and commercial banks on development. Section three will examine some measures for improving the systems mechanism and reinforcing moves towards convegence.

## 3.1 The evolution of and structural changes in the Arab banking system

To examine the evolution of and structural changes in the banking systems of many countries over a long period is a difficult task, but fortunately in the Arab case it is possible to divide the period chronologically in such a way as to associate these divisions with specific changes in the banking structure. We believe that the historical evolution of Arab banking was significantly affected by the arrival of the Europeans in the region, the political independence of the Arab countries and finally the oil price rise of 1973. Our account will be periodised accordingly.

### 3.1.1 Up to independance

In a rudimentary way, banking functions were performed in the region for many centuries by the money changers, merchants and others who were in a position to extend credit. Some of these practices have continued to the present day; indeed the money changers in Kuwait and Saudi Arabia play an important role in the banking system (1). But modern banking facilites are of recent origin, having been first introduced by the Europeans in the late nineteenth century. A group of British and French financiers obtained a currency issue concession from the Ottoman Empire so they set up the Ottoman Bank in Turkey in 1863. It is perhaps the oldest modern banking institution in the area (2). The bank immediately opened two branches in Egypt to benefit from financing the cotton trade there. Around that time, French financiers opened other banks in Algeria and Tunisia. Then at the turn of the century the Ottoman bank opened other branches in the large cities of the Fertile Cresent countries (Syria and Iraq), the French opened banks in Morocco, and the Italians in Libya.

Simultaneously the large foreign communities in Egypt also established their own banks in the late ninteenth century (3). The Egyptian counterpart of the Ottoman bank, the National Bank of Egypt, was established as a commercial bank with a currency issue concession in 1898. It was completely owned and administered by foreign financiers (4).

The introduction of banks was accompanied by the introduction of paper money. During the Ottoman rule, the gold pound was the only legal tender, in the region although other metallic coins such as the Austrian schilling (Maria Theresa) were abundant in the Peninsula countries (5). This system was replaced by different paper money systems introduced by the Europeans in their colonies. For instance the French introduced the Franc to Algeria, Morocco and Tunisia. Likewise they introduced the Syrian pound to Syria and Lebanon. The British introduced the Egyptian pound to Egypt and Sudan, the Palestanian pound to Palestine and Trans-Jordan. But in the Gulf states the Indian rupee was introduced. Italy introduced the Italian lira in Libya and part of Somalia. Nevertheless, metallic money continued to circulate as a useful means for hoarding and exchange (6).

The success of the foreign banks and the negligence of indigenous needs motivated some wealthy Egyptians to establish their own bank to serve the Egyptian people by financing industry rather than foreign trade with which the foreign banks were preoccupied (7). Consequently the Misr Bank was established by the Egyptians in 1920. It was the first bank owned and controlled by an indigenous population. The bank played an outstanding role in promoting and financing some industrial enterprises that still leads Egyptian industrial activites. Its success incited other local people to create their own bank. In 1924 a group of wealthy Syrians in collaboration with Misr Bank established the Bank-Misr-Syrian-Libyan to operate in Syria and Lebanon. The concept of the establishment of a national bank was spread and accepted by the Palestinians who set up the Arab Bank in Jerusalem in 1930. A decade later the Iraqi Goverment set up the Rafedain Bank in Baghdad. The three above mentioned banks have proved successful ventures and today they are amongst the top Arab banks. Other small and family banks established in Syria and Lebanon during that period were not known outside their district of operation. So they were of minor importance. (8) The Peninsula countries hosted their first modern banking institution in 1920 when the Chartered bank opened office in Bahrain. Two decades later it was followed by the British Bank of the Middle East which opened branches in Kuwait, in Dubai and Bahrain in the early 1940's. The National banks were later arrivals in the Peninsula countries. In 1952, Kuwait and Saudi Arabia established their own national bank for the first time, followed by Bahrain in 1957. Likewise the merchants of Dubai created their own national bank in 1963, and 5 years later Abu Dhabi did the same (9).

The above discussion shows that financial growth proceeded faster in the first half of this century in Egypt and the Levant countries (Syria, Lebanon, Palestine) than it did in other countries in the region. But the whole development was simple and dominated by the activities of a few branches of foreign banks. Arab economists attribute the slow expansion of the banking system at this period to several deterrent factors such as, multiple currency circulation, extensive use of gold for transaction and hoarding, deep-rooted Islamic precepts condemning usury, mistrust of banking institutions and the lack of banking control (10). But to this can be added the low per capita income in the region. Nevertheless the banking habit was introduced and the urban areas become monetized to some extent. This helped financial growth in the post-independance period to proceed at a greater pace than would otherwise have been possible.

### 3.1.2 The post-independence period to 1973

Although the Arab countries achieved political independence at different dates during the two decades immediately following the end of World War Two, several structural changes in the region's banking system took place at this period. Among others are the establishment of comprehensive monetary authorities, the issuance of banking regulations, the growth and reorganisation of the banking system and the emergence of Beirut as a commercial and financial centre for the region.

#### 3.1.2.1 Banking regulations

Favourable economic conditions and the increase in oil production at the end of the Second World War attracted more banks of local and foreign origin to operate in the region. Consequently, the banking scene began to change rapidly. By the 1950's the number of commercial banks stood at 26 in Egypt, about 20 institutions each in Syria and Morocco, 7 banks in Iraq and 35 institutions in Lebanon. Likewise the number of banks increased in other Arab countries but on a smaller scale.

The growth of the banking sectors at this stage called for regulations. This is because banks are institutions whose liablilities act as a medium of exchange. They are able to create money. So the ability of banks to create money autonomously had to be constrained by various institutional and legal arrangements if a reasonable supply of money is to be maintained.(11)

Consequently, specific banking regulatins were issued during this period in most Arab countries. The new regulations cover all structural changes in the banking sectors and define their operations.

What is important in the context of this study is to explore the legislation and regulations which affect the operations of the banks such as those regulations controlling licensing banks and those affecting the bank's portfolio components.

With regard to the former the chartering laws of the Arab countries contain essentially the same general requirements. The prescribed considerations to be fulfilled before a bank grants a license are:

1. The new bank takes the form of organisation specified by the law (usually joint-stock company) and has the adequate capital.
2. The organisers of the bank are competent and honest.
3. The market can support another bank without endorsing the solvency of the existing banks.
4. The public cnovenience and needs would be served by the bank. Once a bank has granted a license for operation, it requires further permission to open or close a branch within the country or outside in the case of a local bank.(12)

These regulations ended the preceeding free banking era when any one with some capital could open a bank without fulfilling many requirements. Thus the new regulations have helped to create more sound banking but at the same time the regulations shield the existing banking institutions from the vigours of competition. Some economists object to regulations that insulate banks from failure on the ground that such regulations inhibit risk-taking, discourage financial innovation, circumscribe management decision-making and stifle the benefits to the community that can flow from competitive rivalry (13).

But within the context of the developing economies the argument is not valid and banks have to be watched closely to be geared to the economic needs and the institutional conditions of these countries.

The regulations which affect the banks' portfolio composition are those which prescribe the composition of the banks liquid assets and those which prescribe the area prohibited for lending above a certain ratio of the bank's paid up capital and reserve. The prescribed composition of liquid assets and the prohibited area for banks are also broadly similar in the banking laws of the region. The former include such items as:

1. notes and coin of the national currency.
2. balances with central banks.
3. net credit balances with other licensed banks in the country.
4. net balances in convertible currencies with banks abroad.
5. Government or Government-guaranteed securities with a maximum maturing time of one year.
6. Foreign securities marketable in international financial markets.

7. Other assets as may be approved by the central banks as liquid assets.

The imposed liquidity ratio of the banks' total assets varies from one country to another, but broadly speaking it is high for the banks in the region where it can rise to 35 percent of the banks' total assets (14). The important thing about this ratio it determines the type of investment for about one third of the Arab banks' total assets.

In addition banks are required to maintain the legal reserve requirements in the form of vault cash or deposits with their central monetary authorities. The requirements are set by the board of the central banks or the governers within the range specified by the law. The specified limits established by laws are smaller than the liquidity ratio.

With regard to the area prohibited for banking operation the laws specify which transaction may not be undertaken by banks. Among other things:

1. A bank cannot extend credit to any single customer above the specified percent of its paid-up capital and reserves. The ratio is hovering around 25 percent at the present.
2. A bank cannot engage in trade on its own account or on a commission basis.
3. A bank cannot invest in a single project of an industrial agricultural or trading nature more than the specified amount of its paid-up capital and reserve.
4. A bank may not extend credit to its directors or companies in which its directors have interests above a certain ratio of

its capital. This ratio has been less than 10 percent in the region's banking laws.(15)

The present legislation and regulations of the Arab banking system helped to create a more sound banking system where the safeguarding the interest of depositors and exposure of bank to risk constitute the core of them. The regulations which impose high liquidity ratio is meant to create and provide banks with a cushion. The nature of bank liabilities confirms their needs for liquidity. The banks need assets that are quickly convertible into cash with little or no loss in value. But how much they need is another question.

Similarly the regulations which impose some restriction on the banks' management of their assets are intended to reduce the exposure of the banks to the risk and misconduct of a single customer and failure of one project. So the regulations limited the amount of credit that banks may extend to one customer. Likewise, the reserve requirement is justified, although the historical reason for maintaining bank reserves was to ensure that sufficient funds would be available to meet the claims of the depositor, today the requirement is of paramount importance for money management particularly in the developing countries. The central monetary authorities use the reserve requirements to limit the maximum amount of loans, investments and deposits that the banking system can make. The lower the reserve requirement the more the banking system can expand and in turn make loans to finance industry and commerce etc.

#### 3.1.2.2 The establishment of comprehensive monetary authorities

In every Arab country there is now a single monetary authority performing the function of monetary management, chartering and regulating banks and other financial institutions, giving directions to the classes and purposes for which advances may be made, and accordingly issues instructions from time to time. Our purpose in this section is to examine why these institutions were established and what is their status.

1. The main factors led to the establishment of fully-fledged monetary authorities.

The increase in the number of banks, the great desire for rapid development and the difficiencies of their previous monetary system called on the establishment of a fully-fledged monetary authority in every single Arab countries. All the Arab countries inherited on the eve of their independence a very simple monetary system. The currency issue was trusted to either currency board or to commercial bank. The latter was chartered by various laws to perform a function similar to the currency board arrangements. The currency boards and the commercial banks with currency-issue concessions were merely money changers, because their function was only to issue and redeem the national currency against the receipt of foreign exchange in parity for a small commission on each transaction (16). These arrangements had some domestic advantages, in the sense of providing a sound local currency as its guarantee of full and free convertibility into hard currency at a stable rate of exchange. But it had a serious retarding impact on internal economic development. The maintenance of the 100 per cent foreign reserve investment against notes and coins issued locally and the absence of any control over banking system did not give the boards a role in monetary management and made such arrangements vulnerable to critisism (17).

The maintenance of the 100 percent reserve system compelled such countries to hold their savings in foreign exchange reserves rather than investing them in productive physical capital, providing of course that they chose to hold such savings in the form of currency. In addition the money supply of such countries was tied to the balance of payments performance and not to national production. To quote Drake

> "under a currency board type of system, the currency supply is wholly determined by the balance of payments, because local currency issued only in exchange for acceptable foreign money at a fixed rate. In these circumstances, the currency supply will not be able to expand in step with growing domestic production unless there is also secular growth of external reserves, through a trade surplus and/or net capital inflow. Of course, the local money supply consists of bank deposits as well as of currency. Bank deposits may increase directly through the balance of payments; and the banking system through credit creation may also expand the deposit money component independently, but not regardless, of the state of the balance of payments. The banks cannot disregard the balance of payments because their lending is based upon liquid assets (consisting of interchangeable local currency foreign exchange reserves) which cannot in total grow without a continuing balance of payments surplus. So bank credit would, sooner or later, reach a maximum level determined by any given volume of liquid reserves in the banking system in conjunction with any liquid reserves: deposits ration adhered to by the banks. In the absence of an further growth of reserves via balance of payments surpluses (the only possible way), there is an upper limit to the total quantity of money, and not merely to its currency component" (18).

The second factor is contributing to the creation of the central banks in the newly independent countries is the desire to loosen the constraints of that system by institutional changes and to give these institutions responsibility for separate areas of economic policy.(19) The central banks in the developing countries have more responsibility and wider area for action. They are expected to perform the following functions in the interest of the economy.

1. participate in the balance of payments management through its influence over the setting of exchange rates, over capital movement, and over policy related to international payments.

2. determine the total volume of domestic bank credit to assure maximum utilization of the country's savings.
3. influence credit distribution among different economic activities. They are expected to utilize the credit in productive investment and encourage lending to borrowers who are regarded by financial institutions as poor credit risks.
4. formulate the structure of interest rates to encourage savings on the one hand while not allowing a high interest rate might discourage new investment and cause a heavy burden on the budget

The promotional role of the central banks in the developing countries was one of the major factors speeding their establishment in the developing countries. The departure of the central banks in the developing countries from the traditional concept of central banks was natural and justifiable, because the former would operate in economies characterised by simple economic structure, and rudimentary money and capital markets. In such an environment the structure and practices of a central bank could differ from those of its counterparts in advanced countries with diversified economic structure and sophisticated money and capital markets if the concrete needs of the country's economy were to be met.(20)

To carry out these functions all the Arab countries have established their own monetary authority as seen in Table 3.1.

3.1.2.2. <u>The statutes of the Arab monetary authorities</u>

The statutes of the Arab central banks reflect their British and French heritage in terms of management. But as the Arab countries were among the last to establish their comprehensive monetary authorities, they were able to benefit from the experience of the other countries in this

TABLE 3.1

Central Banking in the Arab Countries in 1983

| Country | Note-issuing Institute | Established in | Ownership |
|---|---|---|---|
| Egypt | Central Bank | 1951 | Government reorganised in 1961 |
| Iraq | " " | 1949 | " |
| Jordan | " " | 1964 | " |
| Kuwait | " " | 1969 | " |
| Lebanon | " " | 1964 | " |
| Libya | " " | 1956 | " |
| Saudi Arabia | Monetary Ageny | 1952 | " |
| Sudan | Central Bank | 1960 | " |
| Syria | " " | 1956 | " |
| Algeria | " " | 1963 | " |
| Morocco | Bank of Morocco | 1959 | " |
| Tunisia | Central Bank | 1958 | " |
| Yemen A.R. | " " | 1971 | " |
| Yemen P.D.R. | Bank of Yemen | 1972 | " |
| Oman | Central Bank | 1975 | " |
| U.A.E. | Central Bank | 1982 | " |
| Qatar | Monetary Agency | 1973 | " |
| Bahrain | " " | 1973 | " |

SOURCES: 1. J. D. Ronall, "Recent Banking Development, In the Middle East, Bankers Magazine (May, 1962), p.

2. National Source.

field. These factors contributed to the common feature of the Arab central banks (21). Thus all Arab Central Banks conform to a broad uniform pattern in terms of objectives and functions.

The administrative organisation of the Arab Central Banks with the exceptions of those institutions in Morocco, Algeria and Tunisia, have a board of directors. The board is usually chosen and appointed by the Council of Ministers. The Governer and his deputy are approved by a higher authority such as the Heads of State. But the Arab Central Bank with a French heritage (as is the case of Morocco, Algeria and Tunisia) has no board and the Govenor of the Bank performs the function of the Board in the British arrangement (22).

The close relations between the Arab governments and their Central Banks are spelled out in their statutes. For instance, the Saudi Arabian Monetary Agency (S.A.M.A.) is charged with the function of assisting the Ministry of Finance and National Economy in centralising the receipts and expenditure of the Government in accordance with items of the authorised budget and in controlling payments so that all branches of the Government shall abide by the budget (23). Similar clauses are stated in the other Arab Central Banks' charters, which made of the Central Banks the arm of the Ministry of Finance in each country.

The complete independence of the Central Banks is not practical any more. The tendency is now to bring the Central Bank under public ownership irrespective of the political organisation of the paricular countries, but some degree of independence is necessary to stop goverments in the developing countries from excessive use of the banks facilities (24). The charters of the Arab Central Banks provide some autonomy and make of them the chief executors of the state's economic policy in the monetary field. And their functions have grown since their establishment and now include many tasks charged to them by their respective governments.

### 3.1.2.3 Reorganisation of the banking system

The growth of the financial sector is closely related to the legislative and regulatory arrangements devised to guide its activities. The formulation of liberal laws for the financial institutions in order to promote growth and development through innovation and competition is a difficult task in the developing countries with their backward economies. So restrictions on the financial institutions are expected in such an environment (25). The experience of the developing countries shows that restrictions on the banking systems dominated by expatriate banks were not found sufficient to involve these banks in the development effort at the desired level. So other measures were taken to bring banks under state control.

In the Arab region, Egypt and Morocco took certain measures aimed at associating their national citizens in the control of the wholly expatriate banks in the late 1950's. The former Egyptianized the banks on its territory by transferring the majority shares of expatriate banks to local citizens. (26). The latter upon independence in 1959 associated its national citizens in the financial control and administration of the twenty expatriate institutions at those days.(27) Similarly a few years later Libya accomplished transferring the majority of the capital of the eight expatriate banks to its national citizens.(28) The broad objectives of these policies was to transform the old banking system into one which is more integrated with the national economy and which conforms to the countries overall economic requirements. But the transfer of the ownership from expatriates to local citizens did little to change the operation of the financial institutions. So the call for bringing these institutions under state control was pronounced.(29)

In Egypt, the task of bringing such institutions under state control was an easy one. The state had been in control of much of the financial sector for a long time. The state owned the Central Bank and a great proportion of the national bank, and with the take-over of the British and French interests in the financial sector in 1956 due to the Suez affair, the state was in control of a large proportion of the financial sector there. So this helped the Egyptian government to nationalize all banks and insurance companies on its territories in 1961.(30)

This policy was followed by Algeria upon independence from France in 1962, when the state took over the financial institutions. One year later, both the Syrian and Iraqi governments brought the financial institutions in their respective countries under their control. By 1967 the drive for public control reached PDR of Yemen which nationalized the financial institutions on its territories. In 1970, three other countries, Libya, Sudan and Somalia also nationalized the financial institutions in their respective countries. The Moroccan and Tunisian governments maintained the status because they were already in control of most of the financial sector in their countries.

Nationalization was the first step in the new reform. The second step was unification of the financial system. The existing commercial banks in these countries have been merged into one commercial bank, as is the case in Syria, Iraq and the Yemen PDR or into a few specialised banks as in the remaining countries in this group.

Structurally the financial systems of the Arab socialist countries have been standardised.(31) A part from the central bank the financial system tends to consists of one commercial bank and a few other specialised institutions. These institutions are autonumous bodies with the specific objectives of promoting medium and long-term loans to their specified sector of operation. Once set up they are meant to deal with their patricular economic activity, operating exclusively in the home market. Thus in no way they may be considered competing institutions.(32)

The remaining Arab countries, particularly Lebanon, Jordan and the Peninsula countries kept within the free enterprise system and have continued to encourage their private sector to set up new financial institutions. Consequently new banks were established there. The scene of the banking system changed relatively fast. The Gulf states with a few branches in the 1950's, show a relatively rapid growth in banks and branches.

In 1966 there were twenty one commercial banks in the Peninsula countries with 93 offices. This means that with a population estimated at 6 million there was one bank office per 64,000 persons a considerable improvement from the 1950's. But the majority of these banks were foreign banks. Data shows the nationality of these banks and where they were operating. (Appendix 3.1) It shows that Saudi Arabia had 2 local banks with 23 offices, 4 Arab banks with 13 offices and 5 foreign banks with 9 offices. The United Arab Emirates had 1 local and 1 Arab bank each with 1 office and five foreign banks with 10 offices. Qatar had, one national bank with one ofice, two Arab banks with two offices and 3 foreign banks with 3 offices. Bahrain had 1 local and 1 Arab bank each with 1 office and 2 foreign banks with 4 offices. And finally, Kuwait had 3 local banks with 17 offices and 1 foreign bank with 6 offices.(33)

Jordan is the other country which managed to host eight banks (with 60 offices) of which 4 were local banks with 44 offices, 2 Arab banks with 6 offices and 2 foreign banks with 10 offices. (Appendix 3.2) With an estimated population of 2.5 million there was 1 bank office per 41,000 persons in Jordan. This ratio is also very high but is better than its counterparts in the Peninsula countries.

A dramatic change took place in the Beirut financial scene. The minimum restriction on movement of both capital and goods and the existence of a large European community had encouraged the emergence of Beirut as a commercial and financial centre for the region. It attracted foreign and local banks more than the Peninsula countries and Jordan did. The nine banks operating in Beirut in the 1940's had risen to ninety banks by 1966.(34) The importance of Beirut as a financial centre will be discussed in Chapter 7.

### 3.1.3 The Period Since 1973

By 1973, Arab banks began to operate in a rapidly changing financial environment. The foreign trade of the region began to rise quickly in parallel to the increase in oil revenues as seen in Table 3.2. The new wealth and the increase in trade accelerated the momentum of the

TABLE 3.2

<u>Oil revenues of Arab Oil Exporting Countries</u>

(million of U.S. dollars)

| Country | 1972 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|---|
| Saudi Arabia | 3.1 | 25.7 | 36.3 | 41.1 | 37.7 | 57.1 | 102.5 | 106.3 |
| Kuwait | 1.6 | 7.5 | 8.9 | 8.8 | 9.4 | 16.6 | 17.8 | 10.4 |
| United Arab Emirate | .5 | 6.0 | 8.4 | 9.2 | 8.6 | 12.8 | 19.4 | 18.7 |
| Qatar | .2 | 1.7 | 2.1 | 1.9 | 2.3 | 3.6 | 5.4 | 5.3 |
| Iraq | .6 | 7.5 | 9.1 | 9.5 | 10.8 | 21.3 | 26.1 | 10.4 |
| Libya | 1.6 | 5.1 | 8.3 | 9.7 | 9.5 | 15.2 | 22.6 | 15.6 |
| Others (1) | | | | | | | | |
| TOTAL | 8.5 | 58.8 | 80.1 | 88.4 | 86.9 | 138.2 | 211.8 | 184.1 |

SOURCE: Organisation of Arab Petroleum Exporting Countries. Oil and Arab Co-operation Vol.9, No.1, 1973, p.56.

(1) Includes Egypt, Syria, Bahrain & Algeria.

regions' financial growth at home and more over abroad.

### 3.1.3.1 Domestic Financial Growth

The emphasis on developing the Arab financial markets at this period took two directions. In some of the socialist Arab countries a new wave of economic liberalization was introduced. The first measure in this direction was taken in Egypt. The introduction of law No.43 in 1974 with its tax holiday capital guarantee and other incentives as well as its legal assurance that invested capital may not be confiscated, seized, or sequestrated except through legal proceedings has caused fundamental changes in the Egyptian banking system.(35)

The previous four public sector banks and the two regional banks (The Arab African bank, 1964 and the Arab International banks) were joined by many banks after the introduction of that law and its amendment by law No.32 of 1977. These laws opened the banking sectors to private Egyptians as well as to foreigners. The present structure of the new banks operating in Egypt under the investment law amount to 47 units of which 12 are joint ventures with a majority Egyptian share holding, 6 privately owned Egyptian commercial banks, eight investment and business banks and one off-shore bank. These banks are exempted from many of the obligations of the Egyptian Banking and Credit Laws of 1957 and the statutes of each bank determine its operation (36). This will be examined in detail in Chapter 7.

The liberalization policy spread to other socialist Arab countries, but none of them has gone so far as to reverse its previous system. Sudan is the other country of this group which allowed the operation of foreign banks on its territory after a ban of almost 15 years on such operations. As a result two American banks and three U.A.E. banks opened branches there. In addition Sudan allowed the operation of several Islamic banks (37).

The other socialist Arab countries such as Syria, Iraq, Libya and Algeria kept a ban on the operation of new commercial banks in their territories, but established many specialized institutions and participated with Arabs and non-Arabs in setting up new institutions. Libya has been among the leading countries in promoting financial growth with other Arab countries. It established banks with Algeria, Kuwait, Egypt, U.A.E. and others (38). Syria created several free zones open to foreign banks and aims mainly to modernize the operation of its banks. It hopes that foreign banks can help to influence the Syrian banks. The latter are often criticized for their rigidity, slowness and bureaucracy. Algerian's policy has been centred on improving the operation of the established system through the encouragement of decentralization where necesary and free operation. Thus a new reform was made in the banking sector enabling it to play a more important role in assessing projects and ensuring that from their inception investments are more tightly managed (39).

Tunisia is the other Arab country which maintains strict control on the operation of private banks, since opening the door to the international banks. It has established off-shore banking units, but it seems that it is turning to the joint venture investment banks with other Arab countries. As a result six such institutions have been established there in co-operation with Kuwait, Saudi Arabia, U.A.E., Qatar and Algeria. The newly established institutions are presumably allowed to engage in certain off-shore banking activities. Today

Tunisia has twenty-six banks of which ten are commercial, eight investment consortia and the other eight off-shore banks (40).

The other Arab countries with a relatively free economic system have witnessed a larger growth in their financial system. The number of banks rose dramatically in the United Arab Emirates to 53 of which 24 are local and 29 are foreign banks. Likewise the number of banks now operating in the domestic market of Bahrain stands at 21 serving a population of less than one third of a million persons. And in 1975, Bahrain for its own reasons, announced the creation of off-shore banking units. Today the off-shore units amount to about 74. An examination of these units will be found in Chapter 7. Then Oman which had only one bank prior to 1970 today houses 25 commercial banks of which 14 are foreign. Jordan and Qatar allowed more banks but fewer than the previous. The former has 16 commercial banks and the latter has 13 such banks, 10 of which are foreign banks (41).

The banking sector in Lebanon, Saudi Arabia and Kuwait did not follow the same path as the previously mentioned countries. Lebanon had been over-banked for a long time, then came the civil disturbances in the mid 1970's and the Israeli invasion in 1982 to make growth in the banking sector proceed at a slower pace. In Saudi Arabia and Kuwait the number of banks has hardly changed since the early 1970's when both countries issued moratoria on the establishment of new banks. However, within the banking sector, Saudi Arabia instigated a policy of Saudi-ization in 1976, according to which the ten foreign banks are asked to issue shares to be sold only to Saudi's, thereby giving the Saudi's a 60 percent share holding in the banks. This process was accomplished in 1980. Since then Saudi Arabia has had 12 commercial banks two of which are 100 percent locally owned and the remaining ten joint ventures with foreign interests (42).

National control of the banking system in Saudi Arabia and Kuwait induced Jordan to apply a new measure by which the majority of the equity capital of foreign banks is to be transferred to Jordanian citizens in the three years ending in 1986 (43). The Saudi's and the Jordanians' new regulations led to make the foreign banks more nationalist in character and ownership and enabled them to expand their capital and open new barnaches throughout their countries of operation. This was something they could not do before.

The increase in the number of banks was outstripped by the increase in banking offices in the region. The number of banking offices rose from about 1661 in 1973 to approximately 3460 in 1983 see Table 3.3. The distribution of banks on the national level shows that there was a considerable difference between countries and between urban and rural areas within each country. For instance the United Arab Emirates with 53 banks with over 420 authorized branches in addition to other financial institutions is probably the most densely banked area in per capita terms any where in the world. On the other end of the scale the Yemen A.R. with ten banks operating in 33 offices serving about 6 million inhabitants is the least banked area in the world. The remaining Arab countries lie between these two extremes in terms of offices per head of population. Saudi Arabia and Lebanon could claim to have a reasonable network of bank branches. With regard to the distribution of bank offices within each country, the urban areas are still favoured by the banks. As a result the banking offices in the region are mainly located in the urban centres.

TABLE 3.3

Banking and Banking Offices in the Arab Countries in 1973 and 1982

| Country | 1973 | | 1982 | | |
|---|---|---|---|---|---|
| | Number of Bank | Number of Banking Office | Number of Banks | Number of Banking Office | Population Per Banking Office |
| Algeria | 4 | 118 | 4 | 295 | 70406 |
| Bahrain | | 32 | 20 | 102 | 4313 |
| Jordan | | 44 | 16 | 124 | 28060 |
| Kuwait | | 78 | 6 | 128 | 12187 |
| Lebanon | 73 | 208 | 74 | 371 | 7331 |
| Egypt | 4 | 307 | 4 | 361 | 123760 |
| Libya | 4 | 79 | 4 | 126 | 25714 |
| Saudi Arabia | 13 | 71 | 13 | 348 | 25689 |
| Sudan | 5 | 61 | 5 | 101 | 189207 |
| Yemen P.D.R. | 1 | 16 | 1 | 22 | 92192 |
| Oman | 2 | 10 | 24 | 14 | 65625 |
| Iraq | 1 | 88 | 1 | 170 | 82434 |
| Syria | 1 | 49 | 1 | 50 | 185060 |
| Tunisia | | 117 | 10 | 270 | 24319 |
| Yemen A.R. | | 21 | 10 | 30 | 200969 |
| U.A.E. | | 89 | 53 | 420 | 2166 |
| Qatar | | 11 | 13 | 21 | 14010 |
| Somalia | | 10 | | 33 | 112136 |
| Morocco | | 252 | | 474 | 44907 |
| TOTAL | | 1661 | 257 | 3460 | 49525 |

SOURCE: The Bankers' Almanac and Year Book 1973 and 1983, and other national services.

### 3.1.3.2 Expansion of Arab banks abroad

The rapid increase in the Arab foreign trade from about $23 billion in 1971 to over $352 billion in 1981 of which the inter-Arab trade represented less than 10 percent (see Appendixes 3.3, 3.4 and 3.5) was paralleled by the increase in number of the Arab banks which established themselves abroad. The presence of the Arab banks on the International scene began to be felt in the late 1960s. The first Arab banks operation in the international markets took the form of consortium banks. In the late 1960s most of the Arab central banks and some development banks in the region sought to create their own institutions in the international markets, but the size and complexity of dealings abroad made them inclined to operate with other European banks. France's favourable stand regarding Arab cause during the time of Charles de Gaulle created better opportunities for co-operation between France and the Arabs. As a result the Arab financial institutions in collaboration with the main French financial institutions set up the Union de Banques Arabes et Francoises (UBAF), Banque Arabe Internationale d'Investissement (BAII) and the Frab Bank. To these should be added the European Arab Bank in Brussels. The share holders of the four institutions on the Arab side are composed of many Arab financial institutions from both deficit Arab states like Egypt and Yemen and surplus states like Kuwait (44). These banks were created to promote trade between the two groups, to marry the technical experience of European banks with Arab capital and to benefit from the technical experience of European banks and gradually transfer it to the Arab banks (45). The arrangement worked well and served the mutal interest of both groups (46). And these institutions, despite the withdrawal of some French interests, are still quite prominent in the international markets and their links with the deficit Arab states helped them to participate in recycling some funds to these countries (47).

In the late 1970's the second wave of the Arab financial institutions sought an international location. This wave took a different form, the Arabs began establishing their own institutions since the consortium form showed that some conflict of interest might arise between parent and consortium (48). In addition the Arab surplus countries were induced to create their own institutions in the aftermath of President Carter's freeze on Iranian assets. The Arab countries have needed to break free of foreign influence and set up and run their own national instiututions.

The resources available to do this however have varied greatly from country to country. The rich Arab countries in bilaterial or multi-lateral co-operation created several institutions, chiefly among them, the Banque Intercontinentale Arabe set up by the Libyan and Algerian governments in Paris, the Saudi International Bank in London set up by Saudi Arabia monetary Agency SAMA, the two local Saudi banks (National and Riyad banks) and other foreign banks as a window in the international markets. Then with the appearance of Bahrain as an off-shore centre of international standing it began to be the base of the new large Arab financial institutions. In the mid 1970's the seven Arab countries located on the Gulf set up the Gulf International Bank with an authorized capital of $100 million. This was increased to $265 million. Then in 1980 three Arab countries namely Libya, the U.A.E and Kuwait set up the Arab Banking Co-operation with a capital $1 billion authorized and $750 million subscribed and already paid.

The participation of the Arab governments in the establishment of such institutions is a clear indicator of their willingness to develop the Arab capital markets and to make them effective in recycling Arab capital on commercial bases. Thus this group of banks is in the forefront of Arab capital market integration and their role will be explored more fully in Chapter 7.

A second group of Arab banks which sought a place in the international markets consists of the traditional and new banks. The former include the long established traditional banks dominant in their home base, such as Rafidain Bank in Iraq, Arab Bank in Jordan, National Bank of Abu Dhabi and the National Commercial Bank and Riyad Bank in Saudi Arabia. These banks have important branch network in the region. The latter consists of many small multi-ownership banks established mainly by private invetors.

The aims of this group vary according to the size of the banks concerned. The large banks' aim was to draw for their funds on the global interbank market and so play a significant part in the recycling of Arab capital surpluses and to play an active role in trade financing. The aim of the smaller banks and other types of Arab financial institutions was variously to fix up deals to act as intermediaries, to advise on the investment of their clients fund and to deploy their own resources (49).

The presence of the Arab financial institutions had been consolidated in London, Paris and New York. Today London houses about 48 institutions of which 17 are registered in the U.K., 18 are representative offices, 12 are branches and two are liaison offices (see Appendix 3.6). Paris is the home of 37 Arab institutions of which 14 are Lebanese banks which choose to follow their clients to France after the disturbances in Beirut. Likewise all the major Arab banks in the International markets currently maintain a presence in New York (50).

In parallel to the increase in the Arab banks at home and abroad, the commercial banking activities have expanded at a rapid pace. In 1981 there were 60 banks in the region and abroad which managed to build up total assets of over one billion dollars each. Together they were holding about $230 billion of which 88 per cent originated in the region and was held in its banks. The remaining 12 percent was distributed between Arab banks in France, Luxemburg, Peru, Spain, U.K. and U.S.A. (see Appendix 3.7).

The distribution of banks, assets among banks in the Arab countries as given in Appendix 3.8 reveals that the banks in Saudi Arabia and Kuwait accounted for over one third of the regions banks' total assets in 1981. Egypt's and Algeria's banks also held considerable assets and the banks in the U.A.E.'s and Libya were just one step behind, while Lebanon with approximately 90 banks held just $10 billion of financial assets. The banks in other Arab countries held very modest assets.

In the global context, the Arab banks have progressed rapidly. The Euromoney annual list of 1983 of the leading 500 banks measured by their assets at the end of 1982 shows four Arab banks among the first 100 and 15 among the first 200. Altogether 40 Arab institutions were listed. This is a great achievement as such lists contained no Arab banks a few years back(51).

### 3.2 Banking system and development

#### 3.2.1 The central banks and development

The majority of the Arab central banks played a major role in the economic development of their repective countries. They are vested with the powers to maintain a sound currency system and assist in promoting the development of their countries economies by fostering the growth of the necessary financial infrastructure. They have done that through their various capacities:

1. As a banking institution, the Arab Central banks regulated and issued their respective national currencies in accordance with the general economic policy of their governments. Some of them found the 100 per cent reserve system to be an impediment in the way of its assumption of the full responsibilities as a central bank. Thus the 100 per cent legal reserve system was amended (52). The amendment of this provision allowed the central banks wider flexibility in currency issue and perform more active role in the development of their countries' economy. Although some Arab countries such as Saudi Arabia, Bahrain and Qatar have continued providing 100 percent legal cover of foreign exchange in convertible currencies, but it is only huge oil revenues accruing to such government which allowed such a conservative approach to continue.

2. As agents of their national government, the Arab Central Banks administer the foreign exchange regulations. Prior to the establishment of these institutions, the commercial banks were in control of foreign assets and in the absence of any exchange controls undertook to redeem domestic money for foreign exchange on demand at the going

rate of exchange. But upon the creation of the Central Banks this function was transferred to the Central Banker, mainly to maintian a reasonable fluctuation in the rate of Foreign Exchange and to reduce the spreads charged to customers by banks who depended for much of their income on exchange profit (53).

In addition, the Arab Central Banks, as agents of their government managed their government national debts. The vast majority of the Arab central banks have made some treasury and bond issues on behalf of their governments. But in the Gulf states there have been no such issues. The development of the government securities is of paramount importance to the integrated Arab market and the development of local markets. The trade in these instruments is one of great importance to control both liquidity and interest rates within the market (54).

3. As financial advisors to their respective governments the banks are eminently placed and well equipped with a high calibre staff. Through their various contacts with the economy in general and the financial sectors in particular, they offered valuable advice with respect to monetary policy and economic development. The periodic bulletins of the Arab Central Banks have been the most valuable sources of reliable and expertly designed statistical series on general economic and financial data in each country.

4. The promotional function is one of the important functions of the Central Monetary Authorities in the developing countries.(55) The charters of the Arab central banks in many cases allow them to subscribe to the capital and loans issued by the financial institutions or enterprises set up with the approval of government for the purposes of promoting economic development.(56) Within this provision the Arab central banks helped in the creation of the development financial institutions and in the development of money and capital markets in general. In addition they regulated the quantity, quality and cost of credit to meet the requirements of economic growth and monetary stability.

3.2.2 The Central Banks and Exchange Rate Management

A number of important steps towards Arab monetary integration have been taken by the Governors of the Arab Central Banks. Outstanding among these are the adoption of a joint position in international economic organizations, and strong monetary and financial co-operation among the Gult States' Central Banks. (57) However, there are many areas in which Arab Central Banks and other monetary agencies can co-operate. These include: co-ordination of monetary and fiscal policies and the introduction of some measures to improve monetary stability. One of these measures which could help considerably is the creation of common currency. (58)

This can be achieved by promoting the Arab dinar as a regional or parallel currency. The Arab dinar could be made a basket composed of national and foreign currencies instead of its present link with the Special Drawing Right(SDR). Each currency's share in the basket may be weighted broadly in line with each respective country's gross national product and foreign trade.

Today, the Arab countries have unsatisfactory monetary arrangements. Data in Appendix 3.14 show the exchange rate arrangements of the Arab currencies in 1985, and the variation in the Arab national currencies' exchange rate. Twelve Arab countries - Bahrain, Egypt, Iraq, Libya, Oman, Qatar, Saudi Arabia, Sudan, Syria and both Yemens - pegged their currencies to the U.S. dollar. Algeria, Kuwait, Mauritania and Tunisia pegged their currencies to a basket of other convertible currencies. Jordan pegged its currencies to the Special Drawing Right (SDR). While Lebanon has left its currency independently floating, Morocco's dirham has been subject to managed floating. Finally Somalia's shillings adjusted according to a set of internal indicators. Variations in exchange rates between 1978 and 1984 for the Arab national currencies is wide and differs in direction. The movements of the Arab currencies' exchange rate mainly follow the pegged currencies. The dollar is used as a standard in which the Arab Central Banks express and compare all rates.

The oil boom of the 1970s, and its aftermath caused balance of payments problems for every single Arab countries. The Governors of the Arab Central Banks of major oil-exporting countries were pre-occupied by their currencies' appreciation which resulted from persistence of large current account surpluses. The Governors of the Central Banks of the remaining Arab countries were also pre-occupied by severe balance of payments deficits. Their exchange management was directed to balancing payments. (59) Both took the view that policy objectives should as a matter of principle, dictate the appropriate exchange rate arrangement and not vice versa. The Governors of central banks with overvalued currencies such as Saudi Arabia, the lower Gulf States and Egypt feared losing competitiveness. This fear went along with the view that a strong currency would reduce domestic output and worsen the current account balance of payments, as it would make the exported goods uncompetitive on one hand and imported goods relatively cheap (60).

General economic disequilibria in the Arab countries affected directly the Governors' efforts to solve these problems and to create a real Arab monetary system to free them from excessive dependence on dollars. The Arab dinar was introduced as a unit of account in 1976 to be promoted as regional currency a few years later. Progress towards creating a single Arab currency has fallen far from expectations which existed when drawing up the Arab Dinar with a view to achieving monetary union. The pre-occupations of the Governors of the Arab Central Banks with their national balance of payments problems has hardly left for the Governors to establish a system of exchange rate links between their national currencies such as that established in the European Monetary Systems' snake, nor have they made sufficient efforts to co-ordinate policies as regards their financial markets. Likewise they have not agreed on the method of financing deficits or utilizing surpluses. Consequently, the Arab Capital Markets have not unified, and the essential Arab Monetary System has not materialized.

### 3.2.3 The commercial banks and development

The gradual extension of monetization and subsequent financial transformation of the economy is usually carried out by the financial sectors. In the developing countries the banks usually carry out most of this task due to the absence or weakness of other types of financial institutions. Their role in development can be examined through their dual function. Firstly, their monetary function focuses attention on the money supply, inflation and the need for banks to be soundly managed. Their second function is the finance function which focuses on the role of the banks in mobilizing saving and channelling them to investment.

To show the banks role in monetizing the economies and institutionalizing savings of their countries of operation, we shall examine some financial indicators presented in Appendix 3.9, 3.10 and 3.11 for individual Arab countries. The data in Appendix 3.9 shows the narrow money ratio/GDP, the domestic liquidity ratio/GDP, the foreign assets to domestic liquidity and finally the total deposit to GDP for the individual Arab countries. From this data many observations can be made.

The first observation is on the ratio of M1 (narrow money i.e. currency and demand deposit) to gross domestic product where we find that M1 ratio has a wide range and varies from one country to another. It is high in a few Arab countries such as Jordan, Lebanon, Yemen A.R. and Yemen P.D.R. and is low in the rich countries namely the United Arab Emirates, Kuwait, Saudi Arabia, Oman, Qatar and Bahrain but it is in between these extreme cases for the remaining Arab countries. It is low in the rich countries and high in the relatively poor countries. The secular relation between the M1 ratio and the per capita income in the Arab countries is unusual. The strange phenomenon depicted by M1 ratio in the two extreme cases can be explained by the pecularities of their economic structure. The low ratio in the rich countries may be attributed to the lag of their financial sectors behind other Arab countries, but we should observe other factors which make this ratio very low in these countries and high in the other countries.

These factors are:-

1. The enormous income generated from oil sales increased the gross doemstic products of the rich countries and was not matched by increasing local currency when a greater part of their income has been accumulated abroad.

2. The gross domestic product of these countries is also larger than their national income due to the existence of a great number of foreign corporations and expatriates who usually remit their earnings outside these countries.

In contrast the countries with a high M1 ratio such as Lebanon and Jordan, undoubtedly have a developed financial sector, but the high ratio is also magnified by the fact that these countries have a GDP smaller than their national income as they have been the major recipients of oil money in terms of workers remittances and official assistance. Thus their M1 ratio is magnified by the smaller denominator. The two Yemens have undeveloped financial systems and the high M1 ratio is also magnified by the enormous amount of their workers remittances from the oil countries.

The second observation is on the M2 ratio. As financial development is associated with an increased range of financial instruments, narrow money and quasi-money can serve as better indicators for domestic financial intermediation and the degree of financial deepening and growth. And for this reason there would be more correlations between per capita income and the M2 ratio. The most noteworthy feature in the M2 ratio is the movement of Kuwait and Bahrain from a low M1 ratio. This is an indication that the financial sectors in both countries are more developed than their counterparts in other rich countries. The diversification of financial instruments diminishes the importance of narrow money in both countries. Likewise, the M2 ratio in Jordan and Lebanon increased greater than either of the Yemens because the first two countries have a more developed financial system.

However, M1 and M2 ratios both have their limitation as indicators of financial growth. These ratios are given for some advanced and developing countries in Appendix 3.10. The ml/GDP ratios of the advanced countries are in the range of 15-32 with the lowest ratio for Britain and the highest for Japan. The non-Arab developing countries also had almost the same ratios. While the M1/GDP ratios in the Arab ountries ranged from 8 to 101, the M2/GDP ratios for the advanced countries ranged from 33 in the United Kingdom to 88 for Japan. In the non-Arab developing countries they range from 17 to 83, while the same ratio in the Arab countries goes from 20 to over 390. Thus the M1/GDP ratios and the M2/GDP ratios for the Arab countries show more variation than exists in advanced and non-Arab developing countries. This is an indication that the Arab financial markets are in a transitional period.

Interpreting these ratios needs greater caution. For instance the United Kingdom indicators are the lowest among advanced countries. Does this mean that the British financial system is lagging behind? The answer, of course is no. The reality is that Britain has the most sophisticated financial system which is second to none. The wide range of financial instruments in Britain relatively dwarfs M1 and M2 among other financial instruments. In contrast M1 and M2 ratios in many Arab countries do indicate that these countries are lagging behind. This is clear where the currency in circulation has continued to be the major component of the money supply in many Arab countries and where cash is the most popular means of payments. This is also clear in the large number of people served by banking office and the concentration of banks in the urban centres.

The third observation is on the ratio of total deposit to gross domestic product. Here the ratios are similar to M2 ratios. This ratio points to the effectiveness of the banks in mobilizing doemstic savings. The low ratios in the majority of the Arab countries are an indication of their weak role in mobilizing funds. The banks which may claim to be performing better are in Jordan, Kuwait, Lebanon and to some extent Bahrain with 68, 62, 339 and 47 (total deposit/GDPx100) respectively. In general the above ratios show the distinctive characteristics of the Arab financial markets which may be classified according to the stage of their development into a high monetization group comprising Lebanon and Jordan. A low monetization group consisting of the oil producing countries and a moderate monetization group which includes the remaining Arab countries.

With regard to the intermediary role of the Arab banks examination of the sources and uses of their funds will show their impact on the saving investment process within the region. The data in Appendix 3.11 show that the private sector is the main source of funds for the Arab banks which hold these savings mainly in current and savings accounts.

The government's savings deposited with banks constituted for the majority less than 5 per cent of the banks total assets. The central banks are important as a source of funds to the banks in Somalia, Tunisia and Algeria. The foreign liabilities of the Arab banks consist perhaps mainly of non-residents, accounts, while the certificate of deposit has been of minor importance as a source of funds for the Arab banks. The composition of the Arab banks liabilities discussed above points to the short-term nature of funds available to the banks and to the banks failure to attract deposits from the Arab governments.

The role of the banks in extending long-term credit to industry and agriculture has been very small. The sectoral distribution of the banks lending in Jordan and the United Arab Emirates (see Appendixes

3.12 and 3.13) show the fact that trade finance is the banks' favourite operation. It accounted for an average of 40 per cent of the Jordanian banks' total credit during the 1970s and it was in the range of 37 per cent to 51 per cent of the United Arab Emirates banks' total credit in the period 1975-78. The decline in the share of trade in bank credit was paralleled by the increase in the share of construction in bank credit in both countries. In general the trade and construction accounted for over two thirds of banks' total credit in the region. This leaves about one third to be distributed among other activities. This indicates that the efforts of the Arab central banks to integrate banks in the process of economic development through the expansion of medium and long-term credit have only achieved limited success.

The argument always raised by banks in the region in defending their conservative policy of lending is their short-term obligations. But in fact, the conservative policy of the Arab banks is due to the banking tradition inherited from he British banks; to quote Croham,

> "There is a marked difference of emphasis between the banking traditions of different countries ... in Britain the banks provided working capital to finance trade credit. In many other countries there was a great tendency for the supply of saving to industry to go through the banks and for a closer involvement of banks with industry."(61)

The Laissez-faire economic policy of Lebanon and the wealth of the public sectors in the Gulf states and Saudi Arabia can excuse the current conservative policy of the banking institutions there. But in countries where capital is scarce, for banks to have any role in the process of development, they should be properly organised and orientated towards specific objectives. This can be achieved by applying the appropriate credit controls. The central banks may impose credit ceilings in order to ensure the most efficient use of the banks resources.

## 3.3 The way to improve commercial banks operations in the savings/Investment process and increase their integration

Deficiencies in the banking system either in terms of its structure or in terms of the financial instruments can influence economic development. The foregoing discussion made it clear that the Arab banking systems have achieved considerable growth in recent years, but they still have some operational and structural gaps which have impeded them from performing effective roles in financing development on the national and regional level. Bridging these gaps is a great step toward changing that role and the establishment of the Arab capital market.

The banks have increased in number and offices. Although the banking offices in the region have more than doubled they are still fewer than one half of the bank offices in the U.K. with a population in the region three times that of the U.K. the average number of inhabitants served by a bank is very large and as the banks are concentrated in the urban centres, the banking habit is not yet established in the rural areas and among a large proportion of people even in the urban areas. Thus one of the main problems facing Arab banks is taking banking facilities to the people in rural areas for there will be no well-balanced economic development unless such services are introduced to the rural areas in order to involve the inhabitants in the saving investment process.

A branch expansion programme should assume prime importance in the Arab countries' drive to build up the institutional machinery required to mobilize resources from the traditional household sector and to channel these resources into development projects. The severe competition between banks increases the banking offices in the urban areas,(62) and is not expected to compel banks to open branches in the poor area. This was clear in the experience of banks in Saudi Arabia, Lebanon and the United Arab Emirates where the increase in banking offices was caused by competition between banks.

In addition the absence of the Lebanese and Oman banks and the appearance of only one bank in Jordan and three in the U.A.E. within the list of top 60 Arab banks points to the small size of the majority of the Arab banks as these countries are housing over two thirds of the Arab banks.

To establish an integrated Arab banking system their structural and operational gaps have to be solved. The building up of the Arab banking system requires a policy imposing merger on the smaller banks, expanding the branch network to cover the rural area, spreading chequing accounts, strengthening the depositors confidence and bringing about a more extensive coverage of the banking system services both geographically and functionally.

The present legislation and regulations of the Arab banking systems helped to promote currencies' stability and sound banking practices, but they still have some short-comings that have impeded the effectiveness of banks in the savings/investment process and reduced the link between the Arab financial centres. For instance, the provisions relating to the composition of legal cover in the Arab

Central Bank's laws together with the provisions relating to the type of assets accepted for the calculation of the liquidity ratios have rendered the securities of the Arab countries unsuitable for such purposes. Foreign convertible securities and currencies are only available in the international markets and none or few if any Arab securities can be accepted for these purposes. Thus unless such regulations are amended, the integration of the Arab capital markets would continue indirectly through the international financial markets.

Another action the Arab Monetary Authorities ought to carry out is to improve the operations of banks. At present, the regulatory agencies in the Arab region with the exception of the Lebanese Agency, have not yet initiated a deposit insurance scheme to insure depositors against loss in case of bank failure. Deposit insurance has been viewed by some economists as having a major contribution towards the development of the banking sector, to quote Marlin, its

> "increasing confidence, encouraging savings, promoting the growth of financial institutions and increasing the flexibility of monetary policy."(63)

This view was supported by other economists, Friedman and Schwartz wrote,

> "federal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic, and, indeed in our view, the structural change most conducive to monetary policy ... after the civil war."(64)

Therefore, the establishment of a deposit insurance scheme or other equivalent scheme is essential for the development of the regions banking system. It stops depositors from running to banks at a time of panic, creates more confidence in the banking system and saves it from the adverse effect of failing a bank.

Similarly, the present legislation and regulations in force on the banking institutions in the region affect the ability of the banks to obtain funds and deploy them. These regulations are of two types. The first is mainly concerned with the structure of interest rates and the second is concerned with qualitative and quantitative credit control. With regard to the first, in most of the Arab countries there has been a specified maximum rate for various types of deposit the banks have to observe. Likewise there has been a ceiling on the interest rate that a bank can charge for its loans. In addition in few cases the Arab Central Banks have applied quanitative and qualitative credit control aimed at channelling more funds for some target group.

The ceiling on time and savings deposit rates imposed by the Arab monetary authorities is intended to keep the cost of funds low for the banks to be reflected in their lending to investors. And the application of the quantitative and qualitative credit control is intended to direct more capital for some sectors of the economy of vital importance neglected by the banks on the ground that it involves higher cost to service and with relatively higher risk. These policies have been controversial issues among economists. Some economists justify a policy of low interest rates on the grounds that a low interest rate encourages investors to invest more. And they justify the quantiative and qualitative credit control on the grounds of the existence of externalities and other market imperfections.(65) Within this context Dorrance wrote,

> "objection to total ceiling or detailed regulations of bank lending should not be carried too far where government policy is based on well-considered development plans designed to foster growth in specific directions, prohibition or limits on lending for purposes which the authorities do not wish to encourage or encouragement to lending for purposes which considered to be in the national interest, may often be appropriate."(66)

Other economists object to these policies, on several grounds. With regard to low interest rate policy some economists argue that this policy would encourage savers to revert to non-productive forms of savings.(67) So they argue that developing countries should allow their financial institutions to offer depositors a realistic rate on financial assets to be able to mobilize their savings. They point to the experience of Korea and Taiwan in the 1950's when these countries increased the interest rates on deposits, the latter grew rapidly.(68)

Likewise, the ceiling on the interest rate that a bank can charge for its loan is also criticised on the ground that interest rates are an indicator of the capital cost and in repressing the interest rate, the criteria for allocating capital will be destroyed and this would lead to the uneconomical use of credit. The distortion of interest rate by the imposed ceiling on it is reflected in the distorted use of capital there. It is common to find in such countries, many capital intensive projects were established while they presumably have abundant labour supply.

Similarly, the policy of differential interest rates aimed at a target group which has been difficult for lenders to service and which often involves higher costs of servicing than for other borrowers is criticised on the grounds that the low interest rates, combined with higher costs, give lenders a double disincentive to extend the loans to the intended group, and moreover if such lenders were offered discount facilities the cheap finance would lead to inflation.

Similarly, other economists object to the quantitative and qualitative credit control applied in the developing countries on several grounds. First, the institution may re-define a sufficient number of its loans and meet the quota requirements without changing the real pattern of its lending. Secondly the bank may find it difficult to place and administer loans effectively outside its area of specialization. And sometimes loan quotas for a borrower may be less than its need.

The arguments in support and against these policies although have some validity but may not be taken in totality within the context of the Arab efforts to integrate their capital markets. We support the policy of liberalization the interest rate structure in the region. Such policy could prove effective, as some economists have argued, in speeding the development of the Arab financial markets as it did in other markets through removing the financial constraints. The ceiling on interest rates in the region reduced the sensitivity of capital movements to differences in money conditions within the region. In addition liberalization the interest rate structure in the peninsula countries to the level of international interest rates could be the only solution under the liberal foreign exchange control inforce and the absence of real foreign exchange risk-as the value of their currencies move with dollar movement-to stop the flow of capital outside these countries caused by the large differential between local and international interest rates.

Within the context of economic development the Arab central banks should continue using the quantitative and qualitative credit control because the externality and the market imperfections is very high in the region. However, the ceiling should be re-examined and readjusted in the light of the economic activities. These measures are justifiable in these countries which suffer from a shortage of capital and whose commercial banks remain the principal source of finance. If banks are left uncontrolled and allowed to act entirely according to profit criteria, development will be far from satisfactory, since the trade sector is the only sector which is willing and able to pay higher interest rates on bank loans. Awareness of the nature and significance of credit as an instrument for development has brought the banks under social control. Banks have to participate in development if they want to survive in developing countries.

To encourage banks to extend credit to target groups, the Arab governments should provide budget guarantee to the banks, that they will repay capital and pay interest on the due date in the place of a defaulting debtor. This would encourage banks to extend loans and the likelihood of any permanent default may be regarded as slight.

## 3.4 Conclusion

Although the Arab commercial banks were the first to emerge as the main financial institutions trusted by depositors and approached by borrowers, their contribution to the economic development of the region has been insignificant. The Arab banks limited their operations to the urban centres from which deposits largely derive and where short-term loans are demanded. Consequently the savings of the rural areas were left largely untapped, and so such areas have not been integrated into the markets. In addition, the banks were not very successful in lengthening the term of financial instruments issued to savers. The Arab banks showed great interest in dealing with the international markets through opening offices and lodging the balances left after trade finance there.

The extensive integration between the Arab commercial banks with the international financial markets and their concentrations on trade finance and short-term self-liquidated loans are not in line with the real economic development of the region nor in line with creating an Arab common banking market. The large growth in the Arab governments especially the oil rich countries - domestic expenditure and the associated expansion in private income allowed the financial assets to grow faster than the banks ability to build up professionalism. The lack of trained manpower, the lack of quantity and diversity of experience were all reflected in the type of financial instruments developed by the Arab banks and the way these institutions deployed their funds.

At the regional level, few Arab banks have extensive system of branches in the region, designed to provide normal banking facilities in the region as well as to finance trade between the Arab countries. The operations of the majority of the Arab banks is concentrated into the country of origin. The lack of direct relations between the Arab financial centres reflects the pattern of regional trade for not more than 10 per cent of total Arab exports and imports is accounted for by inter-Arab trade. And more importantly, the rigid legislation and regulations affect the ability of Arab banks to obtain and deploy funds at the regional level. These factors have limited the Arab capital markets integration to a low level.

In view of the structural and operational gaps of the regions banking system, the growing needs of industry and agriculture for long term credit and within the context of great divergence between private and social costs and benefits, new financial institutions have emerged to bridge these gaps. Some of them were orientated towards serving domestic needs, others were intended to serve the region as a whole. The establishment of certain specialised financial institutions catering for the needs of certain sectors of the economy such as industry, housing and agriculture is felt to be of great importance, since the specific conditions prevailing in these sectors would render the satisfaction of their needs by the non-specialised financial institutions difficult.

Similarly, the development of the capital market (stock exchange) was thought to be an essential element in the process of growth and for the integration of the Arab capital markets by opening the region to Arab investors who had been hindered by exchange restrictions on capital movements. These developments were accompanied by the emergence of the Islamic financial institutions to serve people who objected to dealing with conventional financial institutions on religious grounds, and by the emergence of the offshore banking units in Bahrain. The evolution and operations of these institutions are the subjects of the following Chapters.

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# CHAPTER FOUR

# DEVELOPMENT BANKS

## Development Banks

### Introduction

The development banks are comparatively new institutions of the post-world war two era(1). They are unique financial institutions and are mainly created by the public sector in the developing countries with few or no institutions comparable to them in the advanced countries(2). These institutions introduced the philosophy of long-term investment in the economy of the developing countries which had traditionally been characterised by a short-run outlook(3). They have been the traditional form of financial institutions, involved in a high-risk, long-term financing of agriculture and industry in these countries.

The development banks have been expanding rapidly in the Arab region and their number reached over 70 in the early 1980's see (Appendix 4.1). As a result, the development banks have been the second important segment of the Arab financial markets after the commercial banks and more important the main source of long term finance on the national and regional level. The majority of them were established by individual Arab countries to serve a specific purpose, very few were set up by rich Arab countries or by all the Arab countries see (Appendix 4.2). At the regional level, the setting up of such institutions was to supplement the existing institutional framework in order to cater to the growing demand for credit in the low-saving Arab countries.

The purpose of this chapter is to examine the structure and operation of these development banks in order to identify the problems and the prospects of these institutions within the flow of funds in the region and the integrated Arab financial market. To achieve that an attempt is made to examine the rationale behind these institutions, their evolution in the region, the framework of their operation, the problems of their operation and the way to improve their effectiveness and to enlarge their contribution to development objectives. Finally a concluding remark will be presented concerning the improvement of their operation and integration into the Arab capital market. The discussion will show how these institutions played an important role in development through the provision of long-term finance and technical assistance to the productive sectors, and it will show the importance of the regional institution in the flow of funds on the regional level and the efforts of the two pan-Arab institutions with special mission of integrating the Arab financial markets.

## 4.1. The rationale behind the development banks

There have been many theses in the economic literature trying to explain why such institutions emerge in the developing countries. The main interpretations are:-

1. The emergence of various types of financial institutions in the advanced countries has been spontaneously in response to market forces, as private profit considerations are almost sufficient to induce further financial specialisations and diversification. But in the developing countries where the economy is usually fragmented and suffers many structural imbalances, a poor infrastructure and a shortage of skilled manpower, the expectation of profit is uncertain and low, private institutions with profit maximising objectives are unlikely to become involved in high-risk long-term finance through market forces alone. The failure of the market forces to create the appropriate institutions to finance development efforts in the

developing countries led the governments in these countries to sponsor the establishment of various special credit institutions(4), to provide the necessary funds without much stress on the profitability criterion and to serve the national interest in the long-run.

Thus the main function of the development banks is to provide long-term and medium term finance to firms that could not otherwise obtain such finance in the absence of institutions with some public responsibility.

2. The creation of such institutions was not only necessitated by the lack of finance in certain economic sectors but it was also encouraged by the lack of finance for small and medium-sized industries(5). This argument has been supported by the experience of the developing countries where the small farmers and small scale industralists receive only token aid. For instance in 1979, 0.4 per cent of all private firms and individual borrowers in Jordan received 48.7 per cent of the total credit extended by the country's banks(6). This is an indication of the low chances of small business getting access to credit in the developing countries.

3. The experience of many developing countries revealed that the obstacles hindering development have financial as well as technical aspects. So it is not a matter of finance alone(7). The development banks are required to make finance available as well as to provide managerial guidance and technical advice and initiate feasibility studies(8). All of these are necessary for encouraging domestic entrepreneurship. So the promotional role of these institutions is valued as much as the finance role.(9) With this context some

economists have described development banks as catalysts for investment in the private sector through their provision of finance and management.

4. The inadequacy of commercial banking arrangements in countries which inherited British banking arrangements is another factor behind the creation of development banks. The commercial banks patterned on the British commercial banks, have been reluctant to extend long-term credit and have concentrated their lending on profitable trade self-liquidating loans. They have justified their conservative policy by the short-term structure of their liabilities and have shied away from the policies of their counterparts in Japan and Germany. The deficiency in their arrangements was first highlighted in the historic Macmillan Report(10) in Britain. It led the Macmillan Committee to recommend the establishment of specialist finance institutions - The Industrial Finance Corporation (IFC) and the Industrial Commercial Finance Corporation (ICFC) - in Britain. This gap to some extent had persisted in the operation of the British banks up till now and it is on the British banks' lending record that the case for nationalisation has been chiefly based.(11) But the British financial system as a whole can take care of this gap. If it is suggested that the machinery is still not adequate to meet the demand, the banks argue in defence of their lending policy that the finance most suitable for transformation into long-term funds is primarily that held by life assurance companies and pension funds.(12)

Under these circumstances it is essential for the developing countries in the process of their socio-economical structural changes to accelerate the rate and formation of the financial institutions, which are required to support these changes.

## 4.2 Evolution of the development banks in the region

The early experience of the region in financing agricultural activities began in the early years of this century when the Turkish agricultural credit institutions opened branches in Syria, Iraq, Jordan and other areas in the region but the activities of these branches were limited due to the inadequacy of their capital.

In Egypt some foreigners established such institutions there in the early years of this century, but excessive speculation and the exploitation of small farmers(13) obliged the Egyptian government to set-up the Agricultural Credit and Co-operative Bank in 1931 to provide loans for farmers to buy fertilizers, improved seeds and agricultural equipment. The bank grew rapidly and by 1945 it had 100 branches throughout Egypt.(14) The bank has made an effective contribution to the development of agriculture.

In the field of industrial finance, the region had very little experience before the second world war.(15) The only initiative came from the Egyptian government when it deposited with the Misr Bank about EP 50,000 to be used in financing industry with short - and medium-term funds. But the Misr Bank, relying mostly on its own resources, carried the larger part of industrial financing in the period before independence. The Bank subscribed to the capital of many companies and, its equity investments amounted to about 11 million Egyptian pounds in 1954.(16) No attempt was made to create industrial banks before independence in any Arab countries.

In the post-independence period, in the process of the Arab planning their development, it was clear that the existing financial institutions, mainly commercial banks, were not equipped to handle the required finance. Commercial banks were the only financial institutions with some significance, but provided mainly short-term credit, largely for trade financing. And this type of finance is of less significance in support of economic development needs. The creation of new institutions was thought essential to provide the type of credit required by industry and agriculture since both need long-term rather than short-term credit.

The objectives of the development banks were seen to be the assistance in and promotion of economic activities in their specific sector of operation. In the industrial field such institutions would promote the establishment of privately-owned industry, assisting in operating new industrial enterprises and the expansion and modernisation of existing enterprises.(17) Also they were expected to promote the participation of private capital in such enterprises, by providing managerial guidance and technical advice, initiating feasibility studies and pre-investment surveys in their industry. By exploring and identifying viable domestic avenues of investment, local and foreign investors would be encouraged to take advantage of the new investment opportunities.

Under these circumstances the Arab governments like other developing countries took the initiative by establishing these institutions. Progress in the 1950's and 1960's was slow but the growth and sophistication of these banks started after the mid 1970's, when efforts for development were intensified to transfer the Arab liquid wealth into real wealth. Since then the Arab governments have embarked on a policy of creating such institutions where they are needed. By the early 1980's each Arab country had its own development banks, mostly owned by the public sectors but in a few cases owned either by private interest, or by a combination of private interests and governments. But in the latter case the government guarantees the private capital invested in these institutions implying a high degree of public responsibility.(18)

The region has at present over 70 such institutions (Appendix 4.1) operating mainly at the national level and 8 operating at the regional level. Some of them concern themselves with only one economic sector, others are multi-purpose giving assistance to several sectors.

In general the scope of the region's development banks' activities cover the following areas:-

1. Financing housing projects and real estate
2. Financing agricultural projects
3. Financing industrial, touristic and vocational projects
4. Financing the co-operative movement
5. Financing various rural and urban development projects (19)

The distribution of the development banks according to their activities shows that 15 institutions are assigned to finance housing and real estate, 10 banks are specialised in agriculture, 9 development banks operate in industry and another 9 institutions are multi-purpose development banks. The rest are involved in credit, savings, co-operatives and other social aspects. As the emphasis on the development of various economic sectors differs greatly between the Arab countries, so the development banks differ too. For instance the emphasis in the Gulf states has been on the development of the housing sector, so the development banks concerned with this sector were the first to be developed. Then came the interest in the industrial sector to promote institutions serving its activities. The scarcity of arable land and water in such countries made agricultural development banks the last priority. In the other Arab countries with more balanced sectors interest has been shown in the establishment of all types of development banks.

The increase in the number of institutions has been paralleled by an increase in their financial assets. By 1980 the total financial assets held by the Arab national development banks amounted to about $89 billion as can be seen in Table 4.1. The distribution of the banks' assets according to country reveals that the development banks in Saudi Arabia and Algeria together accounted for about 72.5 per cent of the total Arab development banks' financial assets.

This leaves about 27.5 per cent to be shared by the development banks of the remaining twenty countries. And within the last group the development banks of Kuwait, Iraq, Libya and Syria accounted for the greater proportion.

In fact the developing banks in Oman, Sudan, Somalia, Mauritania and both Yemens together held less than one per cent of the total Arab development banks' assets. Thus the distribution of capital among the Arab development banks reflects the difference in wealth and determination between Arab countries in pursuing their development objectives.

TABLE 4.1

Development Banks - Source and Uses of Funds (in million dollars)

| Country | Number of Institutions | Source | | | | Use | |
|---|---|---|---|---|---|---|---|
| | | Domestic 1 | Foreign 2 | Total 3 | % ½ | 4 Loans & Investment | % 4/3 |
| Algeria | 2 | 31526.2 | 945.8 | 32472.0 | 2.9 | 31766.6 | 97.8 |
| Iraq | 3 | 6842.8 | | 6842.8 | | 5812.1 | 84.9 |
| Kuwait | 3 | 3868.5 | 425.0 | 4293.5 | 9.9 | 2052.3 | 47.8 |
| Saudi Arabia | 5 | 31956.4 | | 31956.4 | | 28203.9 | 88.3 |
| Libya | 4 | 2922.0 | | 2922.0 | | 2192.3 | 75.0 |
| Jordan | 6 | 749.0 | 53.1 | 802.1 | 6.6 | 528.6 | 65.9 |
| Bahrain | 1 | 239.6 | | 239.6 | | 181.6 | 75.8 |
| Tunisia | 7 | 576.8 | 266.8 | 843.4 | 31.6 | 694.4 | 82.3 |
| Syria | 4 | 4819.8 | 377.1 | 5196.9 | 7.2 | 4365.5 | 84.0 |
| Oman | 2 | 75.3 | | 75.3 | | 42.5 | 56.4 |
| Egypt | 4 | 687.7 | 41.0 | 728.7 | 5.6 | 583.1 | 80.0 |
| Morocco | 5 | 1601.9 | 624.2 | 2226.1 | 28.1 | 1833.2 | 82.4 |
| Sudan | 4 | 109. | 13.5 | 122.5 | 11.0 | 96.7 | 78.9 |
| Somalia | 1 | 45.6 | 3.2 | 48.8 | 6.6 | 33.9 | 69.5 |
| Yemen A.R. | 4 | 102.0 | 13.4 | 115.4 | 11.6 | 37.7 | 32.7 |
| TOTAL | | 86122.5 | 2762.9 | 88885.4 | 3.1 | 78424.4 | 88.2 |

SOURCE: The Role of Specialized Credit Institutions in Development Activity in the Arab World. (Amman: Central Bank of Jordan, 1983) (in Arabic)

Examining the source of capital for such institutions as given in Table 4.1. The data indicates that the bulk of the capital with the development banks came from domestic resources. For the development banks of the region as a whole, 97 per cent of the capital originated locally. But at the country level the picture varies considerably from one country to another. For instance for the Tunisian and Moroccan development banks, foreign sources of funds are important. These sources amonted to 32 per cent of the Tunisian development banks and 28 per cent of the Moroccan development banks in 1980. The foreign source for the Tunisian banks increased further in the early 1980's when six joint-banks with large capital were set-up in Tunisia.(20)

The other Arab countries with a relatively high use of foreign sources were Algeria, Kuwait and Syria. Each of them shows foreign capital exceeding in absolute terms that in Tunisia, but because their institution had large domestic sources, the foreign sources in terms of percentage are dwarfed. The other Arab deficit countries, such as Jordan, Yemen A.R. and Sudan had a small amount of foreign resources, but because the assets of their institutions were small, the foreign resources show a relatively high percentage. The other development institutions with no foreign resources were those of Saudi Arabia, Libya, Bahrain and Iraq. See Table 4.1.

Concomitant to the evolution of the national development banks which are mainly concerned with financing development in their host countries, other national and regional development assistance funds emerged to operate at the regional level. The first ambitious Arab financial institutions for Economic development was broached in 1945 by the British Government as part of the Anglo-American oil agreement proposed at that time.(21) This project did not materialise, but fourteen years later, at the meeting of the Economic Council of the Arab league in Cairo (January 1959) subscription quotas for a similar institution were agreed.(22)

The second initiative came in 1961, when Kuwait on its independence in a real desire to consolidate its position with other Arab states, established the first Development Assistance Fund (23) namely the Kuwait Fund for Arab Economic Development (KFAED). As the name of the fund implies, it was empowered to lend only to the Arab states. A decade later Abu Dhabi got its independence from Britain and immediately set up a similar institution namely the Abu Dhabi Fund for Arab Economic Development (AFAED) but on a smaller scale. At the same time, the members of the Arab league set up the first regional assistance fund namely the Arab Fund for Social and Economic Development (AFSED).

After 1974 when the region began to receive enormous oil revenues, the development assistance funds began to propagate on the national level Saudi Arabia, Iraq and Libya each set up its own development assistance funds. And on the multinational level, in solidarity with the African people came the Arab Bank for Economic Development in Africa (BADEA) sponsored by the majority of the members of the Arab league. Similarly in solidarity with the Islamic countries and third world countries came the Islamic Development Bank (IDB) and OPEC Special Funds respectively. The last two multilateral funds are of mixed Arab and non-Arab sponsorship, but the Arab countries have pledged large amounts for both institutions.

In the last decade or so the national and regional development funds have grown significantly in their capital base. The (KFAED) and (AFAED) started with modest amounts of capital in 1961 and 1971 respectively, but they have been increased several times. Likewise the capital of other national and regional development institutions has increased but on a smaller scale because the latter started with a large capital base from the beginning. The aggregate paid-up capital and reserve of all these institutions amounted to about $18 billion at the end of 1982 as given in Table 4.2.

The largest among them have been the (KFAED) and the (SDF): together they held over 55 per cent of the total paid-up capital and reserve with all institutions. However, the capital of the (AMF) and the (AFSED) was doubled in 1982. The rapid increase in the paid-up capital of both institutions reflected the great desire of the Arab countries for further co-operation at the regional level.(24)

## 4.3 The Framework of the development banks operation

As the Arab development banks of national and regional institutions by no means came out of the same pod, there had been specific assignments and guidance for the operation of each institutions.

To begin with regional institutions, the Arab Bank for Economic Developmnt in Africa is limited in its operation to non-Arab members of the Organisation of African Unity. Likewise the Islamic Development Banks is limited in its operation to the Islamic countries and communities. The third development institution funds with a special assignment are the AMF and the AFSED both of these funds are limited

TABLE 4.2

The Capital of the Arab National and Regional Development Funds as at End 1982

| Development Institutions | Date of operation | Authorized captial | Paid Capital |
|---|---|---|---|
| National Institutions. | | | |
| Kuwait Fund for Arab Economic Development | 1962 | 7000.00 | 3904.00 |
| Abu Dhabi Fund for Arab Economic Development | 1974 | 1089.03 | 693.04 |
| Saudi Fund for Development | 1975 | 7288.63 | 6272.95 |
| Iraqi Development Fund | 1974 | 924.00 | 616.00 |
| SUB TOTAL | | 16 301.66 | 11 485.99 |
| Regional and Multilateral Institutions. | | | |
| Arab Fund for Economic and Social Development | 1974 | 2760.00 | 1680.00 |
| Arab Bank for Economic Development in Africa | 1975 | 738.25 | 944.00 |
| Islamic Development Bank | 1977 | 2146.00 | 1295.53 |
| OPEC Fund for International Development | 1976 | 4000.00 | 2074.00 |
| Arab Monetary Fund | 1978 | 953.86 | 828.21 |
| SUB TOTAL | | 10 598.11 | 6 821.74 |
| GRAND TOTAL | | 26 899.77 | 18 307.73 |

SOURCE: Co-ordination Secretariat, Arab Fund for Ecomomic and Soical Developments. Development Financing Operations of Arab National and Regional Financing Institutions as at End 1982. Kuwait, 1983.

in their operation to the Arab region. However, the other national funds such as the Kuwait Fund for Arab Economic Development (KFAED). The Abu Dhabi Fund for Arab Economic Development (ADFAED), have joined the Sauid Fund for Development (SFD) to operate at the global level since their charters were amended to allow them to do so in 1974. This equally applies to the Iraqi Fund for External Development (IFED) and the Libyan Arab Foreign Bank (LAFB).(25)

Within this broad assignment each institution has a special objective to fulfil. The objectives of the Pan-Arab Institutions namely the AMF and the AFSED have been to promote Arab Economic integration together with integrated money markets and unified currencies. The main role of the AMF has been to provide balance of payments support to the Arab deficit countries, and to co-ordinate the Arab financial and monetary policies. The Agreement of the Fund stresses, both in letter and spirit the role of the Fund in the development of Arab financial markets as a means of assisting in Arab economic integration in general and monetary and financial integration in particular.(26) The objectives of the AMF as stated in its Articles of agreement are:

1. Adjustment of balance of payments imbalances among member countries.
2. Stabilization of exchange rates of the Arab currencies with the aim of maintaining their convertability and suppressing current payment restrictions among Arab countries.
3. Strengthening Arab monetary integration with the aim of increasing Arab economic integration and accelerating economic development to achieve the desired rates of growth among member countries.

4. Establishment of appropriate means of expanding the use of the Arab Accounting Dinar (AAD) in a manner promising the establishment of a unified Arab currency.
5. Settlement of current payments with the aim of promoting trade exchanges among member countries.

The charter of the AFESD of 1968 also stresses the role of the Fund in financing economic and social development and encouraging private and public capital investment in those projects consolidating Arab integration. Article 2 of the charter stipulates that priority should be given to projects vital to Arab unity and joint Arab projects (27). The charters of the national Funds in Iraq, Kuwait, Saudi Arabia, and United Arab Emirates stress their role in promoting development at a global level in different degrees. The Iraqi and the Kuwait Funds stress the idea of closer economic co-operation between the Arab countries. The former consitution provides that the fund should concentrate its activities on Arab countries and should give priority to those projects that would contribute to closer economic co-operation and integration between the Arab countries.(28)

The operation of all these institutions is guided by economic considerations. Only projects that are financially feasible and sound may get a loan from such institutions provided that such projets are approved by the recipient country and the government must be either the borrower or the guarantor of the loan. The exception is when the Islamic Development Bank assists in the form of equity participation no government guarantee is required. The basic procedures of project identification, loan implementation and follow-up are similar within all these institutions and are based mainly on the World Bank guide-lines.

The loans are usually extended on very soft terms, loan maturities are usually in the 20 to 30 year range and the degree of concessionary finance is high. A period of grace of four to six years and interest rates between 2-6 per cent are usual. The variations in lending rates have often been in function of the type of projects being financed and the degree of development in the recipient country. (29) The Islamic Development Bank operates as an Islamic Bank and thus charges no interest on its loans. To avoid using the notion of interest, project aid can be provided in the form of equity participation or using profit-sharing or leasing arrangements. Similarly, the Saudi Fund does not charge interest and only collects a small amount as a service charge. But the ADFAED charter allows for equity financing to a maximum of 15 per cent of the total cost of the project. And in departure from the other funds its charter was revised to allow the Fund to accept deposits from local public corporations and organize various financial institutions in the domestic markets.(31)

In recent years the Arab regional institutions have begun intensive co-ordination of their policies and procedures which have resulted in more similarity in their operation. This was possible because Kuwait and Saudi Arabia are the owners of the largest institutions and together hold the majority vote in the other multilateral institutions.

The other Arab development banks, which are concerned with finance and technical advice for specific areas within their host countries are larger in number and the majority are limited in their operation in terms of country and economic sectors. The regional institutions are free to lend to all economic sectors. But similarly to the regional institutions, the majority are prevented by their laws from accepting deposits. The institutions of this kind which are allowed to accept deposits are those which perform both banking and development functions as in the case of La Societe Tunisienne de Banque. Its status allows it to receive deposits of current or term types from all persons public, semi-public and private.(32) But the other development banks in the region with a right to accept deposits are limited to time deposits.(33)

On the assets side, the majority of the development banks of the national and regional type are limited in the maximum amount of funds an institution may extend to a single project. This limitation is related to the cost of the project and the paid-up capital of the institution. The development bank may not exceed a certain ratio specified by its law as to the cost of a project or to its paid up capital. For instance, the Industrial Bank of Sudan is precluded from investing in any project more than two-thirds of the total cost of the project. The maximum investment by the Bank is limited to 15 per cent of its paid up share capital, reserves and loan capital.(34)

The other area stipulated in the operation of the development banks is long-term finance. Development banks according to their regulations should extend mainly long-term finance for projects and some of them are prevented from extending any sort of short-term finance. For instance, the statutes of the Banque Nationale pour le Dévélopement Economique of Morocco stipulated that the institution is allowed to provide long-term loans of at least two years duration.(35)

The operation of these institutions is mainly influenced by their sponsors in so far as charging interest rates is concerned. The government and semi-government institutions were allowed to charge modest interest rates while the privately-owned institutions were almost free to charge and set their own rate.(36) Thus, in the main, the rates ranged between zero and the existing commercial rate at the time of extending a loan. But the common characteristic of the interest rates was their general stability within each institution.

In rich countries with government-owned development institutions the wealth of such countries exerts a decisive influence on the policies of setting the rate. Loans have normally been extended under the most favourable terms with long pay back periods and no interest charges, merely a small service charge. In Saudi Arabia, farmers usually received 50 per cent of the cost of machines and equipment bought by the loan as a gift from the Agricultural Development Bank. Likewise the Real Estate Development Bank usually granted a 20 per cent deduction on the total loans if loans were paid on time.(37) In Kuwait the interest rates charged by its development banks varied greatly from one institution to another. For instance the saving and credit bank, the oldest and largest of the Kuwait development banks, was created in 1960 to extend loans for the promotion and development of industries, real estate, agriculture and for people of limited means who were unable to borrow through normal banking channels. The Bank granted loans for maximum period of 45 years at an interest rate of 2%. Although this was a small charge, it was usually paid by the Ministry of Finance. The Industrial Bank of Kuwait is owned jointly by the government and the private sector. As the Bank has access to cheap government loans, there was a ceiling of 4% on interest rates that the Bank should observe in its lending. While, the Kuwait Real Estate Bank as a joint stock company operated on a commercial basis.(38)

In Bahrain, the Housing Bank is the only development bank there. The Bank extends loans to those eligible to enable them to build their own houses. Borrowers make repayments over a maximum of 25 years in the form of rent, giving the bank a return on its investment of no more than 5 per cent.(39)

Iraq, has three development banks of which the largest was the Real Estate Bank. The Bank usually granted long and medium term loans on soft terms. In addition the lending policy favoured rural projects by granting borrowers in rural areas 60 per cent of the projects estimated cost at an interest rate of 3 per cent while the borrowers in the urban areas were given 40 per cent of the projects estimated cost at an interest rate of 6 per cent. The Agricultural co-operative Bank also granted borrowers medium and long-term loans on soft terms. The Bank also helped farmers by insuring the life of the borrowers and the machines or equipment on the farm. This policy relieves the family of the farmer from the burden of the loan should he die. Insurance of the farm itself guarantees any loss on the loan that the bank might incur.(40)

Morocco is one of the Arab countries with a long experience of the development banks operations. The government supports the borrowers from the development banks by paying on their behalf part of the interest rates. For instance, the government pays 3-5 per cent of the interest rate charged by the Crédit Immobilier Et Hôtelier on loans extended to individuals to construct their houses, but 2 per cent of the interest rate if the loans are used for constructing hotels. Also the government pays 2 per cent of the interest rate charged by the Banque Nationale pour le Dévélopment Economique if loans are used to finance one of the projects stated in the Law for the Promotion of Investment. The policy of interest rate support by the government was used also in Tunisia and Oman.(41)

In Jordan, the interest rates charged by the development banks greatly varied from one bank to another. In the period of 1980-1983 the cheapest rate was charged by the cities and villages Development Bank on long-term loans of up to fifteen years to rural councils at a rate of 4.5 per cent, increasing to 7.5 per cent in the last year. The Housing Corporation had continued to extend long-term loans over fifteen years at a 5 per cent interest rate. Also the Agricultural credit corporation maintained a 7 per cent interest rate on all its long-term loans. The rate of interest charged by the Jordan co-operative organisation on its long term loans was in the range of 6.5 to 8 per cent. The Industrial Development Bank and the Housing Bank charged higher rates close to those interest rates charged by the commercial banks.

The other requirement made by the charters of the development banks is the provision of adequate collateral when loans are extended. Some of the banks required collateral in the form of the assets of the projects and others included raw materials in the size of the loan extended.

## 4.4. Appraisal of the development banks operation

### 4.4.1 Regional development funds

The aid disbursed by the national and regional development funds reached about \$18.4 billion during the period 1962-83 (See Appendix 4.2). The figures show that all of them had been active in extending and disbursing funds during that period. However, the three most active institutions have been the Islamic Development Bank (IDB) based in Jeddah. the KFAED in Kuwait and the SFD in Saudi Arabia. Together they have provided about 62 per cent of the institutions total aid during the period under consideration.

However, the contribution to financing development of the Arab region is far less than one-half of the amount extended by these institutions. The region received about \$8.4 billion from these institutions as can be seen in Appendix 4.3. Of that the infrastructural sectors (transportation, power, water and sewerage) accounted for 54 per cent. The productive sectors received about 33 per cent and the remaining 13 per cent went to other sectors. The aid is very small compared with these institutions' expenditure more importantly when compared to the enormous resources at their disposal. None of them has utilized its full capacity nor taken full advantage of the opportunities.

However, the aid extended to the 18 Arab countries has contributed to their development. Through soft loans it helped the capital shortage countries to build their infrastructure, which is essential for further development.(42) However, the productive sectors received a small share but nevertheless probably larger than those contributions made by these countries' own development banks to these sectors. In the coming years the productive sectors' share of the regional development Funds loans is expected to increase as the infrastructural projects are completed or near completion, Likewise the development of infrastructure facilities helped the establishment of new industries and improved the conditions for investment in the productive sectors.

In addition, the development banks have gained more experience in evaluating and appraising new projects. This would help the expansion of their operations in lending to industry. It is believed that the shortage of professional staff and expertise was the reason behind their small loans to the productive sectors since the problem has been identifying and evaluating projects rather than a shortage of capital.

Apart from extending finance, these funds have contributed to the region's economic development and have also helped to build up the Arab capital markets. For instance KFAED promoted and succeeded in the establishment of the Inter-Arab Investment Guarantee Corporation (IAIGC) in 1974. The Corporation, as its name implies ensures all investment, portfolio investment loans, etc. The creation of this corporation is believed to facilitate and increase the investment in the region.(43) Likewise, the ADFAED helped in saving some banks from bankruptcy in the 1977 crises in the U.A.E..(44) This helped to maintain a sound banking system and gave people confidence in the financial system there. Similarly the Libyan Foreign banks helped in the integration of the Arab financial centres through their policy of establishing joint-banks with other Arab countries. It has already set up many such institutions in Beirut, Tunisia and U.A.E.

Similarly, the AMF in collaboration with the Arab central Banks has made vigorous efforts through support loans, maintaining stable exchange rates between the Arab currencies and encouraging the adoption of a unified Arab currency to accelerate economic integration and to develop the Arab financial markets and integrate the Arab currencies. However, the significance of the impact of these efforts has been limited due to the political factors which so often bedevil wider Arab co-operation.(45)

However, despite these positive factors made by the regional institutions, their insistence on the bankable projects undoubtedly limited their contribution to development, because not all bankable projects are necessarily important for economic development nor is every economically essential project necessarily bankable.(46) Thus it is more helpful to the development of the region and for increasing the flow of capital within the region if such institutions shift to programme lending and increase their aid to the national development institutions.

### 4.4.2 The national development banks

The national development institutions' loans and investment reached $78 billion in 1980, see Table 4.1. This is almost ten times the fund allocated by the regional bank to the region, and more importantly it accounted for 88 per cent of their resources. This points to the fact that the national development banks have been more successful in utilizing their resources than the regional ones. But this achievement varies considerably at the country level. The data in Table 4.1 shows that the Algerian and Saudi banks were the leading ones in terms of fund utilization.

The former extended over 97 per cent of their total assets and the latter 88 per cent. This is a great achievement as these institutions were holding almost three quarters of the total financial assets held by all development banks in the region. These were followed by the development banks in Iraq, Tunisia, Syria and Morocco with the utilization of over 80 per cent of their resources while the Libyan and Bahrain development banks only utilized three-quarters of their total resources. At the other end of the stand the development banks of Yemen A.R., Somalia and to some extent Kuwait where they utilized between one third and one-half of their resources. The low utilization indicates the poor performance of these banks.

The main factor which weakened the operation of these institutions was the shortage of qualified and competent staff, which in the case of Yemen and Oman led to delay and inefficiency in processing loan applications. The same factor was noted in Jordan where development banks were criticised for being two passive in their lending operations and for failing to take the inititative in identifying new investment opportunities and in attracting clients.(47)

The fact that developing countries suffer from a chronic shortage of local managerial and organisational capabilities and competence has an effect on their ability to plan and present their projects properly. So development banks should possess the competence to identify projects and invest their scarce resources to useful purposes and not merely as administrative devices to handle their government's own investment.(48)

The lack of competence is perhaps the main cause for the failure of some development banks in Jordan and in the majority of Arab countries to employ fully their resources in the development of the region.(49)

With regard to the second factor the development bank's operation is affected by the interest rate and the collateral requirement. The interest rates charged by the Arab development banks seem to have been governed largely by the cost of capital to them so that development banks with greater access to government capital extended loans on very moderate terms and sometime free of interest. This policy helped the borrowers and encouraged them to borrow more. But the development banks with private interests tended to charge a higher rate and the small concessionary aid they offered was more than offset by the funds of the public sector deposited with some of them.
The high interest rate policy considerably reduced the demand for their finance and this they were left with much of their resources.

However, the interesting aspect of the interest rate policy of the majority of the Arab development banks was that they charged the same rate of interest to all customers irrespective of the difference in the risks involved. This policy may lead to a higher rate of default, as some economists suggest(50) but it has been motivated by social considerations, especially the desire to avoid charges and complaints of favouritism and discrimination. In addition, most of the local business is directed to the local markets with little competition from outsiders thus making the enterprises in each economic sector face the same risk.

The security requirement in extending loans by the development banks has not been lenient but strictly observed. This policy undoubtedly cut down the rate of default. But it can be argued that the inability to provide acceptable security was one of the main reasons why most small farmers and small scale industry could not obtain credit from commercial banks.(51) Thus if the development banks were to perform their basic function of lending money to correct social and geographical imbalance, they must not lay emphasis on security requirements. Such a policy may be acceptable when the capital of such institution is inadequate since a high rate of default on the part of loan recipients adversely affected its operation, and deprives such a bank of financial resources which could otherwise have been applied to meet fresh loans demanded by the bank's clients. But in all cases development banks should consider the viability of the project intended to be financed by the loan more than the availability of collateral.

### 4.4.3 National development banks and national priority

To examine the Arab national developments institutions' operation against their countries national priority we have to examine how they have deployed their funds among the various economic sectors and then relate this deployment to planned investment in each sector.

Information permitting the analysis of the development banks' loans and investment by sector or sub-sector is scarce and only available for several Arab countries and for 1980 only. What follows is an examination of the operations of such institutions within the constraints of the available data as given in Table 4.3. From the data it is clear that the Arab development banks in seven countries laid great emphasis on the construction and housing sector, a sector which

TABLE 4.3

## Development Banks, Loans by sectors and maturities in 1980

| Country | Loans in $ | % of the total | Total Loan |  | Agriculture |  | Industry |  | Contruction |  | Others |  |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
|  |  |  | % Long | % Short | % Long | % Short | % Long | % Short | % Long | % Short | % Long | % Short |
| Jordan | 205.5 | 1.5 | 96.8 | 3.2 | 9.6 | 3.2 | 10.3 |  | 72.3 |  | 4.6 |  |
| Iraq | 2 939.8 | 22.1 | 96.3 | 3.7 | 8.7 | 2.6 | 1.1 | 1.1 | 86.5 |  |  |  |
| Saudi Arabia | 7 898.9 | 59.5 | 99.9 | 0.1 | 9.4 | 0.1 | 47.7 |  | 42.8 |  | 0.6 |  |
| Kuwait | 369.7 | 2.8 | 100.0 |  | 0.7 |  | 32.0 |  | 61.5 |  | 5.8 |  |
| Bahrain | 79.8 | 0.6 | 100.0 |  |  |  |  |  | 100.0 |  |  |  |
| Morocco | 1 746.1 | 13.1 | 79.8 | 20.2 | 14.9 | 9.6 | 36.3 |  | 26.2 | 8.2 | 2.4 | 2.4 |
| Sudan | 43.7 | 0.4 | 63.4 | 36.6 | 11.5 | 36.6 | 39.8 |  | 12.1 |  |  |  |
| Total | 13 283.5 | 100.0 | 96.2 | 3.8 | 9.7 | 2.1 | 34.5 | 0.3 | 51.1 | 1.1 | 0.9 | 0.3 |

SOURCE: Central Bank of Jordan, "The Role of Specialized Credit Institutions in the Development Activities in the Arab World", (1983), p.99, in Arabic.

accounted for about 52 per cent of the total loans and investment provided by development banks of the seven countries under consideration, while the industrial sector accounted for one-third, and the agricultural sector for just 12 per cent.

At the national level the development banks in Bahrain, Iraq, Jordan and Kuwait channelled to the construction and housing sectors 100 per cent, 86.5 per cent, 72.3 per cent and 61.5 per cent of their loans respectively. This left a small amount to be shared by the industrial and agricultural sectors in these countries. In Saudi Arabia, Morocco and Sudan development finance was spread more evenly to cover various economic sectors.

Although the construction and housing sectors received the largest part of the development banks' total finance, development of the industrial and agricultural sectors has continued to be the top priority in many Arab countries. The small shares of these sectors do not reflect the national priority in most of these countries.

12 per cent of the development institutions total loans for the agricultural sector is very low in a region where over one-half of the population earn their living from this sector. This can be made clear by examining the development banks' loans and investment in relation to the planned investment in each economic sector. From the data is Table 4.4. It can be seen that the loans extended by the development banks were not in compliance with these countries development plans. For instance, the development banks in Saudi Arabia, Iraq and Jordan extended loans to the housing sectors many times greater than the planned investment for housing in their respective countries. In

TABLE 4.4

The Development Banks, loans and the Planned Investment in Several Arab Countries in 1980

| Country | Items | Agriculture | Industry | Construction | Others | Total |
|---|---|---|---|---|---|---|
| Iraq | Loans | 256.0 | 33.2 | 2539.5 | | 2828.7 |
| | Investment | 1285.0 | 2599.6 | 959.6 | 2625.4 | 7469.6 |
| | Loans/Investment | 19.9% | 1.3% | 264.6% | .0 | 37.9% |
| Saudi Arabia | Loans | 739.8 | 3769.8 | 3327.9 | 49.8 | 7887.3 |
| | Investment | 266.4 | 2562.0 | 1095.2 | 14180.4 | 18104.0 |
| | Loans/Investment | 277.7% | 147.1% | 303.9% | 0.4% | 43.6% |
| Jordan | Loans | 19.8 | 21.1 | 148.7 | 9.4 | 199.0 |
| | Investment | 24.2 | 138.0 | 51.8 | 246.8 | 460.8 |
| | Loans/Investment | 81.8% | 15.3% | 287.1% | 3.8% | 43.2% |
| Kuwait | Loans | 2.6 | 118.3 | 227.4 | 21.4 | 369.7 |
| | Investment | 22.6 | 682.6 | 1408.4 | 1228.0 | 3341.6 |
| | Loans/Investment | 11.5% | 17.3% | 16.1% | 1.7% | 11.1% |
| Morocco | Loans | 259.6 | 633.8 | 456.9 | 43.4 | 1383.7 |
| | Investment | 287.0 | 162.2 | 609.6 | 572.0 | 1630.8 |
| | Loans/Investment | 90.0% | 390.8% | 75.0% | 7.6% | 85.5% |
| Sudan | Loans | 5.0 | 17.4 | 5.3 | | 27.7 |
| | Investment | 293.3 | 182.0 | 174.0 | 446.1 | 1095.4 |
| | Loans/Investment | 1.7% | 9.6% | 3.1% | | 2.5% |
| Bahrain | Loans | | | 79.8 | | 79.8 |
| | Investment | 2.0 | 69.2 | | 4.2 | 75.4 |
| | Loans/Investment | | | | | 105.8% |

SOURCE: Central Bank of Jordan, "Report on the Role of Specialised Credit Institutions in the Development Activities of the Arab World", (1983), p.101, in Arabic.

contrast, the agricultural and industrial sectors received less than the planned investment in Jordan and Iraq.

However, some argue that the emphasis on the housing sector in these countries was a natural response to the circumstances of the 1970's.

A brief digression is necessary to shed light on those circumstances. During that period of increased oil revenues the recipient countries spent lavishly on building a new infrustructure: electricity, sewage facilities, the expansion of the ports and imports; on initiating and improving social services, especially education and medical facilities; and also on introducing extensive subsiduaries for food and other consumption items. These, of course, meant an improvement in the income of the people which led to a rise in their prosperity to spend and also to save. Consequently the demand for housing increased and resulted in a sharp increase in rents particularly in the urban areas. People with small means suffered a great deal.

In tackling this problem the governments in the Peninsula countries began constructing new houses for their citizens with average and low incomes and distributing plots of land to those who had money to build their houses. But when demand went up, they resorted to the establishment of special development banks to provide loans on soft terms to their needy citizens.(52)

In the non-oil Arab countries, money sent home by their national workers in the oil countries and the official assitance from the oil countries made some of them experience the boom although on a smaller scale. The demand for houses increased and speculation in land made it possible for the middle and low income groups to secure their houses. So the need for specialised development to support this sector was felt and led to the establishment of appropriate institutions in countries such as Jordan and Lebanon.

Thus we have the reasons why so much was spent in the housing sectors.(53) However, despite these reasons, it can be concluded that the banks in the housing sector had more capital at their disposal than would be allowed given the national priority in these countries. This of course does not apply to banks in Saudi Arabia where all the development banks have substantial funds and extended more than the planned investment. In contrast the development institutions specialised in financing industries were short of funds in many countries. The development banks provided only one per cent of planned investment in Iraq, 10 per cent in Sudan and approximately 15 per cent in Jordan. It was only in Morocco and Saudi Arabia that the industrial banks extended loans greater than the planned investment. This is an indication of the small amount of capital at the disposal of these institutions in other Arab countries.

The agricultural credit institutions were the poorest in terms of capital. This can be seen by the relatively small amount of finance channelled through the agricultural credit institutions compared to the planned investment in this sector. For instance Sudan with its heavy dependence on this sector only managed to channel about 2 per cent of its planned investment in this sector through the development bank.

Therefore, demand on development banks for loans and other forms of financial assistance was much higher than that which they could meet with their available resources as is clear in many cases. Hence the amount of loanable funds available tends to determine the level of loans and investment and the shortage of funds had been the main constraint on the financial operations of most of the national development banks.

## 4.5 Conclusion

The development banks, both national and regional, have contributed significantly to the development of the productive sectors and the infrastructure in the region and filled the gap in medium and long-term finance left by the operation of the commercial banks in the region. The former has been the main source of medium and long-term loans, unlike the commercial banks which have opted for easy profit by serving mainly the export and import sector. The latter has been the main channel for transferring capital from the high saving countries to low saving countries in the region.

In addition, the development banks have been the catalyst in the economic sectors of their operations by providing finance and technical guidance which have helped to strengthen domestic entrepreneurship, and encourage the establishment of new industries and joint stock companies. In addition the issuing of bonds through these institutions contributed greatly to the development of the Arab capital markets.

Although most of the development banks suffered from a number of deficiencies which adversely affected their contribution, the said to have had sufficient resources to meet all demands for the backing of feasable projects, the majority had insufficient capital and as the latter are prevented by their statutes from taking deposits or unable to attract sufficient deposits.

They have looked to their central banks for financial assistance. In essence their activities have been rationalised within the overall programme of development in their countries. It is clear, in order to achieve self-reliance in the long run and to be more effective in their operation, that they should make serious efforts to attract time deposits by offering more liberal interest rates and should tap the capital market as far as possible on the one hand and hire more qualified and efficient personnel on the other.

However, the limitation on the capabilities of such banks to offer real interest rates on deposits and the absence of developed secondary markets to promote their securities have persisted as have other structural gaps in the Arab Financial markets. These gaps were to some extent filled by the emergence of the Islamic banks and the recently organised stock exchanges in the region. These matters will be dealt with respectively in the following two chapters.

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# CHAPTER FIVE

## THE ISLAMIC FINANCIAL INSTITUTION

## The Islamic Financial Institutions

### Introduction

The Islamic financial institutions have rapidly established themselves in the past few years within both the Arab region and abroad. Today many Arab countries have one or more of such institutions and a few countries in the region have embarked on a policy of converting their modern financial systems to operate on the commercial practices of Islam. The Islamic financial institutions operate by coordination the cultural and economic principles of Islam, whilst the conventional financial institutions often neglect the intricate interplay between cultural and economic factors.

The rise of Islamic Financial Institutions and their operation on principles emanating from the regional culture is of paramount importance to the Arab capital market. For any arrangement or innovation in the financial market to be accepted by the participants in it has to spring from their needs and comply with their culture otherise it would fail. Thus the wide acceptance of market participants of financial instruments based on the Islamic code was the force behind the emergence of these institutions.

Islam has been the public faith of the region for so long that it has marked the regional culture. Islam, in the words of the planning Minister of Saudi Arabia,

> "is a decisive and basic reality, an all-embracing value system that permeates and regulates every aspect of public and private life".(1)

The prohibition of interest in Islamic law has been one of the major obstacles to conventional financial institutions in fully mobilizing the available savings in the Moslem countries. The usurious practice of the conventional financial institutions militate against their acceptance by a large proportion of the communities in the region and restrain their development. The negative attitude to usury practice among a large proportion of the communities compelled the vast majority of Arab governments to maintain a ceiling on interest rates.(2) The long imposed ceiling on interest rates has weakened the conventional financial institutions in their ability to compete with the international markets. This combined with a liberal foreign exchange control policy in the majority of the peninsula countries led to the flight of enormous amounts of capital outside the region.

The introduction of modern banking practices came when the Arab countries in Wilson's words,

> "were so locked in a virtual colonial relationship with European powers that they were concerned to do nothing to offend".(3)

In the post-independence period, such institutions were already there, so the Arab governments turned to a variety of conciliatory gestures to reconcile the operation of such institutions within the context of their Islamic objectives. Some Arab countries nationalised such institutions, others officially do not legalize interest payment as in Saudi Arabia and the United Arab Emirates.(4) The long-standing Arab governments' imposition of an interest ceiling on the banks' lending is another gesture. The latter measures in the context of the changing international interest rates and liberal foreign exchange control at home have led to successive liquidity crisis in the region (5).

So there has been a moral and practical need for the development of financial institutions operating on Islamic principles to offer people the financial instruments accepted by them and yet avoiding the usury question. The moral need came from the Islamic teaching which considers money purely as a means of exchange with no intrinsic value of its own. Unless money is translated into a productive process it is considered immoral to pay or receive premiums on it.(6) The practical need for such institutions is inter-linked with the moral one. The conventional banks have failed to mobilize saving and to extend credit to a great proportion of the communities in the region because they deal in fixed interest rates and as hoarding of capital is also forbidden by Islam, so it is essential for the Moslems to find a way to utilize their savings and to secure their needed capital in compliance with their culture. Finally, it seems difficult for the Arab governments to free the interest rate for the conventional institutions. Thus the development of the Islamic financial institutions is of paramount importance to the development of the Arab capital market and may fill some of the structural and operational gaps in their market.

In this chapter an attempt is made to explore the economic principles of Islam then the evolution and operation of the Islamic institutions, assess their intermediary role between savers and investors and finally their effect on the Arab capital market and the economy as a whole.

## 5.1 Economic principles of Islam

The economic doctrine of Islam is closely related to the Islamic concept of life. This concept is based on a network of interrelated concepts concerning God, humanity, and human beings' relation to God. Islam views the human being as composed of two elements, body and soul. Consequently, a person should not neglect either of them for the sole profit of the other. Within this context, believers should be active in their individual and social lives, to satisfy their material needs and fulfil their social obligations within the principle of justice and fair dealing.(7)

Apart from many passages in the Koran which sets down such values, the Koran also provides some specific ordinances in the economic field. The most important for this study are:

1. The prohibition of Riba

The Koran states in several verses how the people should exchange goods and services and condemns some of the prevailing practices of money lending where the debtor has to pay a fixed amount above the principal to the creditor for the use of money loaned. Within this context the Koran states:

> "Trading is permitted and Riba is forbidden".(8)

This passage stopped the previous practice in the Moslem communities and introduced the interest-free lending concept for the small loan, or participation in the gain or loss of the borrowers economic activities resulting from such a loan.

In recent history when the banks spread in the region, Islamic scholars brought up the Riba question and strongly opposed the operation of modern banking. This led to further investigation into the concept of Riba which literally means excess or addition and may be translated as usury or interest.

So Islamic scholars differ in their interpretation of the word Riba. For the minority with a modernist view (9) Riba means only usury. Within this interpretation this group regards interest as legally prohibited when money is lent at exorbitantly high interest rates and thereby exploits the borrower otherwise interest is accepted. So it seems that the imposition of a ceiling on the interest lending rate within the region complied with this interpretation.

But for the vast majority of Moslem economists (10) Riba means usury and interest. They argue that money should not be allowed to grow passively through mere passage of time by earning guaranteed interest when money itself has no intrinsic value. And if a lender of money gets back more than his principle, it is exploitation because this would mean unequal exchange of assets of an equal value. According to this view all dealings in money involving predetermined interest rates violate the religious code and are prohibited. This applies to both loans and deposit.

The last interpretation of Riba as usury and interest is contained in the code governing the operation of the present Islamic institutions. (11) And in analogy to that recent years the conventional banks in the United Arab Emirates failed to collect interest on their loans to customers because the courts of the U.A.E. ruled that the interest provision in a loan agreement is void according to Islamic law. (12)

2. On the validity of a contract between parties the Koran strongly recommends writing the term of the contract in categorical and unambigious words. The commodity should be clearly specified, be truly owned by the seller, be accessible and deliverable and of economic value. Contracts involving legally inconsumable material for Moslems such as wine or pork are not valid. The parties should be responsible free agents of sound mind. (13) These recommendations were meant to reduce the causes of social tension and to promote an optimal climate of peace in the community. In analogy with these recommendations, the Islamic institutions usually enter with depositors and borrowers into a contract binding both parties. (14)

3. The other passages in the Koran concerning specific ordinances are the rate of tax on capital and income. (15) The distribution of a deceased persons estate and the prohibition of capital hoarding.(16) The tax on capital and income and the distribution of the deceased persons estate are meant to reduce capital accumulation in the hands of a few people. The Koran requires a Moslem to pay Zakat on his accumulated wealth in excess of a certain minimum of 2.5 per cent annually, and another ratio of his or her income. The imposed percentage of Zakat on incme is generally related to the source of income. The Zakat was usually collected by the state treasury, but in the absence of government, Moslems should give the accrued Zakat to needy people themselves. In compliance with this the Islamic financial institutions put the due Zakat on their business in a special account and provide from it interest-free loan. (17)

The condemnation of capital hoarding in the Koran is meant to encourage the circulation of money and increase demand for goods. This goes along with Keynesian theory of increasing demand as a pre-condition for further growth in output. Within the context of these codes the Islamic teaching seems to stress harmony among communities and rejects the concept of individuals maximising their own economic interests when pursued as an end in itself. (18)

## 5.2 Evolution of Islamic Financial Institutions

The Islamic financial institutions are of recent origin. They were initiated by the private sector for the first time in the early 1960s, consolidated by the establishment of two Islamic banks by the governments of the region in the early 1970s. Since then the number of such institutions in the region as well as abroad has risen rapidly. The simple style of life that had prevailed in the region for so long did not call for the establishment of the present type of financial intermediaries before. The region's business was simple and did not need great amounts of capital and the savings of the business owner were sufficient for the businesses' growth. If a business required a great amount of capital and this exceeded the means of an entrepreneur, he was able to get the extra capital needed from relatives and friends, or by entering into partnership with others.

In the first half of this century economic activities did not improve very much where small craftsmen and merchants had continued to dominate the scene the introduction of conventional banks was mainly directed at facilitating trade with the Metropolitan countries and at serving the colonial administration in the colonies.

In the post-independence period the region began to witness some structural changes in its economies. The change began very slowly during the 1950's and 1960's but picked up after the adjustment in oil prices in the early 1970's. In parallel to that the per capita income was very low in the first two decades but increased rapidly in the 1970's. In analogy to that the conventional banks grew along with the economy but their operation on usury principles began to encounter more and more objections. People who objected to the usurious system resorted to investing their savings in real estate or in interest free deposit accounts with the conventional banks. This led some people to think in the establishment of financial institutions operating within the context of an interest free system.

The first attempt to set up financial institutions operating within the interest free concept came in 1962 when a local Savings Bank was established in Mit-Ghamer a small town in Egypt by a group of people. The system grew steadily and opened branches in eleven other localities before it was liquidated, perhaps for political reasons in 1971. (19) The institution had operated successfully, the number of its clients increased rapidly and its contribution to development was widely appreciated.

In the early 1970s, the governments in the region showed interest in the operation of the Islamic financial institution. This was evident when the Egyptian government set up the Nasser Social Bank to take over the commitments of its predecessor and proceeded to operate on the same principles. The new bank was required to extend all loans free of interest. In addition to providing mobile banking facilities for residents in rural areas, it has specialised in helping small businesses, the self employed, and students to complete their education. Then in 1974 the Islamic Ministers of Finance Conference in Jeddah established the Islamic Development Bank based in Jeddah as an intergovernmental institution, to promote economic co-operation among Moslem countries in accordance with Islamic teaching. The bank performs many activities; chief among them are:

1. Participating in equity of various projects in the member countries.
2. Extending loans to Institutions and Governments.
3. Promoting trade between member countries.
4. Extending technical advice, particularly in training personnel in economic activities and banking in accordance with Islamic principles.

The new institutions capital was provided by the governments unlike the savings Bank capital which was subscribed by individual.(20) So the new institutions began with the support of the Governments and in a very short time their operations felt by many people.

The successful operations of the two Egyptian Banks and the Islamic Development Bank of Jeddah were instrumental in making more people rethink the morality of interest payments while showing at the same time that Islamic alternative interest-free finance houses were possible and could prove successful. This coincided with the massive increase of oil revenues that began pouring into the region for the governments, but eventually passed in several ways to the private sector. At this stage individuals began to appear who had enormous wealth but who were reluctant to deal with conventional banks.

These wealthy people in collaboration with governments have embarked on policy of establishing more Islamic institutions. As a result a new wave of Islamic financial institutions, be it Islamic bank, investment company or other types of such institutions began to appear. But the new institution began operating on a commercial basis unlike the Islamic institutions before which were not profit-oriented. The first of the Islamic financial institutions of the new type was set up in Dubai in 1975 by a group of local merchants with a small stake for both governments in Dubai and Kuwait. The institution was modelled on the successful experience of Mit-Ghamer Bank and some modification was introduced in its operation to fit its goal of commercial operation. The immediate success of the new experience was copied in Kuwait in 1977 by setting up the Kuwait Finance House as a joint venture between the Kuwait public with 51 per cent, the remaining 49 per cent being owned by the government of Kuwait. At the same time Faisal Islamic Bank was established in Cairo as a joint venture between the Egyptian government (51 per cent) with the rest being held by Saudis individuals. A year later the private sector in Jordan set up their own Islamic bank, then the Islamic institutions have spread further with the emergence of the two largest group of investors namely Dar Al Maal Al Islamia (DMI) and Al Baraka. As both groups have enormous funds at their disposal in very short period they have established in collaboration with many governments new Islamic banks, investment banks, and other type of Islamic financial institutions.

In response to the demand of people for institutions where they can deposit and borrow money without transgressing fundamental Islamic tenets, in 1980 Misr Bank the oldest Arab bank in the region opened its first Islamic branch but the rest of the bank continued normal interest-based business. Likewise, Al Rajhi company for currency exchange and commerce the largest of its kind in Saudi Arabia started operating in 1983 as an Islamic Bank.(21) The order on money chargers to cease taking deposits by the end of 1984, led this company to secure a license to change its status to that of an Islamic Bank. (22) Today the region has over 12 such banks with wider participation among people and government in the region as can be seen from the figures for the major shareholders of such institutions in Appendix 5.1.

The growth of the Islamic financial institution was not limited to the region, in fact, the Islamic financial institutions which have been established so far outside the region perhaps outnumbered the ones in the region and their number is increasing. The Islamic financial institutions outside the region are mainly in other Moslem countries and in the major international financial centres such as London and Switzerland. Some of them have taken to some of the offshore territories as a place for registration perhaps for tax reasons. Today the Islamic financial institutions outside the region are over 13 in number as seen in Appendix 5.2. The Islamic institutions have shown considerable interest in overseas countries. The aim seems to be for such institutions to find investment opportunities. Evidence of that is the great number of financial institutions of this type abroad and the large capital base of some of them.

The largest Islamic financial institution both at home and abroad is the Islamic House of Funds known as (DMI) registered in the Bahamas for tax reasons. Its operating headquarters are in Geneva.

The House adopted a modern, sophisticated and agressive approach in building its liabilities and deploying its assets. To achieve that it has been the main force behind the spread of Islamic financial institutions. It is collaborated with many countries in West Africa, Turkey, Sudan and jointly established new Islamic banks in these countries and to help such banks in deploying their resources it established other investment companies. (23) The other important development introduced by DMI is the establishment of the Takafol Group, two such companies were recently incorporated in Sudan and the Bahamas. The aim is to eventually establish 12 Takafol companies. (24) The important thing about the Takafol companies is the fact that they are the Islamic alternative to insurance. These companies offer the public solidarity trusts whose funds are managed as in investment companies. These trusts assume indemnity payment to policy holders if an agreed risk occurs to the bearer of such policy certificate. The Takafol company in the Bahamas has undertaken to underwrite any default by the Takafol company by providing an interest free loan to such company to meet its Takafol requirements.

In 1982, a new leading Islamic house emerged in Jeddah with a paid-up capital of $240 million. The new house is known as Al Baraka. In a very short period it began operating through its joint ventures in Bahrain, Sudan, Tunisia, Turkey, U.K. and with many associated companies in Jordan. The rapid expansion of the Islamic institutions was in response to the demand of a large number of people in the communities for institutions where they can deposit and borrow money without transgressing fundamental Islamic tenets. (25)

The increase in number of Islamic banks called for the establishment of training facilities for newly recruited staff. Consequently in 1981, the international institute of Islamic Banking and Economics was founded; its main objective is the selection and training staff for the rapidly growing Islamic Bank. (26) In 1981 the Islamic Banks were subjected to the commercial banks' regulation in all the Islamic countries which have such institutions. (27)

In addition to the above development in the Islamic financial institutions a few countries envisaged a plan for a comprehensive switch to the Islamic system rather than making merely symbolic gestures as is the case in many Moslem countries. The planners in Pakistan after nationalizing and reducing the number of conventional banks gave the depositors the choice of depositing their savings at fixed interest rates or on the profit-and-loss-sharing concept. They hoped to achieve their ambitious goal of switching to the new system in a few years. (28) Iran too nationalised and reorganised its banks and perhaps the banks are now oprating under the new system. (29) Finally Sudan has prepared for such a change. Tody it has five major private Islamic banks currently operating in the country. These banks have been very successful in the past and amassed rich experience in the field of credit management and project evaluation and the switch over to Islamic banking is expected to be smooth. (30)

## 5.3 How does an Islamic Financial Institution build its liabilities and deploys its assets?

The development of the Islamic banks and other Islamic financial institutions is a relatively recent phenomenon. Thus their structure and strategies are still immature as economic institutions and should therefore be viewed as a process rather than a finished product. But the main concept controlling their operation will continue.

The experience of the Islamic finance houses has shown in the past few years that there is no shortage of mechanisms available for such institution to build up their liabilities and to deploy their assets in a profitable way without paying or taking fixed interest rates for money transactions. In Islamic financial institutions operations, interest is replaced by profit sharing. Funds are received from savers and advanced to borrowers on the basis of a profit and loss sharing arrangement. In this way such institutions perform the real intermediary role between savers and investors. They pool the savers funds and advance them to clients. Then they pass the profit or loss gained or incurred by the investors to the savers on the predetermined ratio agreed upon before. To do so that Islamic financial institution have developed several financial instruments to mobilize savings and others to deploy funds. With regard to financial instruments used in mobilizing savings, the Islamic financial instruments are similar to their counterparts used by the conventional banks. The difference is only that the depositors with Islamic financial institutions share in the profit and loss of the bank or of a specific project into which their savings are channelled.

### 5.3.1 The financial instruments for mobilizing funds

An Islamic bank is usually established as a public shareholding company. It starts up by using capital provided by its equity share holders then the bank may secure more funds by offering depositors several types of deposit accounts, chiefly current and savings accounts.

a. Current Accounts

A customer may open a current account with an Islamic bank; such an account is not subject to any condition in terms of drawing or depositing and does not receive any remuneration. The bank guarantees payment of these funds on demand and checking facilities are offered.

b. The Joint Investment Accounts (saving accounts)

The current account seems to be deposited with an Islamic bank for transaction and contingency purposes. But the saving accounts are opened with Islamic banks to earn income and they do participate in the profits realised from investment activities in accordance with the allotted ratio of each individual account under which they are placed. This ratio varies according to the period that money in the account is tied up. For instance, Jordan's Islamic Bank used to announce at the beginning of each year the basis of investment deposits' share in the overall profit and loss of the bank. This basis was almost the same from one year to another. Such ratios have been for the depositors with Jordan Islamic Bank for the period 1979-1981 as follows:-

(i) Savings accounts participate with 50 per cent of the deposit.

(ii) Notice accounts participate with 70 per cent of the deposit.

(iii) Fixed accounts participate with 90 per cent of the deposit. (31)

Here the principal difference from commercial banking practice emerges. Customers have been encouraged to deposit their funds in investment accounts on the basis of predetermined profit and loss sharing. The profit and loss ratio is usually higher for the long-term deposit accounts because they are more stable and the bank may use the funds for long-term investments. But it is natural for the savings account for depositors to receive a smaller percentage because the money deposited in this account is partly to earn income and partly to provide protection against unexpected expenditure. And such an account fulfils the functions of an investment account as well as those of a current account. (32)

In addition to the current and joint investment accounts Islamic banks have offered specified investment accounts. Here, depositors deposit theirfunds with a bank to be invested in a specified field or project, on the basis of receiving their profit and bearing their loss, where the bank obtains a certain per cent of net profit realised from the investment as compensation for its work and efforts. (33)

Similarly the Islamic banks have developed several instruments used in deploying their funds. These instruments are mainly based on early intruments formerly in use in the Islamic countries such as Modaraba, a partnership form of contract; and Takafal mutual guarantees against hazards. But with the increasing sophistication of present economic activities other instruments are being introduced. Today the Islamic institutions use the following instruments:

1. Morabha (trading finance) This technique has been used as an alternative to an interest-based letter of credit in financing trade by Islamic banks. Banks act as merchants by acquiring domestic or foreign goods at the request of their clients who will pay the bank for these goods in a lump sum or in installments, which includes a mark-up fee.

2. The second instrument Modoraba (trust financing) is one of the most important Islamic methods of financing an economic project. An Islamic financial institution may provide risk capital for the project in the form of equity and loans with equity features. Modaraba is a contract under which capital is advanced by an institution with the business and management efforts being the responsibility of a client. Profits are split according to a negotiated agreement and not as a percentage of capital. But loss

is borne by the institution alone, unless it can be proved that it was caused by negligence on the part of the client. This instrument has been used by Islamic financial institutions in advancing most types of long-term finance.

3. The third instrument is Musharaka, a system whereby a bank enters into partnership for a limited period of time with the client for a particular project. Both the bank and the client contribute to the capital, with the client maintaining the right to buy back gradually the bank's shares. Profits emanating from such a project are normally shared by the bank and the client according to predetermined ratios agreed by negotiation and not by the prevailing rate of borrowing capital. This technique is used in financing house building as in the case of the Housing Bank in Bahrain. The bank extends the loans fully or partially to the borrowers to build their own houses. The rents of the houses are received by the bank against the funds advanced for their construction. When the advanced funds are completely amortized the bank has no other right in regard to those houses. (34)

To these major instruments others have been added, such as the rental or lease agreement. This instrument has been used by the Islamic Development Bank and other Islamic institutions; they buy equipment which is then leased or given on a hire purchase basis according to the chairman of D.M.I. The system differs from normal rental because profits earned on repayment to such institutions are deducted from the total sum owed. Thus the borrowers end up paying much less than the principal if the institution makes significant profits on its overall investment operation. (35)

In the insurance field, the _Takafol_ companies have developed a solidarity certificate. These companies assume indemnity payments to their participating member if an agreed risk occurs to any of them. The funds of the company are managed as investment companies. Investment premiums paid into such companies and their accruing profits are re-invested in favour of the participants and remain their property until they withdraw from it. These certificates have been used for all types of insurance. The _Takafol_ is achieved by the creation of a _Takafol_ fund. Each policy holder agrees to donate a small poportion of the premiums to the fund. _Takafol_ benefits are paid from these funds which receive further support from the _re-Takafol_ company where the _Takafol_ fund premiums from different _Takafol_ companies are pooled.(36)

## 5.4 The importance of these instruments: Jordan Islamic Bank's experiment

Examining the structural changes in the financial position of the Islamic banks would shed light on the importance of such instruments. Information to permit us to do so is not available. We shall examine here the available data on the Jordan Islamic Bank for finance and investment for the period 1979-82.

From the data available for this bank see Table 5.1 we can see that on the asset side, cash and investment is the major area in which the bank's financial assets were deployed. The cash in hand and at other banks constituted approximately 80 per cent of the Bank's total assets in 1979, the first year of operation, but drastically dropped in 1982 to about 26 per cent. In contrast the bank's investment through the new financial instrument _Morabha_, _Modaraba_ and participation started modestly at about 10 per cent of the Bank's assets in 1979. It had

TABLE 5.1

Jordan Islamic Bank for Finance & Investment Balance Sheet as at end of each period in percentages

| | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|
| Cash in hand and at Banks | 79.2 | 42.6 | 44.8 | 25.8 |
| Financial Investment | 10.1 | 43.6 | 39.1 | 53.1 |
| (Mudaraba, Marababa & Participation) | | | | |
| Other Investments | | | 3.9 | 8.3 |
| Securities Portfolio | | | - | 0.4 |
| Bills Discounted | 0.5 | 0.2 | 0.4 | 0.2 |
| Fixed Assets | 5.4 | 3.9 | 3.1 | 3.0 |
| Specified Investment Project | | 5.4 | 4.0 | 2.5 |
| Other Assets | 4.8 | 4.3 | 4.7 | 6.7 |
| | 100.0 | 100.0 | 100.0 | 100.0 |
| Current Accounts & Other Deposits | 34.8 | 31.3 | 36.3 | 39.4 |
| Joint Investment Accounts | 19.4 | 43.9 | 40.7 | 36.0 |
| (savings, notice & fixed term accounts) | - | - | - | - |
| Bank Deposits | | | 0.2 | 3.6 |
| Specified Investment Accounts | 13.8 | 5.5 | 3.8 | 2.2 |
| Cash Margins | 4.4 | 2.9 | 4.5 | 4.9 |
| Provisions of Investment Risks | | 1.0 | 0.5 | 0.9 |
| Statutory Reserves | | | | |
| Voluntary Reserves | | | | 0.2 |
| Profits Brought Forward | | | | |
| Paid up Capital | 26.1 | 12.9 | 11.0 | 7.7 |
| Other Liabilities | 1.5 | 2.5 | 3.0 | 5.1 |

SOURCE: Jordan Islamic Bank Annual Report Various Issues.

substantially increased to about 53 per cent in 1982. This is an indication of significant progress toward the Bank's objective. Likewise, specific project investment increased in absolute terms but dropped in ratio terms in relation to the Bank's total assets. In 1983 the investment through Modaraba and Morabha increased 42 per cent on the 1982 figure; likewise specific project investment increased three fold. (37) These facts point to the savers' acceptance of some instruments more than others.

On the liability side the current account has been one of the main sources of funds for the bank: it accounted for approximately one third of the bank's liabilities during the period under consideration. The second important source of funds for the bank is the joint investment accounts (saving notice and fixed term account). Although it accounted for about one-fifth of the bank's total liabilities in 1979, it significantly increased to almost 44 per cent of the total bank liabilities a year after then again dropped by 3 per cent in the third year and stood at 36 per cent in the last year. In contrast the share of the specified investment accounts and the equity started high in the first year of operation, but they steadily declined and stood respectively at about 2 per cent and 8 per cent of the bank's total liabilities in the last year.

The structural changes in the bank's liabilities as discussed above seem to indicate the similarity between the Islamic banks and conventional banks in terms of the importance of saving, for both types of bank. Also the high share of the current account among the bank's liabilities which earn no income point, to the fact that depositors are ready to forge some income if there is any conflict with their cultural beliefs. This is evidenced by the maintenance of such accounts with the Jordan Islamic bank while customers have the alternative of going to the conventional banks and earning 2 per cent interest on such accounts.(38) Likewise we can conclude that the increased share of joint investment accounts in the bank's liabilities indicates the confidence and good response of the public to the new system. In contrast the drop in the share of specified investment accounts in the bank's liabilities points to the weak response of the public to such an instrument. But this is to be expected, since if the savers have in mind some project to invest in why should they ask the bank to do this for them when they have the choice of investing directly and earning the whole income instead paying some proportion of it for the bank.

The sectoral distribution of the bank's credit facilities is only available for a very short period as seen in Table 5.2. In fact the trade sector was the major recipient of the Banks' funds, although its share in the bank's facilities dropped from approximately 65 per cent in 1979 to about 43 per cent in early 1981 but it continued to be higher than for the other sectors. The amount of the drop in the share of the trade sector went to the construction sector whose share leapt up from just 1.3 per cent of the bank's credit to over 22 per cent in 1981. The increase in construction's share of credit is natural, because Islamic banks are usually allowed to invest in their own business or to part their funds as a complementary part into someone elses business efforts. It seems that housing projects attract their funds as is evident from the projects carried out by the Islamic Bank of Kuwait and its counter part in Jordan. Each of them developed a site of its own containing flats, schools, commercial buildings and other facilities.

TABLE 5.2

Jordan Islamic Bank's Credit Facilities to various economic sectors for the period December 1979 to January 1981.

| Economic Sectors | 1979 Dec | 1980 June | 1980 Dec | 1981 June | 1981 Dec |
|---|---|---|---|---|---|
| Agriculture | - | - | - | - | 1.0 |
| Industry & Mining | 5.7 | 5.2 | 10.6 | 9.1 | 6.5 |
| Construction | 1.3 | 3.3 | 11.4 | 12.6 | 22.4 |
| Transportation | 25.9 | 4.4 | 10.9 | 8.9 | 16.6 |
| Trade | 64.9 | 82.8 | 63.5 | 58.3 | 43.3 |
| Tourist | - | 1.4 | 2.3 | 1.7 | 7.7 |
| Others | 2.2 | 1.9 | 1.3 | 9.4 | 2.5 |
| TOTAL | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

SOURCE: A Study on "The Role of Islamic Banks in Development". Jordan Central Bank (1982), p.24.

The bias towards the trade and construction finance leaves a small fund to be channelled to the agricultural and industrial sectors. Thus the credit facilities extended to the productive sectors rose at a slower rate than those extended to finance constructuion activities. The relative importance of credit facilities extended to the agricultural sector rose to one per cent at the end of the period and those extended to industry and mining fluctuated sharply from 1.3 per cent to 11.4 per cent then back to 6.5 per cent during the same period.

Against this background of the distribution of credit facilities by Jordan's Islamic bank it seems that the perception of risk among commercial and Islamic banks is the same.Both types of bank have favoured trade activities when extending their credit, because it is the most profitable way of deploying their funds. And this points to the fact that Islamic banks are profit oriented institutions and neither the banks nor their depositors are motivated by purely philanthropic considerations. They reject the interest-based employment of funds but replace it by a mark-up price technique. If this trend in the lending policy of the Jordan Islamic Bank continues this will mean that the Bank's role in the development process will not differ from the role of commercial banks but in objective terms it must be admitted that data for a short period and for only one bank in no way gives conclusive results.

In addition, one has to be realistic enough to see the limitation of bank operations in the early years. If the bank has to employ its funds in such a way that an overall profit will result and which can be distributed to the capital owners and depositors every year, the bank cannot invest all long-term deposits into investments which earn profits immediately. In addition to these objective reasons, some banks are simply too conservative in their loan application procedures and the lack of well-trained staff to evaluate loan applications in the light of the enterpreneurs personal capacities rather than actual guarantees, and taking into account the firm's potential after expansion rather than its present situation would lead to such result.

It seems from the above discussion that the Islamic institutions found the way to mobilize funds and to channel long-term finance for investment. But on short-term borrowing the Islamic banks are less clear. How can they satisfy the demand for consumer credit. The extention of interest-free loans in cases of hardship is not sufficient and in no way can solve the problems in this area of rapidly growing demand. Likewise, the hire-purchase agreement developed by Islamic banks can partially solve the problem because not all goods can be purchased by the Islamic banks to be sold to their clients for payment in instalments.

The suggestion by some that such loans be granted either through a government agency or through people's co-operative societies points to the deficiency in the newly developed financial instruments. The micro-economic conception of Islamic financial institutions on the basis of profit-sharing was originally developed under the explicit assumption of the general prohibition of interest and that the system would function and be successful in modern industrializing economics of Moslem countries. (39)

To some, the apparent impossibility of squaring these difficulties simply under lines the need for further innovation. The co-operation of Central Banks is essential to promote the development of such institutions as is interest-free dealing.

## 5.5 The developmental impact of the Islamic financial institutions

The introduction of the Islamic financial institutions was not merely a response to the desire of those looking for Islamic legitimate dealings, but also a fulfilment of a consistent need for such a specialised institution functioning profitably and in a way that makes usurious transactions unnecessary. According to its proponents it ensures a better allocation of resources and a more equitable distribution of income and wealth.(40) The advantages, as we see them, are as follows:

1. The deposits in the Islamic financial institutions originate from two different groups of customers: those who had accounts in conventional banks (41) and transferred them to the new Islamic institutions; and those who had refrained from dealing with traditional banks even to the extent of depositing funds without claiming any interest. It is difficult to know exactly how much money is kept outside banks because of religious convictions. It has been estimated, however, that such funds are worth several thousand million dollars in Saudi Arabia alone. Others kept substantial sums in non-interest bearing accounts in commercial banks in Arab countries. About a quarter of deposits in these banks are thought to be of this nature. (42)

   The importance to the Islamic bank in mobilizing savings is related to the number of new depositors with no previous contact with the financial institutions. The larger the number, the more important are Islamic banks from the perspective of economic development.

2. In analogy to the savers who had no bank accounts with the conventional banks there had been some entrepreneurs who refrained from borrowing from such banks. The introduction of the Islamic financial institutions made it possible for them to finance their projects which they would not have been able to do had there been no legitimate Islamic way. Thus the Islamic financial institutions have contributed substantially in increasing savings on one side and demand for investments on the other.(43) And the contribution of the financial institutions to economic development is usually related to their role in the saving investment process. Indeed this is the developmental function of every financial institution and by the volume of funds mobilization and allocated by the financial institution its impact on the growth and prosperity of the economy is judged.

3. Developing new financial instruments based on the religious code accepted by the people added to the traditional ones and enlarged the number of financial instruments available to savers and borrowers alike. The developed financial market aids the market with a wide range of financial instruments.

From the developmental point of view the introduction of financial instruments accepted by people with savings may stop the flow of capital outside the region and eventually alleviate the liquidity problem which has been the chief feature of the financial system in the Peninsula countries. The problem was picked out by Wilson as the greatest threat to sound banking practice in such countries and called for the introduction of new domestic savings instruments in harmony with Sharia Law. (44)

4. The joint venture principle of the Islamic institutuions is more ethical according to Al-Sabah, vice chairman of D.M.I.,

> "no project would fail due to the heavy debt service it has to cope with". (45)

This approach prevents the waste of productive human energy. The participation of the Islamic financial institution in profit and loss would release the borrowers from the burden when things go wrong. (46) There are always certain economic and social events, beyond the control of individuals, which may lend to a fall in profits. In the interest rate system this increasing loses of the sponsor who have to pay interest on its borrowed money. In the joint venture arrangements both possibilities are minimized.

5. As the Islamic financial institutions face restrictions on all interest-based employment of funds, they cannot rely as the commercial banks and other conventional institutuions do on the differential between the deposit and lending rate. They have to accelerate the development process in the communities by using full force of their potential and capabilities in the investment resources. (47) And as they are partners with the borrowers they have to examine carefully all the available projects and channel their funds into the most productive ones, which means better

allocation of scarce capital. In addition with a repressed interest rate structure in the region, unification of financial markets is difficult and eventually efficiency in the allocation of resourrces is remote. The Islamic financial institutions with their operation on the profit-and loss-sharing concept avoid the issue completely. Thus it stands a better chance of unifying Arab markets and allocating resources more efficiently than the commercial banks with their sticky financial instruments.

Nevertheless, the Islamic institutions must find profitable outlets for their fast-growing deposits. The ceiling imposed on depositors to discourage them from depositing with such banks is not the answer. (48) The Islamic banks have to take all deposits coming to them and should not discourage new depositors. The finance of trade is the area where strong competition with commercial banks reduces their profit. Therefore, Islamic banks are expected to give more attention to areas which have been neglected by the conventional banks but could bring reasonable profits. Such an area could be financing of new or expanding manufacturing or agro-industries on the basis of profit and loss sharing arrangements. Balancing the chances and risks of medium and long-term investment, most coventional banks prefer to employ their funds in self-liquidating loans usually secured by collateral. Many Arab banks have found in Euromoney and international markets an attractive outlet for placing large sums of their money. All such areas which are most attractive for conventional banks are closed for Islamic banks. Under these constraints, the strategies of the Islamic banks are expected to be directed towards participation in the establishment of new firms. People with entrepreneurial talent find it difficult to get capital from a conventional bank for the establishment of new ventures since they cannot offer the commercial banks the required collateral; and without a well developed capital market, there is usually no other way of obtaining the necessary.

The Islamic banks' investment on the basis of profit and loss sharing arrangements cannot rely on collateral. The banks must base their decisions about the participation on the entrepreneur's qualities. Thus they have to train and acquire highly qualified personnel who are able to understand and asses enterpreneurial decisions and plans. So Islamic banks should have on their staff lawyers, engineers, economists and others if they want to contribute effectively to the development of the region.

## 5.6 Conclusion

The introduction of the Islamic financial institution in the Arab region has filled the gap left by the conventional financial institutions in serving the community as a whole. In addition the operation of these institutions on the profit, and loss-sharing principle, which is not subject to any control, may keep part of the capital in the region which otherwise would find its way abroad in the absence of such an instrument.

However, it seems that the number of Islamic financial institutions which has been established so far is not sufficient to cover the increasing demand on their services. The imposed ceiling on the amount of funds a depositor can save in some Islamic banks is evidence of that. The other shortcoming of the Islamic financial institutions is the fact that they took to the urban areas as a place of operation. Thus for the Islamic financial institutions to be effective in the saving/investment process, they should expand in number and geographical coverage to the rural areas. This will help to pay for the savings of such forgotten areas and allow the bank to identify the investment opportunities in the countryside. The experience of the past few years show that the Islamic financial institutions have emerged in response to the strong demand on their services which in one respect makes them the beneficiary of growth rather than the cause of it. But their operation on the profit-and loss-sharing principle makes them active partners in the process of development, and gives them the feature of the development banks or the supply led institutions.

The prospects of the Islamic financial institutions are promising, but they need further innovation and imagination in order to introduce further instruments. On the short-term borrowing policy of the Islamic banks is less clear and on maintaining liquidity Islamic banks have to strike a balance between income and solvency. Leaving aside the difficulties the Islamic financial institutions may encounter in the management of their affairs.

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# CHAPTER SIX

## SECURITIES MARKETS

## Securities Markets

### Introduction

The securities markets are the markets for the exchange of financial claims for capital. They are an indispensable part of the mechanism of a capitalist economy since they facilitate borrowing by governments and industry and the movements in the price of financial securities on them reflect a country's economic prospects. Their significance for economic development lies in their potential role as a catalyst by which long-term saving may be channelled into productive real investment.(1)

Given this important function expected of such markets, some Arab countries have established their own organized stock exchanges and others are in the process of establishing them. However, the growth of such markets is a slow process and the outcome of the overall rate of development. It is not expected that Arab stock markets will be found to be of much significance in the flow of funds for development. However, the policy of developing the Arab financial intermediaries must be supplemented by the development of securities markets. An efficient well developed national or regional stock exchange might prove essential for the transfer of resources to the sectors in the region where the desired expertise and entrepreneurship are abundant. This chapter attempts to examine the nature and importance of these markets in general, the evolution and development of these markets in the region, and their role in development. This will allow us to explore the conditions of these markets and identify the factors impeding their development and also enables us to propose some measures which could strengthen the existing markets, and other measures to create a regional market.

## 6.1 The nature and significance of the stock market

Securities markets usually begin as an informal agreement between borrowers and lender of funds. Governments and private enterprises usually sell their stocks and shares to the public on such markets. The markets where funds are raised for the first time are known as the primary markets. The holders of these securites may sell them for funds if they wish on the secondary market. The stock market provides facilities for dealing in these securities and in particular outstanding securities. When the securities grow large along with their buyers and sellers, some of these markets become organized through the efforts of their participants or public authorities. The best known organized market of securities is the stock exchange.

The stock market is the prime institution in the capital markets of Britain and the U.S.A. Historically, the stock markets in these countries evolved at an early stage of their financial development to provide long-term finance for housing or plants and equipment. This allowed the banking system in both countries to became too specialized. In Germany and Japan, where the climate was not favourable for the stock markets, the universal bank was introduced and the stock markets remained small and dependant on banks for their growth.(2) In the developing countries, the stock market made its appearance when the governments, public authorities or private enterprises began borrowing locally.(3)

The significance of the securities market for a country's economic development emanates from the two functions of the market: Firstly, the market acts as a link between borrowers and savers in the economy. Secondly the market via the stock exchange provides the holders of such securites with a mechanism to reshuffle them and restore their liquidity. This enables savers to place their funds in long-term securities with firms and governments, and so keep up the flow of funds demanded by the latter since the savers know that they will be able to withdraw their money at the time of their choosing by selling their securities for a reasonable price on the stock exchange.

In an efficient market, long-term investments in real corporate assets do not have to be financed by equally long-term commitment of funds by any one investor. The funding is long-term for investors as a group, but it can be short-term for any individual investor who can sell his securities to another investor.

Within this context the Wilson Committee Report outlined four ways in which the capital market may contribute to the economy:

1. By balancing saving and investment at a high level.
2. Facilitating saving and investment by providing a wide range of securities which borrowers may wish to issue and savers may wish to hold.
3. By valuing securities so as to reflect consistently the returns expected from them.
4. Facilitating pressures on management to use the resources under their control efficiency.(4)

In the developing countries with different institutional arrangements, many economists have been very sceptical regarding the importance of stock exchanges or economic development.(5) This scepticism emanates from several factors. First, the necessary condition for the effectiveness of these markets does not exist to the same content as in the

the developed countries. Few, if any, of the present developing countries can claim to possess a high monetised economy, a large number of savers and borrowers or more importantly an established habit of investment in financial assets. Without these conditions a stock market would remain weak and ineffective.(6) Secondly even if all these conditions did exist, creating an efficient market according to any reasonable definition (7) would not necessarily take care of the need to channel resources into socially desirable projects not subject to the price mechanism.(8)

Other economists have called for the development of the capital market (including the stock exchanges) as one of the major instruments in mobilizing savings and channelling them for investment.(9) This issue has been discussed before but I feel it is necessary to add some arguments relating to the stock exchange itself. Newlyn justified the establishment of stock markets as being complementary to financial intermediaries in countries where the formal banking system is patterned on the conventions of the 'British' type of banking system.(10) Williams called for its establishment to speed up the flow of long-term saving from comparatively capital-rich countries to the capital-hungry developing countries, and to ease rich countries problems involing balance of payment.(11) Drake acknowledged the fact that although the securities market is not a key to rapid economic growth it does enlarge the financial sector and so increases the opportunities for specialization, the division of labour and a reduction of costs in financial activities.(12)

## 6.2 Evolution and development of the Arab stock exchanges

The Stock Exchanges in the Arab region are of recent origin and the vast majority of the Arab countries have yet to establish such institutions. This is due, among other things, to the fact that institutional conditions for the operations of such markets do not yet exist in many Arab countries. Such institutions were first introduced in the early years of this century in Lebanon, Tunisia, and Morocco by the French colonial authorities, and in Egypt under the influence of the foreign community.

However, their introduction at that time, in the absence of any indigenous financial securities and low per capita income, meant that these institutions were only markets for gold and some foreign securities, and when foreign interest was liquidated their activities almost ceased.

It was only in their post independence period that the Arab countries began to truly develop their financial systems. This proceeded slowly during the 1950's and 1960's, but the 1970's saw an increase in development. In the early 1970's, after the oil prices rise, the region witnessed an unprecedented flow of liquid wealth, which was reflected in considerable structureal changes. During the course of development in the last three decades, the Arab governments have played a major role in economic activities and have invested heavily in various economic sectors. Consequently, some important economic measures have been undertaken and controlled by government agencies or corporations. However, business and industry have primarily remained in the hands of the private sector.

To encourage the private sector to play a more active role in the development efforts and so improve productivity, absorption of modern technology, and fuller utilization of their capacity, the Arab governments initiated and organized the appropriate facilities. So many specialized credit agencies were created as examined in chapter four. In addition investment allowances were introduced for local and foreign investors. These include, tax incentives, risk insurance, joint ventures, project preparing institutions, local training facilities, but incentives are usually accompanied by limitations.(13) Other Arab countries governments have followed this line of private sectors promotion and have thus established their own organizational stock markets in order to facilitate to the private sectors more long term finance. Kuwait and Jordan officially organized their stock markets for the first time in the late 1970's. In the Peninsula countries with enormous liquid wealth the laws for such markets was passed but not implemented yet. Tunisia, Morocco and Egypt reviewed their previous stock institutions and officially reorganized them. So today, the organizational pattern governing the Arab securities markets ranges from an almost total absence of rules to a pattern which is based on extensive regulation.

### 6.2.1 Structure and practice of the Arab stock exchange

The organized stock exchanges in the Arab region (in Jordan, Kuwait, Egypt, Tunisia and Morocco) are public autonomous institutions, having an exclusive right to operate an exchange for public trading in, and quotations of, equities, bonds and similar securities.(14) However, beside these organized markets there are also unofficial markets for securities in these countries. The organized markets are supervised and run by their respective committees.

A Stock Exchange Committee is usually appointed by the Minister for Industry and Finance for a period of three years. But the committees differ in their number and in their representation of economic activities. For example, the Amman Financial Market Committee is made up of six members of which three represent the public sector and two the private sector in addition to the director of the market.(15) Whereas, Kuwait's Stock Exchange Committee is broader than AFM's committee and more representative of the private sector. It is made up of eleven members and chaired by the Minister of Commerce and Industry. The other members, apart from the market director, comprise three representatives of the public sector and six of the private sector.(16)

The securities and exchange committee's main function is to protect individual investors by ensuring that prices are fair, open and competitive and that market advice is impersonal and informal. To achieve these objectives, the Committees have by law, been given the power to issue further regulations, specifying the information needed in the published prospectus, setting the rate of commission collected by dealers, enforcing discipline, hearing disputes or complaints between members, authorising the quotation of equity shares, bonds similar securities, cancelling the quotation of stocks and if necessary suspending all operations for a short or long period.(17) However, any decision of the latter nature made by these committees must be ratified by the Minister for Industry or the Council of Ministers as set out in their acts.(18)

The securities traded on these markets are on the whole specified by their laws. These securities fall into two main groups, the fixed-interest paper such as debentures and government bonds, and dividend certificate-shares. The law governing Amman's Financial Market defined the financial papers that may be traded on the Market as the negotiable shares, bills and bonds issued in Jordan by the government, government institutions, municipalities or public and private Jordanian share-holding companies, or any other negotiable financial papers.(19) The Kuwait Stock Exchange law defined the financial paper that may be traded in the same manner of AFM's law but adds foreign securities if accepted by the Market.(20)

However, the provisions of regulations on listing financial instruments on these markets differ from one country to another. For instance Amman Financial Market's law make listing compulsory for all bonds issued by government or governmental institutions, public share-holding limited and private companies. Also every Jordanian public share-holding limited company with a paid capital of JD 100 000 or more is obliged for listing its stock on AFM.(21) This is in contrast to Lebanon where governments securities are not allowed to be traded on the market.(22) In the other Arab stock exchanges the listing of financial instruments is optional but the requirement for admission by the markets differ from one country to another. For instance in Kuwait and in Jordan, companies seeking admission to the markets must show profitable activities in the previous two years to their application to be accepted into the markets. In Morocco such companies may be accepted without fulfilling many of these requirements.(23)

The brokers in the Arab stock exchanges differ also from one country to another. In Saudi Arabia and Morocco, commercial banks are the only brokers on both markets. This is an analogy to the German practice. In Jordan, Kuwait and Egypt brokers are limited to those holding a stock broker's licence. That means any one person or legal body filling all the conditions prescribed by these markets can apply for a license and act as broker. This is in line with London Stock Exchange System.

The laws of these markets stipulate that all dealings have to be made through the brokers. The latter buy and sell securities on these markets for clients on commission basis at a rate fixed and supervised by the Markets' Committees.(24)

The Kuwait Stock Exchanges' new regulations prudently stated that brokers are strictly forbidden to deal from their own account and must execute such trade through another licensed broker.(25) While in AFM recently abandoned this practice. Here brokers are classified according to their functions, into five categories:

1. Broker's acting as agents for buying and selling to the public.
2. Broker's acting for their own account.
3. Broker's acting as underwriters for shareholding companies which offer their shares for public subscription and underwrite the new issues of bonds.
4. Broker's acting as sellers of new issues.
5. Broker's acting as advisors.(26)

For a broker to take underwriting business or to operate for his own account AFM's regulation requires it to be a public share-holding company with a specified amount of capital.(27) The discrimination between brokers on the basis of capital is not justifiable and it is considered to represent a bias towards certain interests. This is clear in the regulations as these leave it at the discretion of the Committee to allow a broker to operate on his own account. If those brokers allowed to underwrite public issue were also allowed to deal for their accounts they might manipulate the sale of securities in their own interest. Furthermore, if those allowed to deal for their own account were also allowed to deal as agents, a conflict of interest would soon arise, particularly if prices went down. Such a broker may sell his shares before taking the interest of his customer.

The broker on the Arab stock exchanges are changing over time. The number of brokers on AFM reached 27, of which two are ordinary companies, while the other 8 are joint - stock companies with a total capital of about JD 40 million.(28) The number of brokers in the Kawait stock exchange amounted to 16, but since 1983 a new formula has emerged. The 16 brokers have emerged into four brokerage houses.(29) For a long time the brokers in the Moroccan Stock Exchange have comprised the eleven Moroccan national banks and the Moroccan broker company. In Egypt the number of brokers has declined from over 300 a few years back to just 22 in 1983.(30) Dealing and quotations take place on these markets on all week days, except public holidays, during fixed hours. Quotations take place on the basis of the bids and offers made. In Kuwait quotations were originally based on free dealing between members,(31) but recently this was changed to an auction system. Dealing, closing prices and turnover are marked on the exchange board and published for the interest of the public. Non of them had a clearing system. Securities bought are collected by the buyer at the sellers place of business but there are time limits for settlement.

In addition to these organized markets there have been other unofficial markets for financial securities. These markets have been operating in less stringent fashion than the organized ones. No committees supervise their operation and no admission requirements are laid down for the securities or brokers. On the regional leel few if any co-ordination measures were taken between the Arab Stock Exchanges. Apart from the establishment of the Federation of the Arab Stock Exchanges. (32) The Arab Stock Exchanges remain national markets with their own management, regulations and powers relating to their own members. Their operations are limited to their national financial securities and citizens. No foreign securities are currently quoted or dealt on any of them. The adoption of an investment code recently,(33) by the Arab states based on multilateral support and recognition of the interest of both investor and host country could play an important part in regional development by encouraging a greater volume of inter-Arab capital flows which may lead for listing Arab securities on all Arab Stock Exchanges.

To explore the Arab Stock exchanges growth operation we shall proceed to examine the two active markets separately, followed by an overall development of other markets.

### 6.2.2 Amman Financial Market

The call for the establishment of a stock exchange in Jordan was first made in the 7 Year Plan of 1964. It noted:

> "considering the state of recent economic and financial development in Jordan, serious efforts must be made to encourage and accelerate the growth of the capital market in the country. Although the development of such an institution is essentially a slow process, its early establishment would be instrumental in orienting Jordan's financial structure to the long-term growth requirements and potentialities of the economy",(34)

Considering the state of Jordan's economic structure in those years during which agriculture was the predominant sector contributing to the GDP of the country, and the industrial sector was mainly composed of small hand crafts, the call was not based on solid grounds. In short, the institutional conditions required for such a market to be effective did not exist. However, in the late 1970's continuous spill over of neighbouring countries' wealth to Jordan created considerable structural changes; the industrial sector grew, new financial institutions were created, more joint stock companies were established and, moreover, people became interested in holding financial assets. These changes were confirmed by the International Finance Coporation's feasibility study in 1976 concerning the establishment of a stock exchange in Jordan.(35) Among other things the study estimated a rough figure of JD 200 million in securities outstanding by 1980,(36) an amount which was considered adequate to warrant the establishment of a Stock Exchange in Jordan. So the provisional law No.31 of 1976 was passed to provide the framework for the operations of AFM.

Jordan has resorted to domestic borrowing unlike the oil rich countries. Since 1969 the Government of Jordan has introduced Treasury Bills to even out seasonal variations in the normal flow of its revenues and to provide local outlets for the retention of funds. Then in the early 1970's it began issuing bonds to secure long-term funds to finance development. Since then the government securities have grown in size.

The outstanding treasury bills and bonds stood at the end of 1983 at JD 96.5 million and JD 85 million respectively.(37) Corporation bonds were late arrivals. The first of such instruments was issued in 1979.

Since then there have been fourteen such issues amounting to JD 62 million at the end of 1983.(38) The equity shares appeared in Jordan in the late 1940's and since then there have been subsequent issues. By 1978, the shares of the public shareholding companies with a capital of over JD 100,000 reached about 85 million capitalised at JD 246.(39) When AFM began operation in 1978 there was some government securities and equity shares in the market. The trade in equity shares began on the market in 1978, and one year later some government and corporate bonds were listed on the market.

The trade in shares had grown steadily but the bonds market were on the whole left outside the market. This is clear in examining the securities transacted on AFM during the period 1978-1983 as given in Appendix 6.1. In terms of number and value the major proportion of transaction has been in equity shares. The number of traded shares was about 2-4 million in 1978, and steadily increased to approximately 36.4 million in 1983. In parallel to this the volume of trading rose from JD 5.6 million in 1978, to slightly over JD 119 million at the end of the period under consideration. During the same period, transactions in government and corporate bonds has been insignificant. The highest was in 1981 when about 217 000 bonds to the value of JD 2.3 million was traded in the market. This fell to 43 000 bonds with a value of JD 0.6 million in 1983. This left the bonds market in the hands of the financial institutions as it can be seen in Appendix 6.2.

The relatively active trade in equity shares caused the price to increase rapidly. So to curb this AFM applied a ceiling on price movements in 1980.(40) The ceiling was kept for two years then abolished in 1982. With speculators now left with no control over their activity, the overall traded shares price index went up sharply from 199 in 1981 to 263 in 1983.(41)

In dealing with this problem, the supply of shares was thought to be small, and so the Market agreed in 1982 to allow trade in the shares of the newly established companies to take place on the Market without fulfilling the official market requirements (i.e. to have made profit in the previous two years). This action was justified on the grounds of allowing fair dealing in the shares of these companies by exposing their trade for greater participation. Consequently, the parallel market began in 1982 in the shares of twenty four companies for half an hour before trading hours on the AFM. The volume of trade in the shares had grown but continued to be modest.

Other measures were taken to increase the supply and demand of financial securities in Jordan. These included:

1. Exemption of the net profits of an approved economic project from income tax and social services tax for a period of nine years, if the project was a public share holding company. Otherwise it would be exempted for six years.(42)
2. Subjecting public shareholding companies to tax rates lower than the tax rates on unincorporated business.(43)
3. Exemption from income tax, and social services tax, all income earned from government and corporation bonds as well as capital gain originated from trade in financial securities.(44)
4. Requiring the listed companies to make more disclosures by sending their annual and audited balance sheets and income statements to the share holders and a copy for the AFM, and

prompt notification of AFM of all matters arising which may influence the company's share prices.(45)

In addition to these measures, other measures were taken to attract Arab capital towards investment in Jordanian financial securities or to allow Arab projects to raise capital on the AFM.
These included:

1. Arab investors being exempted from obtaining the approval of the Prime Minister to trade in securities listed on AFM.(46)
2. Arab investor being allowed to buy listed securities of Jordan public share holding companies with any currency. Also they were allowed to sell these securities and transfer their values abroad in any currency, without fulfilling any conditions.(47)
3. On a reciprocal basis it was made possible for any Arab project or citizen to raise funds in Jordan if the Jordanian project or national could do so in their country.(48)

### 6.2.3 The development of securities markets in Kuwait

Kuwait was the first of the peninsula countries to develop various types of securities markets, since it was the first to enjoy wealth and so develop more sophisticated savers. It began receiving enormous oil revenues two decades earlier than its neighbours. The oil revenues accrued to the government, of course, but they found their way to the Kuwaiti citizens in various ways, chiefly among them the land purchase programme at inflated prices. Through this programme the government bought land from the private citizens valuing over KD 1260 million during the 1960's and 1970's.(49) Consequently, the Kuwaiti private sector became the most prosperous sector in the region and developed the equity shares market and the Kuwaiti dinar bond. In contrast, the wealth of the public sector in Kuwait prevented the development of any type of government securities.

Regarding the equity share market: although Kuwait's wealth was dear in the early 1950's, trade in shares did not begin until the early 1960's and finally became effective in the early 1970's. During the 1950's, Kuwait had only two public share holding companies, compared with 15 in 1963 and 31 in 1973.(50) With the increase in the number of share holding companies the market in their shares was consolidated and trade began to be very hectic. In the mid 1960's, the World Bank Mission to Kuwait criticized the way in which Kuwait's government channelled funds to the citizen, and called for the introduction of an organized securities market to deter the flight of capital outside the country.(51) This promoted the government of Kuwait to pass Law No.32 of 1970 which asked the Minister of Commerce and Industry to chair a Committee for the study of the possibility of establishing a stock exchange and to draft its law and regulations.(52)

In 1971, the Minister order the Department of Companies and Insurance Control in its Ministry to supervise dealings in the securities market. Consequently a decree was issued obliging dealers in Kuwait to register at the Ministry and to report daily information concerning all transactions in securities to the Ministry. So, the Department began producing daily data concerning the price and volume of investment of shares. This practice continued up until 1976 when the Minister of Industry issued a decision (No.61 of 1976) concerning the trade in financial securities. In accordance with this decision the financial securities committee was established and given great powers to organise the trade in the financial securities. The committee succeeded in its assignment and in 1977 the Kuwait Stock Exchange was established.(53)

In 1977, two separate stock exchanges began operation in Kuwait. Along side the official Market where the equity shares of the Kuwait companies were traded on, unofficial market emerged better known as Sug al-Manakh where the shares of companies incorporated in the Gulf States traded. The development of the second market was inevitable in the circumstances of Kuwait. The increased number of the public shareholding companies in Kuwait in the early 1970s, and given the narrow base of the country's economy persuaded the government of Kuwait to restrict the establishment of new companies. This caused the extremely wealthy Kuwaitis to look elsewhere for establishing their own companies . Soon they found the other Gulf states with their liberal financial legislations the appropriate place for their companies. Consequently many companies were established there. As these companies were not incorporated under the Kuwaiti companies law they were not eligible to be accepted on the official market. So the unofficial market began.(54)

By the late 1970s, there were about 42 Kuwait public shareholding companies capitalized at KD 429 million, and over 30 companies registered in the Gulf states. Trading in equity shares on both markets was very large but with erratic fluctuations. For instance the volume of traded shares on the official market was about KD 176 million in 1976, dropped to KD 60 million in 1977 then rose to KD 164 in 1978 and further to KD 246 million in 1981 then dropped again to about KD 162 in 1982. See Appendix 6.3. There are no available trade figures on the unofficial market but presumably it was almost equivalent to trade on the official market because they had almost the same number of listed companies and the share prices on the unofficial market witnessed the most dramatic rises that have ever been recorded.

The speculative activities were facilitated through the use of post-dated cheques for payment on delivery. In this uniquely Kuwaiti mechanism of future trading using post-dated cheques, the buyer immediately received the shares which he could then use to keep the cycles going. The seller had a post-dated cheque with a built-in interest rate reflecting expectations of the shares' future value. The interest rates on these cheques was in the mid 1970s about 25 percent premia for a 12 month delivery but in 1980/1891 it had risen to over 100 percent. Under this inflationary system, the buyer could then sell his shares, while the seller could secure more funds with his post-dated cheques. The system could not last, however, as more and more traders jumped onto the bandwagon. The result was dramatic rises in the share prices in some years followed by steep decline in others.(55)

In 1982 the unofficial market collapsed leaving about $97 billion of unsettled post-dated cheques,(56) and making a drastic effect on the future of Stock Exchanges in the region because it left that huge amount of debt unsettled.(57)

Due to successive crashes in the Kuwait Stock Exchanges in order to cool speculate fever, new regulations were passed in 1983 modelled on AFM regulations. These included six-day a week trading during morning and evening sessions of two hours each. This would give the participants sufficient time to think. Settlement would be in cash within three working days. This implied a ban on post dated cheques which had led to the two crashes in the securities markets in Kuwait. All trading must be done on the floor and registered on the 'big board' to eliminate any insider trading. If these regulations were observed the stock exchange in Kuwait could function properly.

The other most significant development in the Kuwaiti securities market has been the development of the Kuwaiti dinar bond market. It was initiated in 1968 when the World Bank effected six private placements in Kuwait dinar totalling KD 130 million through the Kuwaiti investment companies. The market was initially supported by the government on the grounds that developing financial instruments dominating its own currency would reduce the risk inherent in foreign exchange and the market would help to diversify the holding of financial securities.(58)

In 1974, the market received the first public issues. This was followed by 75 public issues in the subsequent years as seen in Appendix 6.4. The market was at its highest between 1975 and 1979 with 56 issues brought to the market worth nearly KD 390 millions. To develop a market in local bond the Industrial Bank of Kuwait issued a KD 5 million bond in 1975. This was followed by similar issues by the Real Estate Bank. So the Kuwaiti dinar bond was developed for local and foreign customers. However, the high interest rate on the dollar adversely affected the operation of the market as much of Kuwaiti capital left the country. As a result a muratorium was imposed upon new issues for some time to ease domestic liquidity. And in organizing the market the central bank of Kuwait stipulated that for an issue to be raised in Kuwait it must be managed or led by a Kuwaiti institution and to give prior information about the issue.(59)

The lack of new issues gives rise to continued concern as to the long-term viability of the Kuwaiti dinar bond market with its implications of a declining volume of medium term fixed income investment assets in the monetary system. But the favourable investment mechanics of the market contributed to renewed interest from borrowers and lenders alike. The former came to the market to benefit from the artificially low rate against the rising dollar interest rate. The latter also bought the bonds because the yields on Kuwait dinar bonds exceeded intermediate money market rates by some points. In addition the surge in market activity was also related to advances in Kuwaiti monetary infrastructure, including the creation of a secondary market mechanism. (60)

Secondary trading got off the ground with the formation of the Arab Company for Trading Securities (ACTS) in 1978. Appendix 6.4 shows dealing was extremely active with a total turnover of over KD 140 millions which represented at that time almost half of the floated bonds. The high turnover was mainly stimulated by the fact that funding costs were in the range of 5-6 percent compared to yields of 9-10 percent on medium - term bonds.

### 6.2.4 Other Arab Securities markets

The experience of Kuwait can in no way apply to other Peninsula countries. Saudi Arabia government has received more oil revenues than Kuwait, but the population of Suadi Arabia is almost six times that of Kuwait. Likewise the UAEs has received a great deal of oil revenues but the oil discovery was late in 1970. The other Gulf states such as Qatar, Bahrain and Oman have relatively modest oil revenues compared to their neighbours. So under these circumstances none of them has developed securities markets equivalent to those in Kuwait.

In the early 1980s when the financial instruments grew large enough to create organized stock exchanges in these countries, they were discouraged by the crash in the Kuwait Stock Exchange. So dealing in shares has continued in unorganized markets, although the laws for such markets were passed in Bahrain and the United Arab Emirates, but the formal market has not been established yet in any one of them.

Bahrain set up a new stocks and shares information centre in the Commerce Ministry. Consequently, there are now 19 dealers registered in the Ministry and the investment companies are trying hard to assume the same function and trade on the market. (61) The drive for the establishment of the Bahrain stock exchange is due, among other reasons to the efforts of the offshore financial institutions to develop a regional capital market there. They hope to see a developed market to bring in the Japanese and US stocks and to be listed on the market through the issuing of depositary receipts.(62)

Saudi Arabia had not tried to develop a fully fledged capital market probably for fear of internationalizing the riyal, and so proceeded cautiously in this direction.(63) The need for the establishment of order in the equity market was felt with the emergence of several large shareholding companies in recent years. In 1983, the government ended the old practice of share trading through the share dealers offices when a Royal degree was issued asking Saudi Arabia commercial banks to act as share brokers.(64) As the banks are not acquainted with this line of business they collectively set up a commercial company to register ownership and transfer of shares. This conservative approach is in compliance with the overall financial development policy of the country. The desire on the part of the government is to build an egalitarian economy and the feeling that share ownership is concentrated in few hands prevented it from establishing a full stock exchange.

In the Northern Arab countries namely, Egypt, Lebanon, Morocco and Tunisia, their old stock exchanges were established through the efforts of the market participants, so they were not officially recognized or based on legal rules. Their organizations were based almost entirely on self regulation. The council in these institutions enforced the rules against one member on behalf and for the protection of all other members. For this they were merely an association in respect of their member.

In the post-independence period, the Egyptian, Moroccan and Tunisian governments began borrowing locally to finance their development effort. Hence the need for an organized securities markets was pressing. So Tunisia and Morocco reorganized officially their own stock exchanges in the late 1960s, and Egypt revived its stock exchange in the mid 1970's after almost 15 years of closure while Lebanon passed a new resolution to modernize its institutions.

The stock exchanges of these countries have grown very little. This is evident in the small size of the securities listed on these markets and more important in the small volume of traded activities. For instance the Beirut Stock Exchange had attracted little business. In its peak, in 1974 the market had succeeded in listing 33 companies with a capital share of about 1157 million Lebanese pounds, and the volume of trade was about 49 million. In the following years the market activities have declined.(65) In contrast the market for government securities has grown very rapidly. The favourable balance of payments and the government budget of Lebanon before the civil war in the mid 1970s prevented the development of any significant government securities in those years. But in recent years the Lebanese government has resorted to domestic borrowing on a very large scale as its revenues fall short of its expenditures. This is so because the long civil war and the Israeli invasion of Lebanon in 1982 destroyed the country. Government borrowing began mounting year after year as can be seen from (Appendix 6.5). Consequently the outstanding debt rose from half a billion Lebanese pounds in 1977 to over LP.17.3 billion in 1983. The great amounts of government issued bonds created a _de facto_ free wheeling government bond market. As the government securities are not allowed to be traded on the stock exchange and left to the banks, the Lebanese Bank Association set, in 1981, a Lebanese company as a market maker to encourage trade in government bonds. In order for the company to carry out this function it has been supported by the central bank of Lebanon and its share holders.(66) It is worth noting here that the bond market grows many times larger than the equity markets.

In Egypt, Morocco and Tunisia also the stock exchanges have developed modest activities. Although some of them have a listed securities of relative importance such as the Egyptian and the Moroccan markets but the volume of trade is very small and some time in decline. The volume of trade on the Tunisian stock exchange reached about TD 23 million in 1982 the highest figure achieved during the life of the market.(67) In Morocco the transacted shares and bonds amount to only 86 million dirham in 1982.(68) Data on share trading on the stock exchange of

Egypt is not available but the dramatic decline in the number of dealers and brokers from 300 in the first year of the market operation to just 23 in 1983 points to the low activity of the market.

To enhance the activities of these markets some measures have been taken. In Morocco, several measure become effective from 1983. These include:

1. exempting 3,000 dirham of the listed companies distribution profit from taxes.
2. Any investors obliged to pay surtax can deduct from his income 10,000 dirham for the purpose of calculating this tax.
3. listed companies are allowed 50 percent deduction of stamp duties and registration fees on the time of increasing their capital or applying for registration.(69)

Lebanon's efforts to enhance the market were directed toward allowing trade in raw material and precious metals, in addition to the improvement in supervision of the market operation. In Egypt also, there has been an array of suggestions for securities market development there.(70)

## 6.3. Stock exchanges and economic development

The establishment of the stock exchanges in some Arab countries and the drive for establishing more of such institutions in the remaining countries emanates from the great desire to realise a better utilization of the available financial resources by mobilizing local and foreign savings and directing them towards productive projects. This desire is clearly stated in the objective of the established institutions of this type in the region. For instance the aim of the Amman Financial Market and Kuwait Stock Exchange in their charters are to:

1. Mobilize savings by encouraging investments in securities and channelling savings to serve the interests of the national economy.
2. Regulate and control the issue of securities and dealing in them with the financial interests of of their countries and the protection of the interest of small savers.
3. Gather and publish the necessary data to realize the above mentioned objectives.(71)

To what extent these objectives have been attained is the task of this section. With regard to the first objective of mobilising the domestic and foreign savings, the narrow base of the Arab stock markets and speculation activities minimized their role in this respect. It is only in those markets with wide range of securities varies in term of yield, risk and maturity which give more choice for savers, can some influence on the rate of saving occur. The Arab stock exchanges have not achieved the characteristics of such market, so they have not positively influenced the rate of domestic savings.

Likewise, the Arab exchanges have not attracted any significant capital from abroad. This is clear in the absence or meager flow of portfolio investment to these countries. The International Financial statistics show that amount the Arab countries with stock exchanges, Egypt was the only one receiving portfolio investment in the last four years of the magnitude of $3-4 million a year.(72) This is a small amount and not necessarily attracted by Egypt Stock Exchange. AFM prides itself on having attracted about JD 4 million from the Arab and Jordanian abroad in two and half years.(73) These were the amounts of capital which flowed from abroad and were invested in securities traded on the market. Both amounts are very small, considering that one of the claimed goals of these markets is to attract Arab capital surplus.

The poor performance of the Arab stock exchanges can be further delineated by relating their intermediary function with other financial intermediaries in the countries of their operation. This is clear in the case of Tunisia, Lebanon and Morocco stock exchanges where the total transactions on their markets is very small and merely a fraction of the credit outstanding of commerical banks there. This indicates the modest role of these markets in the saving investment process. In contrast the intermediary role of AFM and Kuwait stock exchange had been of some significance compared to intermediary role of other segments of the financial markets there.

With regard to the second objective of the protection of the interest of small investors, the Arab stock exchange has achieved very little and sometimes harm these interests. For instance the prices of securities have been very volatile in the Amman Financial Market and Kuwait stock exchange. And the markets were dominated by minority traders who set the prices in their interest. The traders of Kuwait stock exchange were described by Hollis in these words:

> "the active traders who set the tone of the market number no more than a couple of hundred at the most. Almost all are sterling millionaires at the very least to whom dividends are of little interest. There is virtually no one in the market buying for yield and in consequence share prices are very high by standards prevailing elsewhere in terms of yields, earning or assets. In 1980 for example the major banks stood at dividend yields of less than 1 percent and in some cases under 0.5 percent".(74)

The speculation activities of these investors distorted the prices of securities significantly and caused the market to crash in Kuwait in 1977 and in 1982. Only government intervention saved the small investors from losing all their savings. So the market in an indirect way has been a real threat to the future of Kuwait's financial market and caused great damage to the interest of small investors. In general the speculation on the market impeded it from achieving its positive role in social and economic development and sometimes harmed development itself.

With regard to the second and third objectives of these markets AFM and recently Kuwait stock exchange may claim some success. Scrutenizing the financial position of companies before admission to the markets created confidence in the financial securities. The publication of information by the markets on the capital structure, and annual result of the listed companies exposed them more to the public and lessened the number of insiders dealing on these markets.

## 6.4 The factors adversely affecting the growth of Arab stock exchanges

The foregoing discussion showed that the growth of the Arab stock exchanges varies from one country to another as the economic situation of the Arab countries inevitably varies to a considerable extent, depending on domestic circumstances. However, the existing stock exchanges, are undeveloped and the factors impeding their development can be found in the absence of one or more of the preconditions - examined earlier in this chapter - which are essential for such markets to emerge and to be a reasonably workable market.

In chapter three, it was shown that the economies of many Arab countries have not yet been monetized, and that if they were monetized the low ratio of quasi-money to M2 indicates that savers' sophistication has not been established yet. This factor alone explain the absence of the stock exchange from many Arab countries.

In other Arab countries where stock exchanges have already been established the low turnover of the outstanding securities indicates the lesser popularity of stock exchanges, while the high turn over in others indicates the extensive speculation activities on such markets.

The underdeveloped conditions in the existing markets could be related in part to the newness of these markets since the development of such markets is a gradual process involving gaining increasing acceptance by of, and demanders for securities. Apart from the time factor, the low degree of trading activities and the thinness of these markets can be explained by the paucity of securities. Paucity has been due to many factors operating on both sides of the market.

On the supply side, it is possible to detect many factors all contributing one way or another to reducing the supply of securities. The predominant mineral activities in some and the service oriented economies in others left the industrial activities of little importance in the Arab countries with stock exchanges. For instance the manufacturing sector's contribution to the GDP of Jordan, Tunisia, Kuwait, Lebanon and Egypt in 1982 was 19 percent, 12 percent, 4 percent, 13 percent and 12 percent respectively.(75) This is an indication of the modest industrial activities in such countries and is one of the main constraints on the supply of securities. Furthermore the organization structure of industry itself in the Arab region militates against the supply of securities. Industrial activities in the Arab region are mainly found in the form of a few large plants, owned and controlled by the governments or in small plants owned and controlled by families.

Along with the above mentioned decisive factors, it is possible to refer to other less important factors involved in reducing the supply of securities or promoting the development of fixed interest bearing securities against the equity shares. These include:

1. The relatively low cost of borrowing from Commerical banks and other financial institutions. The roll-over of the overdraft facilities significantly reduced the need for many corporations to issue more financial securities and sell them to the public to secure the needed fund. This can be illustrated by the structure of lending rates in Jordan. For instance the rate on commerical banks loans in 1983 was 8.75 percent and development bonds 7.5 - 8.8 percent.(76) The rate is very close, but companies issuing bonds might need to add one or two points to its rate and must pay the underwriters commission and the risk of not selling the issues. These additional points will make raising funds through issue more costly. Even if the cost of borrowing through the banks were higher than that of borrowing through public issues, many corporations would continue preffering the bank loans rather than diluting their interest through the alternative.

2. The enormous wealth of the public sectors in the major oil-exporting countries freed them from all types of borrowing. This led to the absence or weak presence of government securities on the market of these countries. The government securities usually constitute the largest proportion of the financial securities traded on the stock exchange of the advanced countries.(77)

3. The central bank's stand to buy and sell government securities in some Arab countries reduced the need for trading such securities on the stock markets. This is clear from the minor trade of government bonds on AFM, as the Central Bank of Jordan has been supporting and dealing in these securities.

4. The high rates paid on government securities and their exemption of taxes, made them attractive instruments for long-term investment particularly by those in the high bracket income group and banks. This is clear in the Jordan market as seen in Appendix 6.3. The holders of these securities usually hold them until maturity. This reduces the supply of government securities on the market. The main point is that a market cannot develop properly in a climate where interest rates on non-risk instruments exceeded reasonable returns.(78)

5. The strong relationship between some of the Arab countries and the previous colonial power give them access to the financial markets of these countries and secure the necessary funds there. This also reduces the supply of securities for the markets in the region.

On the demand side it is possible to detect some factors impeding the development of the market in the region. These include:

1. The low per capita income in Morocco, Egypt and to some extent Jordan and Tunisia, considerably reduced the demand for financial securities particularly in the private sector. This claim is true in these countries although there is no data on the share of the financial securities held by individuals, but the low per capita income in Tunisia and Morocco was echoed in the absence of private investors on their markets.(79)
2. The high inflationary pressure in the region (see Appendix 6.6) and the low earnings of the financial securities considerably reduced their attractiveness to the investors. Likewise in Egypt among the whole range of factors detering investors there has been the dramatic devaluation of its currencies. In 1979 the value of 1 US dollar was equal to 0.7 Egyptian pounds, but by the early 1980's, the exchange rate had fallen to 1.2 Egyptian pounds to the dollar.(80)
3. In the Peninsula countries the *de facto* link with the dollars and the significant difference in the structure of interest rates at home and abroad led to the flight of capital abroad and in turn affected the demand on local securities.
4. The existence of foreign securities in Lebanon and in the Gulf States absorbed part of the capital which would be directed to

local securities in their absence.(81)

5. The loose regulations, little disclosure, secrecy and lack of ethical standards hardly create confidence to invest in the financial instruments. In the current evolutionary stage of commercial law in the Gulf region, there are few guidelines for the auditor, and public accountant, and firms work largely to their own standards.(82)

6. The speculative activities on the Kuwait stock exchange was the most deterrent factor for the development of the market there. The crash in the market in 1977 induced the Kuwaiti government to reluctantly buy shares to the value of KD 150 million. With the collapse of the unofficial market in 1982 the government bought shares valued at hundreds of millions of Kuwaiti pounds. As a result the government today control over one half of companies share.(83) In addition many people lost their investment and the confidence in all financial securities.

## 6.5 Toward development and integration of the Arab stock exchange

### 6.5.1 Financial measures directing the development of local stock exchanges

As the development of capital market institutions is a long-term gradual process that takes place during the course of economic and financial development, it is natural to find stock exchanges which are of recent origin in this process of development. It is true that circumstances are different from one country to another, but the similarity in the nature of problems facing stock exchange development in the developing economies makes it possible to draw on the successful experience of other countries in this field. So the development of the

Arab stock exchange could be fostered and hastened by some promotional measures that proved effective in similar circumstances elsewhere. In such circumstances, the efforts made to accelerate the development of securities markets by policy measures were usually directed to create confidence in the financial instruments and increase their supply and the demand for them.
To increase the supply of securities in the Arab capital markets several devices may be used. These include:-

1. Tax incentives

As the modern corporate sector in the Arab region is still in the early stages of its development, characterised by a sharp dichotomy between a few large enterprises and relatively numerous small-scale family enterprises, tax differential treatment between private and public shareholding companies would induce some of the unincorporated enterprises to go public. The Jordanian tax system in recent years was adjusted to allow favouring treatment to public shareholding companies. Likewise the Venezuelan capital market law gave certain tax exemptions as high as 50 per cent, per company should it convert to an open company.(84)

Such policies undoubtedly induce private companies to go public, but this has an adverse effect on government revenues. So caution has to be taken in deciding the magnitude of the offered concession: A large concession would disturb the market itself. For instance when the Pakistan government in 1963 gave support and generous allowances to traded shares, obviously many companies issued new shares, consequently a severe price fall and a loss of private investors' confidence followed.(85)

2. Divesting of some of the public corporations

Some countries may sell part of the public corporation to the private sector. Saudi Arabia's government divested itself of the ownership of some quasi-state organisations such as the National Shipping Company, Saudi Basic industries Corporation and the Saudi Consolidated Electric Company.(86) Such policies would immediately increase the supply of securities on the market, but it is not recommended if a corporation has special importance in serving the public or the privatization leads to a transfer of ownership from the public to a few private investors.

3. Indigenization of foreign companies

The indigenization is another way to increase the supply of securities. This policy is used in Nigeria and in Saudi Arabia. In both countries the foreign banks were asked to issue a majority new share to the local citizen.(87)

4. Increase the capital of corporation

Ordering the existing companies to increase their capital through a new issue, increases the supply of securities. This policy was used in Jordan recently when banks and insurance companies were asked to increase their capital, as a way to increase the securities and to broaden the ownership of these institutions.(88)

5. Introduction of the securities of other Arab countries to the existing stock exchange.

At present, dealing in the Arab Stock Exchanges is limited to national securities. Although the law in Kuwait allows the introduction of foreign securities, in Jordan the law allows reciprocal treatment. It is possible for any one of them to increase the securities by allowing the securities of other Arab countries to be traded on its market.

6. The support operation

The specialized financial institutions, and the contractual saving institutions such as insurance companies and pension funds may encourage promising enterprises to incorporate and increase the supply of securities, by offering to take upon their shares after incorporation. These institutions may sell the securities bought from the previous ones and buy shares of the new incorporated ones. By doing this they help to increase the supply of securities.

On the demand side also there are many devices which may be used to increase the demand for securities. These include:

1. Tax incentives

The tax system may be made to encourage people and institutions to hold financial assets In Jordan the tax system encourages holding financial securities in the sense of exempting their income from income tax or from capital gain tax. Likewise the Venezuela capital market law gives 100% percent tax exemption to people buying shares in public shareholding companies.(89)

2. Giving advances to individuals

This policy can be applied in broadening the ownership of industrial financial assets, and to enable people to buy securities. The experience of Iran in applying this policy in the development of its capital market is of special interest. Corporations were asked to issue new shares for workers participation, and staff were advanced the equivalent of three months wages to pay for these shares. The loans were guaranteed by the state, over a minimum of three years and were virtually interest-free. This enabled workers to buy shares in the companies for whom they were working. Against that, the new shareholders were subjected to some restrictions. The shares were not allowed to be traded in until the loan was repaid. If the employee changed his job before he had paid for them, they must be sold back to the company.(90) Kuwait also applied such a policy: In spreading the shares among its citizens Kuwait limited the number of shares that may be bought by a single investor and gave the right to every Kuwaiti to buy shares. To achieve this goal, the price of shares was kept very low,(91) and the commercial banks were asked to lend to needy people on the collateral of their shares. This policy enhanced the ability of small savers to buy new shares.

3. Opening the stock exchange for non-residents

This policy can increase the demand for securities tremedously in the Arab stock exchanges particularly in Kuwait where the national citizen there constitutes less than 50 percent of the population. While Jordan, and Egypt encourage other Arab citizens to deal on their markets. Thus it may be helpful in Kuwait to allow the resident Arab citizen to trade on its market.

4. Improve disclosure

The stock exchange authorities can enhance the demand for securities by enforcing companies to make further public disclosure and enforcing unified accounting procedures. At present, data on Arab companies, sources and uses of funds, return on investments, profitability balance sheets and capital structure are not regularly published. An audited annual and a six-monthly report on business progress helps enormously in exposing it to more investors.

5. Promoting an active network of institutional investors

The mutual funds, unit trusts, contractual saving institutions such as insurance companies and pension funds and other investment companies represent the major source of demand in active stock exchange of developed countries. For instance the share of such institutions in the ownership of quoted ordinary shares on London Stock Exchange rose from 16.4 percent of market value in 1963 to about 32.7 percent in 1975.(92)

As far as the institutional investors are concerned, the region is still in the process of developing them. The insurance companies were the first to emerge in the region, but they are of minor importance in terms of mobilizing and allocating long-term funds.(93) The other institutional investors such as investment companies have spread rapidly in Kuwait but on a smaller scale in Saudi Arabia and Jordan. In recent years, most Arab countries have established social securities or pension funds. But the open-ended investment trusts and mutual funds are rare in the region.

The importance of such institutions for the development of the Arab Capital Markets emanates from the long-term nature of their fund. The investment companies are corporations that sell their own shares to investors, then take these proceeds and invest them in the securities of other companies. And the contractual saving institutions are financed by the regular contributions from their participants. The proceeds are usually invested in securities, and when a participant retires, the savings are paid out in the form of an annuity or some other type of settlement.

Besides the above policies, the monetary authority should create the conditions conducive to the growth of the capital market. This includes the curbing of inflation and pursuing realistic interest rates policies.(94) The interest rates in real terms were low but positive in most Arab countries, but turned negative in some of them when the annual inflation rate exceeded the ceiling on interest rates. However, there are several considerations which militate against adjusting upwards the level of interest rates in the region to reflect any higher rates of inflation. Historically, the Arab countries have not looked to interest rates as a tool for promoting the financial development. They were concerned with the cost of credit and some people objection to the usury system. This policy could be acceptable in rich countries which implies a relatively low opportunity cost of capital, other things being equal, but one should recognise, the importance of liberal interest rates in the process of financial development through its effect on both the supply and demand of capital.

### 6.5.2 Financial measures to integrate the Arab stock exchanges

In the Arab drive to accelerate the flow of funds in the region they have established among themselves several agreements concerning the capital flow. To the agreement examined in Chapter two is added the agreement for the guarantee of Arab investment within the region which was followed by the subscription of all the Arab countries to the Kuwaiti - supported Inter-Arab investment Guarantee Corporation.(95) This was followed by all the Gulf states with the approval of Saudi Arabia going ahead with plans to establish a Gulf Currency as a first step toward an Arab Dinar. In addition to the Arab Monetary Fund efforts to unfify Arab currencies and integrate their financial markets.

Expanding on these efforts it is possible to create the Arab capital market by stages. In the first stage therefore, one might suggest the creation of a central stock market for the shares of the joint Arab ventures. In the second stage one should integrate fully the Arab stock markets. In the first stage the Arab countries may collectively establish a higher issuing committee and strong underwriting houses. The Arabs have already established many ministerial and other councils organized on a functional basis which meet at regular intervals and constitute an important institutional mechanism of control, advisory and co-ordinative service.

Once could recommend that the deputies of the Arab Ministries of Commerce and Industry might make up the higher issuing committee. The committee would approve the published prospectus of any joint-venture seeking to raise funds and ensure the accuracy of the financial information made available to the public. This would create confidence among Arab investors and protect their interests.

Likewise, the Arab may entrust the Inter-Arab Investment Guarantee Corporation to work as underwriting houses. This would guarantee full subscription for the issuing companies. To enhance the development of the Arab capital market, these issues should be denominated in the Arab dinar. This would inspire confidence in the Arab dinar as a potential regional currency, serve as common denominator for issues floated in several markets, and provide a limited guarantee against exchange rate changes for debtors and creditors alike.

In the second stage, when the Arabs experience further integration and the movements of capital within the region become virtually free they may agree among themselves on:

1. The introduction of the securities of one country on the stock exchange of other country.
2. The purchase of the securities issued by residents of every Arab country, by the residents of other countries.
3. The issue of the securities by the residents of one country in the capital market of another country.
4. Unifying their tax systems, companies laws, prospectus formats, the admission requirements of securities to official listing, terms of trading and execution of all financial transaction in all Arab stock exchanges.

This would create a common and unified network of financial services for the region as a whole, make for greater interpenetration of national securities markets and speed the emergence of the Arab capital market.

## 6.6. Conclusion

The Arab organized securities markets are few, small and late-comers to the financial scene in the Arab region. This is a predictable state of affairs, as the natural process of such markets is not only related to the overall development process, but is indeed an outcome of such a process.

It must be pointed out, that in the prevailing conditions of underdevelopment, the region's economy is still primarily geared to agricultural and mining activities. Therefore it would be highly unusual to find widespread inefficient securities markets. The main obstacles to the development of such markets can be briefly described as follows. Firstly, the markets have a limited, short-term operational period; secondly, the economy has a narrow base and the wealth is unevenly distributed through Arab countries; and thirdly, the institutions are traditionally rigid and lacking in any effective entrepreneural capacity. All these above mentioned factors inhibit the rapid development of growth both in the demand for, and the supply of securities.

Under these circumstances the Arab stock markets continue to be of minor importance, they have little or no significance in enconomic development, and indeed they often produce negative economic effects. Unless these markets evolve and are efficiently organized and regulated it would be impossible for them to emerge as viable and effective institutions, that would enable the mobilization of saving and the direction of these savings towards economically productive activities.

The introduction of new measures, aimed at increasing both the supply and demand of financial securities, and which specifically attempted to make financial securities more attractive for savers and borrowers alike was quite successful and partially improved the situation. Nevertheless, there is still room for improvement, particularly with regard to promoting further, the supply and demand of securities. This could be achieved by financial and fiscal policies as discussed earlier. Additionally, there is a need for a more effective regulation, or organization and streamlining of the flow of information regarding the result of the shareholding companies. Such measures would reduce the manipulative practices of inside trading within the market, whilst at the same time decreasing the repercussions of speculative activities which continue to hinder development.

The Arab region as a whole has a fundamental need and a vital interest in the development of a sound and efficient regional stock exchange. As a means for the implementation of such a market, the Arab countries collectively might initially introduce the establishement of a regionally regulated committee and an effective number of underwriting houses. These two organizations would be responsible for both monitoring and publishing information on securities. The establishment of such committees and underwriting houses should be restricted to Arab joint-ventures securities. The committee decides on the information to be published at the time of issue in the prospectus, as well as on the contents of successive financial reports to be presented on a regular basis in ensuing months by such ventures.

The underwriting houses in their turn would guarantee the sale of all securities. This would centralize the flow of Arab savings and help direct the capital towards the joint-venture projects, which in turn would serve to increase integration within the region as a whole.

On securing the establishment of the initial phase, a second stage could be introduced, which would encompass a radical change in the structure of the Arab economy. In the long-term the Arab economies might hope to achieve a widening of the industrial base and take greater measures towards bringing about economic integration. The latter would allow free movement of capital and labour between Arab Countries. There would be a need for an overall review of the finance sector in the region and this would take the form of a committee to review the functioning of all financial institutions, as was carried out in the United Kingdom by 'The Wilson Committee of 1980'

The findings of such a committee would be applied to facilitate the creation of a genuine comprehensive and more unified Arab stock market.

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Burhan Al-Dajani,

# CHAPTER SEVEN

# OFFSHORE BANKING IN THE REGION

# Offshore Banking in the Region

## Introduction

The introduction of the offshore banking units to the region since the mid-1970s has integrated the Arab financial markets with their international counterpart. This undoubtedly increased competition between the financial institutions in the region and improved the service rendered by such institutions. But integrating the Arab financial markets requires more links between the Arab domestic markets and less integration with the international ones.

Beirut had served during the 1950s and 1960s as a regional financial centre for the operation of International Banks. It was an acceptable place for banks to meet, had an excellent communication system and more importantly enough financial expertise on which to draw. But the civil war and the massive expansion in business and wealth in the Gulf region in the Mid 1970s made the international banks re-examine their position and look for an alternative. The banks showed interest in Kuwait and Saudi Arabia as they have been the richest countries in the region, but the latter showed no interest in lifting the ban on the establishment of new banks in their territories. So the international banks looked to Athens, Cairo, Tehran, Amman, U.A.E. and Bahrain. As they found Athens and Tehran not suited to serve the region, they concentrated on the Arab countries.

These efforts coincided with the wish of some Arab countries to receive them. In 1975, Bahrain announced the creation of offshore business. This policy reflected Bahrain's realization that without significant oil resources, it could capitalize on its location and its excellent communications. Dubai was also prepared to receive such banks and had introduced so called restricted bank licenses. Egypt was the third to pose as a regional financial centre. A major effort to set up the necessary legal framework for such centre was persuaded. This framework consisted essentially of Law 43 of June 1974 regarding the investment of Arab and foreign capital in Egypt which grants Egyptians and foreigners the right to undertake banking operations in Egypt in a joint venture, merchant banks, investment banks or in branches. Tunisia joined this club and also announced its offshore business. Consequently the international banks have established themselves in these centres on different scales.

The introduction of this type of banking to the region has increased the integration of the Arab financial markets with the international banks and caused further drains on the region's accumulated saving and adversely affected Arab efforts to integrate their own financial markets.

The present chapter will examine the evolution of the offshore financial centres in general and in the region in particular, then assess their impact on the international banks, the host countries and the region. This would enable us to see these banks in the right perspective and therefore to suggest measures to be taken in order to bring them into line with the Arab efforts to integrate their capital markets and probably to lessen their adverse effect on the flow of funds within the region.

## 7.1 The evolution of the offshore financial centres

### 7.1.1 The evolution of the offshore financial centres in general

Before tracing the evolution of the offshore centres it is well worth considering what we mean by such centres. Kelen defines the offshore financial centre as

> "a place where international financial business can be carried on in a fiscaly neutral way."(1)

For the offshore banks to do so they are usually licensed to operate under separate regulations, particularly in the area of foreign exchange control and taxation.(2) In addition they are allowed to receive deposits and make loans denominated in currencies other than that of the country in which they are operating.(3)

The creation of such markets was first caused by the restrictive financial environment in the U.S.A. which drove a large proportion of the market in dollars to London. The restrictive legislation adopted in the U.S.A., (namely interest equalization tax introduced in 1963, and the earlier 1934 regulation Q) discouraged foreigners from buying U.S. securities. (4) As a result the number of dollars outside the U.S. began to increase. This gave London the opportunity to create the Eurodollar market to satisfy the needs of foreign holders of dollars.(5) The international banks, of course, welcomed this initiative as they could avoid domestic monetary constraints such as reserve requirements, credit ceilings and interest rate restrictions.

In analogy to that the offshore financial centres have been developed to offer certain advantages for the international private sector not available in the traditional financial centres (London and New York). This development came about despite the fact that modern communications have reduced the importance of the geographical location of a financial centre since it is possible to execute financial operations without the parties concerned having to be physically present in the same place.(6)

In the last two decades or so many small countries have opened their territories up to such business. Singapore, Luxembourg, Jersey, The Bahamas and Hong Kong are the best known offshore financial centres.

The prerequisite for any place to be accepted as an offshore centre is the ability to offer potential users a means of by-passing fiscal regulations in force in their own countries. Some users want a tax haven, some want freedom from exchange control or to escape confiscatory measures and others perhaps want to manipulate their dubious business away from any regulatory influence. In addition to the favourable tax and foreign exchange regulations, an advanced communication system and access to the major centres by air, sea or other means are other necessary conditions for the emergence of such centres. The attraction of offshore centres to the international banks varies according to their regulations and the profitability of the business they expect to be involved in as well as the business they might lose by not participating.(7)

### 7.1.2 <u>The evolution of the offshore banking units in the the region</u>

The decline of Beirut's position as a financial centre within the region in the early 1970s coincided with the massive expansion of business and capital in the Gulf area, resulting from the oil price increase. This made the international banks search for an alternative. The priority of the international banks was the lucrative Saudi Arabian markets, Kuwait and the U.A.E.'s. But the first two countries had not shown much interest in opening their doors to the international banks. Consequently when the international banks were unable to establish themselves in one of these rich countries they sought an alternative in neighbouring countries with good access to these markets.(8) They looked to the U.A.E.'s, Bahrain, Egypt and Jordan.

The international banks exerted great pressure on these countries, and in the absence of national pressure in Bahrain and the loose Federation in the U.A.E.'s the banks succeeded in persuading the Bahrain Monetary Agency and the U.A.E. Currency Board to issue a new form of limited banking license permitting the establishment of offshore banking units (OBUs) in 1975 and 1976 respectively. Under the licensing system adopted in Bahrain (see Apendix 7.1) OBUs can carry out all banking operations with non-residents of Bahrain and with Bahrain's government and its agencies. The only restriction on their dealing is with the private sector in Bahrain itself and here another exception in the system is made to allow development projects to raise funds from OBUs. These units are not required to maintain any reserves with the Bahrain Monetary Agency nor to observe any formal liquidity ratios. The system also allows the existing fully licensed banks to hold an OBU license for their non-resident business. And in the absence of any tax on income or profit in Bahrain an annual registration fee of 10,000 Bahrain dinars is payable by each unit.

As the system seems to be tailored to the benefit of the international banks many banks immediately applied for a license and their number started to increase rapidly. (9) Today, virtually all the major world banks have established offshore branches in Bahrain (see Appendix 7.2). And in the Bahrain Monetary Agency's drive to consolidate Bahrain's offshore financial centre it began issuing investment bank licenses in 1977 and began to admit other ancillary services such as foreign exchange brokers, legal and accounting firms. By 1982, the number of the financial intermediaries that were licensed in Bahrain as offshore enterprises reached 149 units of which there were 74 OBU's, 50 representative offices, 14 investment banks, 11 brokers and securities houses. They represent the world-wide financial interest and in particular the region with 40 units, western European countries with about 41 units, U.S.A. with 21 units and Japan with 25 units. See Table 7.1. Consequently the Bahrain financial centre became an inseparable part of the international financial markets.

The offshore business in the United Arab Emirates began when the U.A.E.'s Currency Board announced in 1976 its readiness to allow the establishment of 12 Restricted License Bank (RLB). The only restriction was of opening current account services. The system was welcomed by the international banks as they viewed the U.A.E. as a natural place for the offshore business. The country has the oil wealth of Abu Dhabi and the entrepôt trade of Dubai, a combination of money and entrepreneure. But soon the Federal government of the U.A.E. showed its reluctance to encourage its growth and a decision was taken to the effect that no fully licensed commercial bank could also hold an RLB license. (10) The decision was intended to discourage the 50 or so banks operating in the Emirates from applying for such a license. As a result the twelve institutions which had obtained this license dropped to just five. So the system had grown very little. This is clear from the small volume of business generated by these banks solely through interbank borrowing from the domestic market their aggregate balance sheets in 1980 were approximately U.S. $ 600 millions compared with comparable figures for the commercial banks of approximately U.S. $ 12 billions.

TABLE 7.1

**The number of financial institutions in Bahrain according to Nationality**

| Countries | Commercial Banks | OBUS | Rep Banks | Investment Banks | Brokers | National Total |
|---|---|---|---|---|---|---|
| Bahrain | 5 | 12 | | 6 | | 23 |
| Kuwait | | 1 | | 1 | | 2 |
| U.A.E. | 1 | 1 | | | | 2 |
| Saudi Arabia | | 2 | | | | 2 |
| Oman | | 1 | | | | 1 |
| Jordan | 1 | 1 | | | | 2 |
| Iraq | 1 | | | | | 1 |
| Egypt | 1 | 2 | | | | 3 |
| Pakistan | 2 | 2 | | | | 4 |
| Iran | 2 | 1 | | | | 3 |
| India | | 2 | | | | 2 |
| Turkey | | 1 | 1 | | | 2 |
| United Kingdom | 2 | 8 | 2 | | 6 | 18 |
| Holland | 1 | 1 | 1 | | | 3 |
| France | 1 | 9 | 1 | | | 11 |
| West Germany | | | 4 | | | 4 |
| Switzerland | | 3 | 3 | | | 6 |
| Belgium | | 1 | | | | 1 |
| Italy | | | 2 | | | 2 |
| Spain | | 1 | 1 | | | 2 |
| Greece | | | 1 | | | 1 |
| Luxembourg | | 4 | | 1 | | 5 |
| U.S.A. | 2 | 9 | 7 | 3 | | 21 |
| Canada | | 2 | 2 | | | 4 |
| Brazil | | 3 | 2 | | | 5 |
| Sweden | | | 1 | | | 1 |
| Taiwan | | | 1 | | | 1 |
| Philippines | | 1 | 1 | | | 2 |
| Hong Kong | 1 | 2 | 1 | | | 4 |
| Indonesia | | | 1 | | | 1 |
| Malaysia | | 1 | | | | 1 |
| Korea | | 2 | 1 | | | 3 |
| Japan | | 1 | 16 | 3 | 5 | 25 |
| Australia | | | 1 | | | |
| Total | 20 | 74 | 50 | 14 | 11 | 169 |

Source: Appendix 7.2

The other Arab countries which have allowed the operation of offshore banking on their territories are Tunisia and Egypt. In their intense efforts to speed up development they made a move to attract foreign banks. Tunisia issued an offshore banking law in 1976 but as its intention was to finance local development it limited the growth of such business to eight banks.(11)

In Egypt the drive to create financial centres began after the "open door" policy was introduced in 1975. The law No.43 of 1974 relating to the investment of Arab and foreign capital in Egypt was revised and amended to allow the operation of foreign banks and to ease foreign exchange controls. According to the provisions of this law foreigners are allowed to establish banks in Egypt with up to 100 percent equity or participate in joint ventures in which local Egyptian capital constitutes at least 51 per cent of the total. The law is too long and complicated for a bank established under this law to engage in local currency transactions it should in the form of joint ventures. (12) The activities of the other banks, the investment banks and merchant banks, should be confined to transactions effected in freely convertible foreign currencies.(13) This law put an end to the ban on the operation of foreign banks in Egypt. Consequently many banks have been established there. By 1982 their number reached 49 of which 18 were commercial foreign ventures, 10 non-commercial banks, 20 branches of principal foreign banks and one an offshore bank.(14)

## 7.2 The impact of the offshore banks on the international banks

The establishment of the OBUs has benefitted the world wide financial communities and in particular the international banks in three different ways.

1. The development of the OBUs in Bahrain has introduced an alternative to Beirut.

2. The high volume of the OBUs activities represent a significant share of the world Eurocurrency market especially outside the major traditional financial centres.

3. Bahrain's time zone has allowed the international banks to complete the chain of money markets around the globe.

With regard to the first, Beirut was once the undisputable financial centre for the operation of international banks in the region. It began the development of its infrastructural facilities such as the airport and ports during the French mandate half a century ago. And it has housed the American University since the early 1940s. Through that Beirut emerged as a commercial and cultural centre of the region, and many international banks established themselves there.

To enhance Beirut's financial position in 1956 a banking secrecy law was promulgated. Under this law banks were authorised to open secretly coded accounts for their customers and it became illegal to provide any information to any third party about this account without the prior permission of such clients. This coincided with the political unrest in the region. Under these circumstances the international banks found a lucrative market in Beirut and adopted it as the focal point for their activities in the region. Consequently the number of banks operating in Lebanon increased from 31 in 1955 to 93 in 1965. (15)

A decade later, the position of Beirut as a regional financial centre began to crack with the failure of Intra Bank, the largest Lebanese bank which accounted for about 20 per cent of total deposits with commercial banks in 1965, with several Lebanese commercial banks holding large deposits with it. The failure of the Bank with 16,000 depositors' funds tied up, (16) severely damaged confidence in Beirut as a financial centre and capital began to leave Beirut seeking safety and profits elsewhere.

The failure of the Intra Bank, promoted the Lebanese Central Bank to carry out its duties by closely supervising the operations of the commercial banks. Consequently the central bank asked the small banks to merge with other banks. As a result the number of banks fell to about 70 in the early 1970s from 93 banks in 1965. This restored some confidence in Beirut. But the civil war in Lebanon in the mid 1970s, and the increasing sophistication of other Arab countries' financial institutions sharply eroded the need for Lebanese banking services. (17) In fact at the height of the civil war in Lebanon over 100 firms and banks had their regional offices in Beirut moved to Amman, (18) and perhaps more of such business moved to Athens or Cairo. Since the Lebanon has entered its longest recession which culminated in the Israeli invasion in 1982 which shattered and divided the country in all but name. However, once political problems are solved, it is by no means certain that the attitude of Lebanon to business and banking will be the same.

Beirut's popularity and its traditional role would continue to finance the large volume of trade going through its port. But Beirut's financial prosperity is seriously threatened by political uncertainty and the loose supervision of the central banks. As one observer noted recently, "The Lebanese banking sector's envied control-free foreign exchange and bank secrecy laws will become worthless myths."(19) if indiscipline persists.

The international banks by establishing themselves in Bahrain obtained a place in one of the richest virgin territories in world banking. Bahrain had a long tradition of being a service centre for the Gulf region. Its airport is used as a stopover point between Europe and the Far East. Its local and international telephone system are extremely efficient.

Secondly, Bahrain's favourable position on the door step of the richest countries in the region allowed the OBUS to build up their financial position, in a very short time. At the end of 1983 the total assets of the OBUs stood at about $63 billion. This compares favourably with figures of about $80 billion in Singapore and about $49 billion in the Cayman Islands.(20)

Thirdly, the time factor is very important for the international banks. The geographical location of Bahrain, midway between Europe and the Far East made Bahrain the ideal place to complete the chain of money markets around the globle for the international banks. So many banks in Bahrain maintain a dealing room to take advantage of this situation. These banks, helped by the licensed brokers with their world wide network have been funding Singapore's deficit in the early morning and as Bahrain's markets closed passed their surplus to the financial centre in Europe as they opened.

## 7.3 The impact of the offshore banks on the region

The offshore banks in Egypt and Tunisia have had very little or no impact at the regional level because their operations are more closely scrutinized and mainly directed towards the local markets. But the purpose of the OBUs in Bahrain was to create an international money trading centre in the Gulf to handle dealings in local currencies and to act as a channel for the surplus liquidity of the region. (21) Eventually the operations of the OBUs have affected the surrounding countries. Some of these effects are considered by some writers to be positive and by others to be negative.

The advocates of the market claim that it achieved the following goals.

1. The establishment of the OBUs brought branches of the major banks to the region which gave the public and private sectors the opportunity of placing their surplus funds with them locally and during the working hours of the individuals living in the region. And for this the OBUs have been the ideal vehicle for tapping the deposit market within the region.(22)
2. The OBUs have created and developed money and inter-bank markets in the region. They have become a major free market for Gulf currencies, in particular the Saudi riyal and the Kuwaiti dinar. The wide margins which used to apply to large transactions in Gulf currencies have become minimal, and the extent of European currency deals has become similar to those existing in European and American centres. Meanwhile the inter-bank market in OBUs linked the commercial banks in the neighbouring countries into one large market. The banks from the other Gulf states could deposit funds in Bahrain if interest rates were higher there or borrow, if they were low. As a result, rate differentials have tended to decline in the region.(23)
3. The development of the forward market for the region's currencies and foreign currencies reduced the profit on currency exchange.(24)
4. The OBUs brought with them the most advanced systems used in

banking operations and they introduced a new level of service which is reflected in the improvement of other banks' services in the region.

The arguments presented above in support of the OBUs seem to be exaggerated or of minor importance to economic development of the region and conceal the OBUs adverse effect on the surrounding countries. The exaggeration lies in the claim that the OBUs brought the top national banks to the region and that they were behind the improvement in the operation of the other markets. The truth is that the top international banks have been in the region for a long time through their branches in the U.A.E., Oman and Qatar. They are also present in Saudi Arabia and Kuwait through minority share holdings in commercial banks in Saudi Arabia and in finance and investment companies in both countries. Also the international banks had been present through the management services they offered to many local financial institutions. This is evident in the fact that the big players in the OBUs are those banks which have local branches. The adverse effect of the OBUs on the surrounding countries can be seen in the following areas.

1. The OBUs dealing in the regional currencies created the forward market in them. The market began small but rapidly increased to a few billions in a very short time as seen in (Appendix 7.3). The OBUs bought local currencies for a reasonable period based on interest differentials against the dollar, then they hedged elsewhere against other currencies. Likewise they sold local currency to customers on demand or on the spot and lent it in the inter-bank markets until the customer was due to collect. Through that they collected the dollars by selling regional currencies and invested them for more than they

paid for borrowing local currencies. The speculation of the OBUs in the regions currencies created many liquidity crises. For instance their speculation in U.A.E. dirham in 1977 created a dirham crisis and led to the failure of two commercial banks there.(25) The failure of the two banks and the liquidity crisis undermined confidence in the whole banking system in the U.A.E.

Dealing in the region's currencies has been on the rise despite the strong objections of the surrounding countries. The outstanding forward deals of about $8 billion in the region's currencies in 1982 are very large for countries with small economies and could create great trouble for the management of their economies.

2. The lending operation of the OBUs sometimes undermines economic stability in the Gulf States. Their excessive lending to shore market speculators accelerated the collapse of Al-Manakh Market in Kuwait. (26) The OBUs have opted for trade finance rather than lending long term, because this type of lending is profitable and does not require substantial funding. Financing construction through providing performance bonds, advance payment guarantees and letters of credit have constituted the other none-trade activities. The maturity structure of the OBUs as given in the Appendix 7.4 shows that the share of assets with a maturity of over one year had been low and in the range of 12-18 per cent of their total assets. This is an indication that the OBUs had concentrated their activities in short-term finance in competition with local banks.

3. The operations of the OBUs, free from many restrictions, have drained the regions accumulated savings. An examination of the figures on geographical distribution of the OBUs as given in Appendix 7.5 shows

that the region has provided the OBUs with almost two thirds of their resources and only received about one half of their total finance in the period 1979-1982. So the region lost part of its accumulated savings instead of adding to them, as the OBUs through suit-case bankers and inter-bank dealing have collected more capital from the region than they extend to it.

4. The introduction of the OBUs to the region has impeded (a) the use of local currency in large transactions and (b) the development of the local market. The increased dealing in regional currencies and the fear that these currencies would become internationalised compelled Saudi Arabia, Kuwait and other countries to price their large contracts in dollars. (27) This reduced the transactions in local currencies, and perhaps discouraged these countries from integrating their currencies for fear of internationalization. Likewise the introduction of the OBUs with their liberal interest rates gave them the edge on the local financial institutions, since the latter's observance of a ceiling on interest rates prevented them from competing with the OBUs. Therefore, the development of the local institutions would have been faster had not the OBUs tapped a large part of their domestic savings. These savings would have gone to them in the absence of the OBUs, as the non-bank customers of the OBUs have been mainly private depositors who prefer to keep their savings at home.

## 7.4 The impact on the host countries

From the discussion of the evolution of offshore banks in the region it has been seen that Bahrain, Egypt and Tunisia are the only Arab countries to have such enterprises on their territories. The preliminary objective of setting up such a business differs from one country to another. For instance Bahrain as a small island with a population of less than 340,000 persons with a long history of being a regional service centre and with a free economic system has different objectives to those of Egypt and Tunisia which stood at the opposite end of the scale in terms of population territory and economic system.

Bahrain's objective in setting up OBUs can be seen as an expansion of the service industry which it was undertaking in order to diversify its sources of income,(28) while the objectives of Tunisia and Egypt can be seen in terms of the offshore business's contribution to economic development mainly through finance and less through invisible foreign exchange earnings.(29) So the impact of the offshore business on these countries should be seen within this perspective.

However, the economists found that the major benefits of hosting an offshore business were derived from their local operating expenditures, to the extent that these contribute to the domestic welfare of the country. (30) These enterprises pay salaries, rent, tax and other fees. These benefits appear to be loosely related to the volume of business routed through a centre but closely related to the number of banks and the types of operation carried out. Against that, a host country incurs direct and indirect costs. The direct cost is associated with expenditure on the regulation and control of such enterprises. The indirect cost is associated with building and maintaining efficient telecommunication and network services, education and the potential diminution of the autonomy of domestic monetary policy and perhaps increased tax evasion by businesses and individuals.(31)

### 7.4.1 The impact of the offshore banks on Egypt and Tunisia

Given the nature of factors involved on the benefit and cost side of hosting an offshore bank, it is not possible to obtain satisfactory quantitative estimates. This difficulty is even greater in estimating the contribution and cost of offshore banks in Egypt and Tunisia because of the absence of data and the confusion in the framework guiding the operation of these banks. The banks operating in Egypt include, investment banks, joint-venture commercial banks, Egyptian-owned banks and multinational offshore banks. Likewise, the offshore banks in Tunisia are joint-ventures with very little distinction from the domestic institutions.

The influx of foreign banks with greater technological and managerial know-how has raised the standard of Egyptian banking and created a better atmosphere for foreign investments. This goes along with the objective of the new policy adopted in Egypt since 1975 which was intended to encourage foreign investment and rouse the Egyptian private sector. Likewise, the operation of foreign banks in Tunisia may help to improve the operation of Tunisian domestic banks through the new competitive environment created by the foreign banks.

But the main objective of accepting these banks in both countries was to finance development. The hope had been that foreign banking operations would have become part of the policy of encouraging private enterprise, by managing and providing the finance to promote development but this has not materialised at the desired level.

The bulk of foreign bank's finance has been raised for imports and some of the foreign banks were heavily involved in currency speculation. The speculative activities of some of the foreign banks have drained Egypt of much of its foreign currencies (32), which it is badly in need of and which was one of the main purposes of accepting foreign banks in Egypt in the first place. In short these banks kept themselves away from the involvement of long term finance which is the only way to promote economic development. The experience of Egypt in this respect is described by Cooper in his study "The Transformation of Egypt". Until the end of 1977 economic liberalization was an utter disaster. It produced none of the benefits that the government had projected on the side of production and investment, there was a deindustrialisation of Egypt literally, and a shrinking of industrial activity as a percentage of economic activity. Arabs rushed into financial activities, tourism and luxury construction. Egyptians shifted their activities into the free zones to escape the socialist laws and into commercial activities to serve the expanding international trade. Very little in the way of industrial activity, not to mention advanced technology industries was even contemplated.(33)

The other important disadvantage of allowing foreign banks to operate in Egypt was the internal brain-drain. The well-trained Egyptian bankers, were lured by the high pay offered by the foreign banks. As a result many of them left their previous positions with local banks and joined foreign banks. (34) Consequently the local banks were obliged to increase the salaries of their employees tremendously to keep them. The movement of such high calibre employees from the local banks undoubtedly affected their operations and perhaps some of their customers were lost.

### 7.4.2 The impact of the OBUs on Bahrain

The impact of the OBUs on Bahrain to some extent differs from that in

Egypt and Tunisia due to the greater number of institutions in Bahrain and its smaller national income. However, in the absence of any personal or corporate taxes in Bahrain, the main contribution of the OBUs to Bahrain has been the banking expenditures to the extent received by Bahrain.

Banking expenditure is difficult to evaluate,but is closely related to the number of banks and people working on their payroll. However, in 1982, banking expenditure of all financial institutions including those with an offshore license was estimated at $160 million. (35) So this figure represented the total expenditure of all the financial institutions in Bahrain. To estimate the contribution of the OBUs to Bahrain, we can look into their annual registration fees, salaries paid to Bahraini, and other expenditure spent on goods and services produced in Bahrain. With regard to the first, Bahrain had received annual registration fees of $25,000 from each unit. This means that Bahrain had received an annual registration fee of less than $2 million. The salaries paid to Bahrain or spent on goods and services is larger than the registration fees. The number of Bahrain's working with OBU has risen to about 3,000 in 1984. See Appendix 7.2. But in a country where a high percent of the labour force is foreign, (36) where the indigenous population has no financial experience and few of them master the English language, we expect to find the Bahrainis in low level jobs such as clerical work so their total earnings would be in the magnitude of $30-40 million in 1984.

The other direct benefit to Bahrain from the OBUs is their contribution of a 1 per cent levy on their monthly payroll to finance the Bahraini Bankers Training Centre which came into operation in 1981. (37)

To these benefits may be added another $10-15 million paid in rent. The other banking expenditures go to expatriates or are spent on imported goods, and had very little positive effect on the welfare of the Bahrain's. So in all the yearly contribution of the OBUs to Bahrain would be in the range of $40 - 50 million.

It is not expected that the OBUs will have any effect on the efficiency of the banks operating in the domestic market despite the general assumption that they would have. The truth is that the domestic banks' are mainly composed of branches of top multinational banks such as; Chase Manhattan, Citibank, Grindlays, British Bank of The Middle East and others. These banks were established in Bahrain before the emergence of the OBUs. (see Appendix 7.2)

Against the partial contribution of the OBUs to the economy of Bahrain, the influx of banks and companies put a severe strain on the tele-communications system, housing and all other services networks. As a result the Bahrain government has incurred the initial cost of modernizing its communication systems and other network services and incurred the subsequent cost of running and maintaining these systems. In addition the government has incurred the cost of supervising and regulating the OBUs themselves. The cost of the adverse effect of the OBU's activities onshore is difficult to specify, but as eleven banks have onshore activities the distinction between domestic and offshore operations is a little blurred and could have adversely affected the domestic market.

The social effect of the OBUs on the Bahrainis has been great. The arrival of the OBUs in the mid 1970s pushed up the cost of rents and services and boosted inflation.(38) This caused an increase in the cost of living for the Bahraini citizens who rarely benefit from their arrival. The other effect on the people of Bahrain came through the high salaries paid by the OBUs. This discouraged the Bahraini from working in other economic activities because the pay was far less than in the banking industry. In addition the extravagant spending of the OBUs made people in Bahrain regard these enterprises as not being too serious and being more interested in show business.

The most important adverse affect of the OBUs on Bahrain concerns its relations with neighbouring countries. The activities of the OBUs in the surrounding countries have not been welcomed by many and has caused certain problems which have been discussed in our examination of the OBUs impact on the region. The prosperity of Bahrain is dependent on its co-operation with its neighbours and because of this we consider that the adverse effect of the OBUs on neighbouring countries is costly to Bahrain.

## 7.5 The prospects of the offshore banks

The future of the offshore banks in the Arab region is dependant on their profitability and adaptability. The former is a necessary condition for the operation of the banks and the latter is essential for their acceptance by the region in general and the host countries in particular.

To begin with Bahrain's offshore units, Bahrain's status as an international financial centre has been consolidated by different factors among which we find the following:-

1. The market has been developed in terms of the number and variety of financial institutions and it has developed the necessary

administrative machinery and tradition of financial expertise. So it has achieved economies of scale which militate against the establishment of competing centres nearby (39). Today the offshore business in Bahrain is composed of 149 units representing the interests of the world-wide financial communities. These interests will try to keep the business going. In addition, the strong relationship between the banking units in Bahrain and their parents abroad and the establishment of sufficient secondary services to provide accounting, investment, and legal advice assure the success of the market through its efficiency. The market, at present has an eternal vigilance and capacity to process and pass on information about development to various other financial centres and get its share as long as foreign exchange is kept free in the region.

2. The growing presence of the Arab financial institutions in Bahrain has created more support for their operations in the surrounding countries. Bahrain has the largest Arab banks with government participation such as Gulf International Bank and Arab Banking Coporation. It is now the base of other regional institutions prominent among which is the reinsurance company (40) and with the new established cause-way between Bahrain and Saudi Arabia more companies are expected to establish their head office in Bahrain.

3. The market has begun to develop new activities. Although foreign exchange is still the forte of the OBUs operations, the deposit side of the OBUs is building up and the banks have begun diversifying their activities.

There is also uncertainty about the future of the OBUs in Bahrain and this emanates mainly from the conflict of interest and the development of the surrounding countries' financial systems. With regard to the first the relationship between the OBUs and the surrounding states has never been an easy one because Kuwait and Saudi Arabia view OBUs as a threat. (41) Conflicts of interests exist. In the face of mounting pressure on their currencies, the nearby states resorted to certain financial measures to diminish the operation of the OBUs in their territory. The Kuwaitis revised the domestic banks liquidity requirements to stop the flow of Kuwait dinar to the OBUs.(42) Likewise the Saudi have taken several measures the main ones being:

1. Restrictions on the participation of foreign banks in Saudi riyal syndication.
2. An application to tax the foreign bank's earnings on direct lending to Saudi clients.
3. The introduction of special 90 days deposit banks to soak up liquidity within the domestic market. (43) This instrument has also been introduced recently in other Gulf states for the same purpose.

The other factors which would affect the future of the OBUs is the development of the financial systems in the neighbouring countries.

The OBUs have taken full advantage of the inadequacy of the financial systems during the last few years in some of the neighbouring countries. Today the Arab capital surplus countries have developed their own institutions to export their capital and to serve the domestic market. This is clear from the experience of Kuwait and the U.A.E.s and to a lesser extent of Saudi Arabia.

Kuwait experienced wealth many years before any other Arab countries. As a result it explored foreign investment and developed its own institutions for this purpose many years before other countries in the peninsula did. It allowed its national banks to grow strong by banning the operation of foreign banks on its territory, and it has helped in the equity of many financial institutions. The government of Kuwait has provided part of the capital of two commercial banks, the Islamic bank and more important the two most powerful investment companies, namely the Kuwait Foreign Trading Contracting and Investment Company (KFTCIC) and the Kuwait Investment Company (KIC). And in a matter of policy it has given its national institutions a great role in channelling its surplus capital within the region as well as abroad. (44). This leaves very little for the OBUs to offer Kuwait.

Likewise in the U.A.E. apart from the restricted license banks system, the country has developed its own institutions and has housed the top international banks. In the 1970s, the financial infrastructure of the U.A.E. has developed enormously, with its centre located in the city of Abu Dhabi, chiefly as a result of the financial strength of that Emirate as the principal oil and gas producer. To export its surplus capital, Abu Dhabi developed its own institutions such as the Abu Dhabi investment Authority and the Abu Dhabi Fund for Economic Development in addition to the National bank of Abu Dhabi. And to facilitate the latter's activities in exporting capital the bank added to its commercial activities a merchant banking division in 1977.([illegible]) Since then these institutions have been active in the deployment of Abu Dhabi's surplus capital and they are now considered to be the most aggressive institutions in this field.(45) In addition, Dubai has been housing a number of wellknown foreign merchant banks such as wardley Middle East Limited, the merchant banking subsidiary of the British Bank of the Middle East and the Country Bank, and the merchant banking subsidiary of the National Westminster Bank.(46)

Thus the variety of financial institutions in the U.A.E. left nothing for the OBUs to offer their country of operation.

Saudi Arabia has a less sophisticated financial system but the phenomenal growth and aggressiveness of its local banks after the Saudi-ization of the foreign banks (completed in 1980) substantially changed the scene. Today Saudi Arabia houses twelve large banks of which ten have a foreign minority interest and which all have access to levels of skill and professionalism matching those available to the OBUs. These developments considerably reduced the need for the OBUs service any more. (47)

The development of the local financial system applies equally to other countries in the region. The financial systems of Qatar and Oman have grown very rapidly and in the light of their small local markets, both are overbanked consequently with very little room left for the OBUs. (48)

The above signs of discontent and the fact that the financial markets in the region started to match Bahrain's financial markets raise some serious questions about the future of the OBUs in Bahrain. So we believe that for the OBUs to provide a service they should find a way of complementing rather than competing with other markets in the region. (49)

The future of the other offshore banks in Egypt and Tunisia is not certain. The resentment towards foreign bank practices is common to both countries. A former Egyptian Minister of Finance described the scene in Egypt as a cow grazing the pastures of Egypt with its udders being sucked dry from outside. (50) In Tunisia the criticism levelled at the new foreign banks is that too much faith is being put into such institutions with no results.

As a result, Tunisia has restricted the operation of such banks and the authorities have shown no desire to become an offshore centre. In fact the Tunisian move in the first place was intended to help finance its own development needs, rather than to fulfil a regional role. And for this, Tunisia turned toward joint-ventures. (51)

In Egypt the trend these days is to subject foreign banks to tighter controls through the central bank of Egypt and to transform them into joint-ventures. (52) And it is expected that those banks who feel committed to Egypt may decide to change their status to joint-venture banks, with a majority Egyptian shareholding.

Indeed some foreign banks have already changed their status to joint-venture as such arrangements give them a wider scope of operation and make more investment opportunities possible.

## Conclusion

The region has a slow capacity for introducing institutions conducive to economic development at the particular time they are needed. The state of affairs opened the way for the offshore banks to establish themselves in the region on the assumption that they would participate in the regions development. The OBUs have succeeded in developing exchange and interbank markets. This is to their credit but these developments are of minor importance for economic development.

Granting permission to commercial banks to operate freely under developed economies when their main objective is profit maximization is merely a way of emptying the region of accumulated savings or directing these savings into unproductive activities. Banks only participate in the financing of development in developing economies when national interests become the priority of such institutions.

The introduction of the offshore banking units in the region where liberal foreign exchange controls are in force and where there is always a ceiling on the interest rate structure for social and religious reasons does no more than open a window for money to fly out. Private investors have engaged in foreign currency investment because the normally investment vehicles in the domestic markets were repressed, and the de facto link of the national currencies with dollars made foreign exchange risks negligible. As a result funds were moved into dollars and so deprived the local banks of the local currency deposit base needed to support local lending.

After the development of the local financial markets in the Peninsula countries coupled with the existence of the major international banks there, the most important justification for the offshore banking has gone, and it is no longer necessary to circumvent the range of supply bottlenecks in the banking systems of other countries.

In addition, the advantages which OBUs enjoy as a result of protectionism in Kuwait and Saudi Arabia will come to an end after the full implementation of certain measures which are at present underway to bring about economic integration in the Gulf region. (53)

The benefit accruing to Bahrain from integration would be more than offset by the fees lost if some OBUs were to be liquidated. Thus there is an obvious need to restrict further the OBUs operations through new and effective regulations. A coherent Arab common policy towards the outsiders is necessary, to build up on integrated Arab capital market capable of serving the region as a whole. It is hoped that such regulations will reduce the speculative activities of these banks and bring them into line with economic development needs and more importantly lessen their outside links and strengthen regional relations.

## NOTES AND REFERENCES


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# CONCLUSION AND RECOMMENDATIONS

## Conclusion and Recommendations

In drawing our conclusion on the development of the Arab financial markets we focus on their effectiveness in discharging the most important function expected of any financial system in the developing economies namely mobilizing savings from surplus sectors and making them available for borrowing by deficit sectors. In presenting our recommendations we acknowledge that the creation of unified financial markets is a gradual and long-term process, but significant moves to this end may be taken through standardization and unification of the financial services in the integrated area, and this depends on the co-operation of all parties involved in this process.

According to the first criterion, the examination of the Arab financial markets in the previous chapters reveals that they failed to discharge their most important function of mobilizing savings and making them available for the productive sectors at the national and regional level.

In our examination of the constituents of the Arab financial markets we found that the commercial banks were the most developed sector although ill-equipped to mobilize domestic savings and to extend effective lending outside the trading sector. The number of commercial banks differs between Arab countries. Some of them are over banked and others have only one or several specialized commercial banks, but all banks are concentrated in urban areas. This leaves the rural areas outside the organized markets on the one hand a prey for moneylenders with their extravagant interest rate charges and on the other hand without the possibility of investing their savings.

In addition it was found that Arab commercial bank lending was mostly directed to finance trade with very little for the industrial and agricultural sectors. The adherence of the Arab commercial banks to orthodox banking practice (short-term self-liquidated loans) and their dominant role among other financial institutions in the vast majority of Arab countries has resulted in discrimination against the traditional and industrial sectors and has left a gap in medium and long term finance. This has led to differential costs of borrowing and lending in the different markets within such countries.

The failure of the commercial banks to tap the rural area's and certain parts of the urban area's savings coupled with their reluctance to extend medium and long-term finance led to the emergence of other types of financial institutions. Some of them were deliberately created by governments , others emerged in response to the demand for the services they could offer. The development banks were of the first type of institution, sponsored by the government. Some of them were created by individual Arab countries while others were established collectively or by other rich Arab governments in order to extend medium and long-term finance for the region as a whole so as to reduce the wide disparities among Arab countries. The establishment of such institutions has contributed significantly to the development of the productive sectors and the housing sector through the extension of medium and long-term soft loans and the provision of the technical advice needed to formulate and carry out such activitiies. But the contribution of these institutions has been limited for various reasons. The development institutions of the deficit Arab countries were severely constrained by their inadequate resources, and the other development banks, particularly in the rich Arab countries, with great capital resources at their disposal, were of recent origin. Consequently they had not had enough time to build up the technical capability needed to operate effectively and were merely regarded as administrative devices to administer government funds. Meanwhile the contribution of the regional development banks was limited due partly to the difficulties in identifying feasible projects in the region and partly because they limited their contribution to government projects or projects guaranteed by government.

The emergence of the Islamic financial institutions added new financial instruments acceptable to those who objected to the operation of the commercial banks on the usury system and who refrained from using their facilities. This helped to tap the previously untapped savings of pious people and brought new customers to the financial markets both as savers and borrowers. But the Islamic banks have not spread widely enough to satisfy the growing demand for their services. As their operations have not yet been finalized it is really too early to judge their position within the Arab financial markets.

The evolution of stock exchanges in a few Arab Countries did not add much to the financial markets of these countries as their operations were loosely regulated. The dominance of the family controlled business in the region and the enormous wealth of the government in the oil-exporting countries have constrained the expansion of such markets. The former severely limited the number of equity shares for sale and the latter prevented such governments from restoring any type of domestic borrowing. On account of this the securities markets in the region are small and consequently the stock exchanges in the region remain of little significance in financing development.

The collective Arab efforts in developing the region's integrated financial market have been limited to the activity of the Arab Monetary Fund whose principal aim, as stated in its article of agreement, is to achieve full monetary integration among the Arab member countries so as to facilitate the economic development of the region and strengthen its structure. The efforts of the AMF in this direction have achieved very little success. It has put most of its effort into finding a suitable method for the settlement of payments among member countries and in helping individual Arab countries to set up new financial institutions and markets. The Fund has done very little to increase the number of countries which have established free foreign exchange markets, to decrease the number of bilateral payment agreements among the Arab countries themselves, or to decrease the number of Arab countries which apply multiple exchange rates. Likewise the Fund has done very little to bring a unified Arab financial market into being. Although it brought some co-ordination to the activities of the professional associations and the national bodies responsible for supervising the proper functioning of the Arab financial markets, a general code of conduct for the region has not been issued.

As a result, the financial legislation and regulations of the Arab countries have continued under the control of the national governments. Co-ordination in this respect has been minimal. The financial markets in the individual Arab countries grew independently in order to serve the national interest regardless of the interest of the region as a whole.

So the link between the local financial markets and the international markets remains stronger than the link between the local markets themselves. As a result we observed that the local financial markets developed their own peculiarities to serve the international markets rather than the regional markets. For instance, the financial markets in the oil-producing peninsula countries with enormous liquid wealth and limited investment opportunities at home sought outward growth beyond their national boundaries. To this end Kuwait developed its many investment banks and the Kuwait dinar bond markets to export capital mainly outside the region. Similarly the financial markets in the U.A.E. developed in order to export capital but as the wealth of the U.A.E. was less than that of Kuwait and its financial system was less sophisticated than that of Kuwait, its role in exporting capital was modest.

The Saudi financial system was the weakest among them. It developed to serve local needs despite its great wealth, surplus capital, and greater investment opportunities. This motivated Bahrain, with no wealth of its own, to call on the international banks to set up business on Saudi Arabia's door step so as to benefit from their operational expenses. So the off-shore banking units in Bahrain established themselves as an inseparable part of the international banking industry. The financial markets in Qatar and Oman have improved remarkably but because of their countries' modest wealth and their late start they do not have the sophistication of the markets in neighbouring countries.

In the remaining Arab countries, the growth of the financial system was also affected by their countries' wealth but more by economic policy. In Algeria, Iraq and Libya, the oil revenues were almost sufficent for these countries' financial needs for development, so their financial systems grew merely to serve the local markets within the state's control. In other Arab countries such as Egypt, Jordan and Tunisia, the financial systems were faced with heavy demands for funds without being able to meet them from local resources. As a result, Egypt and Tunisia opened their doors to foreign banks to help finance their development, while Jordan greatly benefited from the considerable worker's remittances from its citizens working in the neighbouring countries, so its financial markets grew to accommodate these capital flows.

Today the region has a few developed financial centres which together make up the Arab capital market. But their development on specialised lines and the limited links between each other have impeded their intermediary role in covering the region as a whole. This is evident from the great role which has been played by the international financial markets in accommodating the capital surplus of some oil-exporting countries and in lending the requirement of the Arab deficit countries for the last twelve years or so. So the financial dimension of Arab unity is at present undeveloped and fragmentary. The internal components have not been formed and the effective function of financial intermediation is not assured.

The above summary leads us to conclude quite firmly that the Arab national financial markets are certainly undeveloped and that an integral Arab Capital Market has not yet materialized.

We now propose to return to the arguments presented in the first chapter which, it will be recalled, dealt with certain empirical and theoretical aspects of the financial problems facing developing countries. More precisely the initial chapter was concerned with the importance of capital accumulation in the process of the development of technologically-backward countries, the importance of financial markets and institutions in the saving/investment process and the importance of financial integration in transferring funds from the high savings countries to low saving countries, all of which have significant implications for current Arab efforts to unify the financial markets.

It was shown that the development of the financial markets may assume an important role in the process of economic development. The development of the financial markets of an individual country may boost the saving/investment process in two ways:

1. It may stimulate additional saving and investment through the introduction of a wide range of financial instruments with certain features of safety, liquidity and yield in which the complex needs of savers and investors are matched. Financial development with its twin pillars of monetization and financialization of the economy would lead eventually to a higher saving/investment process in countries where a large proportion of the household sector's savings are still put into land, livestock and to a certain extent durable goods. The financial development is expected to change the saver's, wealth in favour of financial assets rather than existing assets of a non-productive nature e.g. gold and jewelery which at present constitute a substantial part of the region's savers' portfolio. The transfer of such savings to financial assets makes additional funds available for lending to productive investment.

2. Financial development is essential to bridge the structural and functional gaps in the present financial markets. Their continuance may retard development because the financial structure in any country may either facilitate or hinder the flow of funds for economic development.

The advantage of financial development at the regional level is almost the same as at the national level. A dynamic and integrated Arab capital market makes the savings from the high savings countries available to investors in low saving countries where investment opportunities in the latter are far in excess of the available funds for domestic savings. In this way the market would bring the cost of borrowing and lending in the different Arab markets into parity which in turn would lead to using Arab capital where it would make the largest contribution to the region's development. All of which would contribute towards building a firmer basis for Arab economic integration.

In the light of the present situation where there are many elements, conducive to further efforts towards integrating the Arab capital markets and increasing the flow of funds within the region, intensified efforts are needed to overcome the shortcomings of the Arab financial markets and to move toward further economic integration.

Our recommendations for the improvement of the operation of the existing Arab financial markets in order to enhance their role in economic development on the national and regional level, are presented under three main headings. The first is the effort necessary to encourage the mobilization of domestic savings and increase the volume of medium and long-term finance. The second is the effort necessary to create a real economic base and a conducive environment for Arab capital to flow freely within the region and the third is the effort to integrate the Arab financial markets.

1. **Measures to encourage the mobilization of domestic resources and increase the volume of medium and long-term finance.**

a. Measures to increase the mobilization of additional resources. To institutionalize domestic savings in the Arab region several measures have to be taken.

1. New savings banks or institutions similar to the building societies in Britain have to be created. No Arab country at present has such an institution, yet I feel that this is imperative for mobilizing the savings of small savers.

2. The commercial banks can take several measures namely deposit insurance, increasing capital, branch expansion, better training, all of which supports the growth of deposits. The introduction of a deposit insurance scheme to insure against loss in the case of bank failure would encourage depositors to keep their savings with the banks. Likewise an increase in the number of bank offices would extend the geographical coverage of the banks and bring them closer for more people thus stimulating savings accounts. The consequent growth of the banks' capital would generate more good will and encourage people to save with them as a cushion against any loss increase. Then training employees would enable the banks to offer better services and attract more savers.

3. The development banks should be allowed to compete for deposits by offering rates close to those of the commercial banks and by giving priority to the depositors to receive loans when the need arises. For this the development banks' laws have to be amended.

4. The development of unit trust companies is a further way to mobilize the savings of people with modest means. Therefore, such companies should be established in countries with sufficient equity shares.

However, to help the banks carry out these measures-some of which are costly, the governments could support the deposit insurance scheme and impose mergers on small banks to increase their capital and spread their network of branches. In addition the adoption of a flexible and realistic interest rate policy is essential. Likewise to encourage savers to hold long term financial instruments with the development banks the goverments could give tax concessions to holders of such instruments.

b. Measures to increase the volume of medium and long-term finance:

1. The commercial banks should promote new financial instruments with long term maturity. The certificate of deposit is one such instrument which if used effectively could change the present short-term nature of the Arab banks' liabilities. This change is a precondition of the banks' extending long-term finance.

2. The development banks in the deficit Arab countries should pool their resources through the creation of a central office to co-ordinate their activities. This would allow better use of the existing resources and improve the present situation where some have excess capital and others reject applications because of the lack of capital at their disposal.

3. The establishment of stock exchanges would help people to a acquire long-term instruments in the knowledge that they can liquidate such instruments on such markets if and when the need arises. The existence of stock exchanges helps banks to manage their liabilities in a way more beneficial to long-term finance.

However, for the banks to direct more of their funds to medium and long-term finance, they should be given the appropriate discount facilities by the central monetary authorities and should be allowed to hold equity shares in industrial activities.

2. <u>Efforts necessary to create a real economic base and to encourage the flow of funds in the region</u>

The obstacles to capital movement are not confined to the restriction on its flow through exchange control in the backward economies. The obstacles are many and interwoven within the prevailing economic and financial environment. With regard to the Arab region there are three major obstacles to this movement. We noted in chapter two that the Arab countries have failed to create any real industrial base and have continued to depend on the outside world as a market for their raw material exports and as a source for all sort of imports. Their backward economies integrated them with the rest of the world and lessened the inter regional exchange of goods. Likewise we noted that the Arab governments are the owners or holders of the large proportion of the region's domestic savings. This concentration of funds lessens the efficiency in deploying them for the development of the region. Finally obstacles may arise from differences in tax systems, poor communication facilities and inefficient administration. Therefore, we have the following suggestions to make.

a. Change the pattern of trade.

The international orientation of the Arab commodity exchange has significantly lessened Arab capital market integration and increased individual Arab countries' financial market integration with the international banks. Total Arab external trade represented on average about 82 percent of total Arab GDP in the two years of 1981 and 1982. This shows that external trade occupies an important position in the region's economic life (Inter-Arab trade accounted for less than 10 percent of this). The small size of inter-Arab trade is mainly due to the failure of the Arab countries to achieve real structural changes in their economies. The structure of the exported and imported commodities reveals these facts. Crude oil and other minerals constituted over 96 percent of the region's total value of exports. The imports were more diversified ranging from food-stuffs to all sorts of manufactured goods.

In planning to increase regional trade, the Arab states have concluded several agreements between themselves aimed at removing the trade barriers. But the absence of any significant tax barriers on imports to the Peninsula oil countries (the largest market in the region at present) and the similarity of agricultural and manufacturing products among other Arab countries made such an agreement virtually meaningless.

Abolishing trade barriers to increase the flow of goods within the region is not the practical answer within the context of the present Arab economic structure. Had greater attention been paid to the structural change in the real economy many of the problems of the present Arab financial markets would have been solved. Therefore, we advocate the creation of strong industrial base. This can be done by directing more effort to co-ordinating investment in the region within the context of economic integration, and in particular through the development of forms of collective investment, taking the greatest advantage of the economies of scale and pooling the scarce technical resources and specialists in the region. Unless this desired structural change is achieved inter-Arab trade will continue to be small and consequently the financial superstructure resulting from such a volume of trade will also be small, and there can be no real progress towards greater economic integration.

**b. Improvements in the administrative, legislative, and political environment**

The present situation suggests that the great proportion of capital supply and demand in the region comes through the public sector. Thus, reforming the Arab governments' financial machinery is of paramount importance in eradicating the rigid centralisation of sources of funds and demand for them. The oil-exporting countries (Saudi Arabia, Kuwait and U.A.E) have enormous wealth which is now managed by few people. For these funds to be managed efficiently, expertise of a high calibre capable of making feasability studies in the region as a whole should be recruited. Likewise the government machinery in the deficit Arab countries has to be reformed. Public enterprise should be allowed to operate more freely, smaller specialized units could be created to increase economic resilience and to compete for funds. In addition, the deficit Arab countries should set up a central autonomous development office vested with full authority to decide and follow up matters concerned with other Arab investors. At present the establishment of new projects involves inevitably dealing with many official bodies concerned with investment incentives, taxation, land, immigration, labour, customs, foreign exchange control etc. These bureaucratic procedures may well discourage Arab investors.

Improving the governments' mechanisms responsible for the investment of billions of dollars in the Arab surplus countries must be taken as a pre-requisite for the efficient deployment of the Arab funds. Efficient government machineries in all Arab countries would help to identify profitable projects within the region and to increase the flow of capital. In parallel with the improvement in administration, the political environment should be conducive to the operation of the market. In the first place, once financial markets are created their mechanism will depend more on confidence, attitudes and the legal and economic environment rather than the strictly institutional aspects of the market. In the second place, as the financial institutions are profit maximizers, they are expected to put their funds where the profit rate is high, the risk is small and the cost of administering the loans is low. In such a situation funds would not flow to the socially most effective project.

The diversity in the Arab countries legislation with a full liberalization of capital movement within the region would drive capital not to where it is most needed, but to where it is least taxed. In general the present Arab administrative, legislative and political environments where decisions are frequently altered reserved or suspended is not helpful to the flow of funds in the region.

### c. Promoting the status of the AFSED

The creation of the AFSED in 1972 was an important milestone on the road toward economic integration of the Arab region. Together with the other national development banks with a regional mission it is helping to reduce the region's disparities. The fund at present is put in a straitjacket by the bureaucratic practice of the Arab governments and it is less capitalized than some national institutions. Therefore, we advocate substantial increases in its lending potential, political authority to enable it to initiate projects which have the highest priority in regional development, and to participate effectively with other Arab governments in drawing up their development plans. This would allow the co-ordination of all Arab general and sectoral policies and promote measures affecting the region as a whole. In addition, its long experience and access to information on the regional level can play a major part in confronting bottlenecks that relate to limits of the region's capacity for absorbing new investments. It would take over the task of preparing feasibility studies, a great number of which are presently provided by foreign concerns.

3. **Measures towards integrating the financial markets.**

Almost a decade has elapsed since the decision taken by the Governors of the Arab Central banks to work towards an economic and monetary union. The progress which has been made since then has been disappointing. The enthusiasm which existed when the decision was taken did not in general express itself sufficiently in the form of effective action. As a result, the Arab dinar, the central element of the Arab Monetary System remains only as a unit of account. Likewise the Arab currencies exchange rate arrangements continue to be linked to the dollar and to a smaller extent to other convertible foreign currencies. Consequently, the fluctuations in the rate of exchange between Arab currencies have been wider than those with the foreign currencies and the magnitude of the external influence has become ever greater.

In essence an Arab Monetary System, as such, is non existent. Integration logically requires concentration of monetary powers. Within this context, this power has to be given to the AMF. Likewise in the Arab region, as far as concern us the weak or vulnerable currencies, it is unavoidable, that the Arab dinar is promoted as a parallel currency to create a zone of monetary stability to improve the prospects of economic development.

1. Promote the status of the AMF to acquire the central monetary management function from Arab central banks.

The Arab states have done quite a lot to provide a financial structure for the integrated Arab capital market. This is evident in the establishment of the AMF itself, the AFSED and the other multilateral

To allow it to play a more decisive role and greater political authority, partial pooling of the Arab central banks' reserves with those of the AMF should take place as a first step.

Simultaneously it should be endowed with limited fidiuciary power. The former proposal would enable the AMF to contribute to the adjustment of imbalances in global and regional payments, facilitate stability in member countries, in exchange rates and develop bases for autonomous regional liquidity creation and management. It would also analyse Arab member countries' disequilibrium systems, evaluate economic performance in member countries and design through the collective judgement of members, regional and national policies in specific circumstances.

The latter proposal would help the AMF to create regional liquidity which would enhance the use of the Arab dinar as means of payment and as a reserve instrument. The acceptance of the Arab dinar at the official and private level within the region may eventually lead to its acceptance as the regional currency. The unification of Arab currencies is one of the greatest steps towards the development of the integrated Arab financial market.

2. Strong underwriting houses should be created mainly by the Arab financial institutions with shares distributed equally among the Arab states. These houses should be supported by a long line of credit and should be allowed to deal specifically in the equity shares and bonds of the Arab joint ventures. They would underwrite the primary issues of such projects and sell them to private and institutional investors in the regions.

The development of a secondary market in these instruments would follow naturally if there were many issues. But at first these houses should be prepared to buy such instruments from their holders if the latter wished to sell.

3. The Arab Monetary Fund should try to instigate a gradual programme of dismantling barriers to capital movement within the region, unifying the financial markets' services through unification of the financial legislation and regulations governing banks, insurance companies and stock exchanges. Simultaneously, it should place more restrictions on the operation of the international banks in exporting capital in order to ensure an orderly opening to the international market and to stimulate the financial institutions' growth and development to act effectively as an engine of development.

The integrated Arab capital market would help to make rapid economic growth possible. But the basic factors that would determine how far economic development can be achieved in the region in the foreseeable future are the stability of the region, the quality and range of Arab enterpreneurial ability and skill and the adaptability of the Arab workforce, and the growth of co-operation between the Arab countries themselves.

Perhaps the questions raised and the conclusions drawn in this study, will serve as a critical and analytical guide to readers who are interested in the development of the financial markets which are subjected to similar conditions. After all, a detailed strategic programme for such institutions has a fundamental bearing on the advancement of Arab economies.

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APPENDIX 2.1

Illiteracy Rates in the Arab Countries

| Estimated Illiteracy Rate | | | |
|---|---|---|---|
| 1978 | 1973 | 1968 | Country |
| 24.90 | 34.60 | 45.60 | Jordan |
| 31.03 | 48.75 | 66.50 | U.A.E. |
| 36.06 | 48.16 | 65.00 | Bahrain |
| 48.90 | 58.90 | 68.90 | Tunisia |
| 68.30 | 73.30 | 78.30 | Algeria |
| 57.92 | 69.77 | 81.17 | Saudi Arabia |
| 48.20 | 62.00 | 75.50 | Sudan |
| 44.30 | 50.05 | 55.80 | Syria |
| 39.50 | 57.00 | 74.50 | Somalia |
| 47.20 | 61.20 | 75.20 | Iraq |
| 36.50 | 52.64 | 71.00 | Kuwait |
| 38.00 | 52.00 | 66.00 | Libya |
| 52.50 | 59.10 | 65.70 | Egypt |
| 77.60 | 84.00 | 92.00 | Yemen A.R. |
| 52.80 | 66.30 | 80.20 | Yemen P.D.R. |
| 46.95 | 58.52 | 70.76 | Average |

SOURCE: Joint Arab Economic Report, 1981
(U.A.E.: Dar al-Khalig, 1982), p.242.

APPENDIX 2.2

Arab Countries Industrial Labour Force in 1980

| | Industrial Labour 000 1980 | % of Labour in Industry | |
|---|---|---|---|
| | | 1970 | 1980 |
| Algeria | 1074 | 12 | 25 |
| Iraq | 808 | 18 | 25 |
| Kuwait | 133 | 34 | 35 |
| Saudi Arabia | 350 | 10 | 13 |
| Libya | 184 | 17 | 27 |
| Jordan | 295 | 26 | 19 |
| Tunisia | 378 | 18 | 24 |
| Syria | 480 | 19 | 22 |
| Lebanon | | 23 | 27 |
| Egypt | 3085 | 12 | 26 |
| Morocco | 1076 | 14 | 20 |
| Sudan | 598 | 6 | 9 |
| Somalia | 98 | 4 | 7 |
| Mauritania | 22 | 3 | 5 |
| Yemen A.R. | 235 | 7 | 11 |
| Yemen P.D.R. | 104 | 15 | 21 |
| TOTAL | 8920 | | |

SOURCE: World Development Report, 1981
Joint Arab Economic Report, 1981 op. cit. p.205

APPENDIX 2.3

Arab Countries: Land and its usage

in 000 hectors

| Country | Total Area | Arable | Pasture | Forest | Irrigated |
|---|---|---|---|---|---|
| Algeria | 238,124 | 6,875 | 36,321 | 4,384 | ,341 |
| Iraq | 43,397 | 5,250 | 4,000 | 1,500 | 1,750 |
| U.A.E. | 8,360 | 13 | 200 | 2 | 5 |
| Qatar | 1,100 | 2 | 50 | | |
| Kuwait | 1,782 | 1 | 134 | 2 | 1 |
| Saudi Arabia | 214,969 | 1,040 | 85,000 | 1,601 | 395 |
| Libya | 175,954 | 1,753 | 13,000 | 600 | 225 |
| Jordan | 9,718 | 1,190 | 100 | 125 | 85 |
| Bahrain | 62 | 1 | 4 | | 1 |
| Tunisia | 15,536 | 3,190 | 2,550 | 490 | 145 |
| Syria | 18,405 | 5,230 | 8,378 | 466 | 539 |
| Oman | 21,246 | 18 | 1,000 | | 38 |
| Lebanon | 1,023 | 240 | 10 | 73 | 85 |
| Egypt | 99,545 | 2,700 | | 2 | 2,855 |
| Morocco | 44,630 | 7,269 | 12,500 | 5,195 | 510 |
| Sudan | 237,600 | 12,360 | 56,000 | 48,940 | 1,750 |
| Somalia | 62,734 | 1,050 | 28,850 | 8,860 | 165 |
| Mauritania | 103,040 | 192 | 39,250 | 15,134 | 9 |
| Yemen A.R. | 19,500 | 2,740 | 7,000 | 1,600 | 245 |
| Yemen P.D.R. | 33,297 | 187 | 9,065 | 2,450 | 70 |
| Djibouti | 2,198 | 1 | 244 | 6 | |
| TOTAL<br>% | 1,352,270<br>100% | 51,302<br>3.8% | 303,656<br>22.4% | 83,430<br>6.1% | 9,244<br>0.6% |

SOURCE: Food and Argriculture Organisation, Production Yearbook, 1982 and previous issues.

APPENDIX 2.4

Gross Domestic Product and Per Capita Income at market Prices of the Arab Countries

| Country | 1971 GDP $ million | 1971 Per Capita $ | 1981 GDP $ million | 1981 Per Capita $ |
|---|---|---|---|---|
| Algeria | 5073 | 340 | 41383 | 2040 |
| Iraq | 4145 | 430 | 31810 | 2350 |
| Emirates | 1130 | 4040 | 32013 | 37660 |
| Saudi Arabia | 5108 | 800 | 154224 | 17830 |
| Qatar | 400 | 3330 | 8831 | 35330 |
| Kuwait | 3880 | 4910 | 24262 | 16620 |
| Libya | 4565 | 2210 | 30329 | 9780 |
| Oman | 301 | 450 | 6769 | 7360 |
| Jordan | 521 | 220 | 3678 | 1090 |
| Bahrain | 261 | 1190 | 4516 | 11290 |
| Tunisia | 1709 | 330 | 8224 | 1260 |
| Syria | 2105 | 320 | 16158 | 1740 |
| Lebanon | 1672 | 660 | 3774 | 1400 |
| Egypt | 7219 | 210 | 29610 | 680 |
| Morocco | 4234 | 280 | 14779 | 720 |
| Sudan | 2186 | 150 | 7993 | 420 |
| Somalia | 331 | 120 | 1580 | 420 |
| Mauritania | 218 | 170 | 702 | 420 |
| Yemen AR | 281 | 60 | 2838 | 480 |
| Yemen PDR | 156 | 110 | 788 | 390 |

Source: Arab Monetary Fund, National Account Country Tables for the years 1971-81, 1983 (Abu Dhabi, 1983).

APPENDIX 2.5

Gross Domestic Product Sectoral Distribution (at Factor Cost in 1971)

| Country | Agriculture | Mining | Manufact-uring | Electric Water & Gas | Construction | Commerce | Transport | Finance | Services | GDP |
|---|---|---|---|---|---|---|---|---|---|---|
| Algeria | 532 | 499 | 705 | 79 | 537 | 985 | 276 | | 1165 | 4778 |
| Iraq | 601 | 1451 | 335 | 33 | 123 | 267 | 226 | 58 | 796 | 3890 |
| Sub Total | 1133 | 1950 | 1040 | 112 | 660 | 1252 | 502 | 58 | 1961 | 8668 |
| % | 13.0 | 22.5 | 12.0 | 1.3 | 7.6 | 14.4 | 5.8 | .6 | 22.8 | 100 |
| U.A.E. | 20 | 718 | 31 | 15 | 71 | 86 | 83 | 50 | 56 | 1130 |
| Saudi Arabia | 226 | 2815 | 436 | 66 | 224 | 238 | 329 | 235 | 463 | 5032 |
| Qatar | 7 | 254 | 11 | 5 | 25 | 30 | 29 | 17 | 22 | 400 |
| Kuwait | 9 | 2549 | 152 | 26 | 93 | 252 | 89 | 65 | 645 | 3880 |
| Libya | 93 | 2587 | 97 | 20 | 328 | 212 | 244 | 82 | 789 | 4452 |
| Sub Total | 355 | 8923 | 727 | 132 | 741 | 818 | 774 | 449 | 1975 | 14894 |
| % | 2.4 | 60.0 | 4.9 | 1.0 | 5.0 | 5.5 | 5.2 | 3.0 | 13.0 | 100 |
| Jordan | 67 | 6 | 39 | 6 | 21 | 92 | 41 | 51 | 142 | 465 |
| Bahrain | 2 | 188 | 6 | 4 | 5 | 14 | 3 | - | 39 | 261 |
| Tunisia | 321 | 96 | 139 | 28 | 102 | 194 | 91 | - | 512 | 1483 |
| Syria | 460 | - | 410 | - | 84 | 375 | 230 | 188 | 358 | 2105 |
| Oman | 40 | 178 | - | 1 | 49 | 7 | 5 | 2 | 19 | 301 |
| Lebanon | 144 | 232 | - | 37 | 74 | 534 | 136 | 61 | 454 | 1672 |
| Egypt | 1965 | 146 | 1379 | 110 | 294 | 676 | 340 | - | 2099 | 7009 |
| Morocco | 942 | 146 | 679 | 148 | 197 | 893 | 165 | - | 1064 | 4234 |
| Sub Total | 3941 | 992 | 2652 | 334 | 826 | 2785 | 1011 | 302 | 4687 | 17530 |
| % | 22.5 | 5.7 | 15.1 | 2.0 | 4.7 | 15.9 | 5.8 | 1.7 | 26.6 | 100 |
| Sudan | 844 | - | 201 | 64 | 87 | 214 | 196 | - | 580 | 2186 |
| Somalia | 167 | 3 | 29 | 1 | 16 | 17 | 16 | 13 | 29 | 291 |
| Mauritania | 58 | 55 | 10 | - | 15 | 13 | 12 | - | 42 | 205 |
| Yemen A.R. | 145 | 3 | 12 | 1 | 14 | 43 | 9 | 6 | 38 | 271 |
| Yemen P.D.R. | 37 | - | 24 | 3 | 4 | 33 | 11 | 7 | 35 | 154 |
| Sub Total | 1251 | 61 | 276 | 69 | 136 | 320 | 244 | 26 | 724 | 3107 |
| % | 40.2 | 2.0 | 9.0 | 2.2 | 4.4 | 10.3 | 7.8 | .8 | 23.3 | 100 |
| Grand Total | 6680 | 11926 | 4695 | 647 | 2363 | 5175 | 2531 | 835 | 9347 | 44199 |
| % | 15.1 | 27.0 | 10.6 | 1.5 | 5.3 | 11.7 | 5.8 | 1.8 | 21.2 | 100 |

SOURCE: Compiled from Arab Monetary Fund Report 1983, Arab Countries National Accounts 1971-81, Arab Monetary Fund 1983.

APPENDIX 2.6

Arab Countries: sectoral contribution to GDP in 1972 (at Factor Cost and in million U.S. $, at current prices)

| Country | Agriculture Fishing & Forest | Mining & Fuel | Manufacturing | Electric Water & Gas | Construction | Commerce Rest. & Hotel | Transport Comm. & Storage | Finance Ins. & Bank | Services sector | GDP |
|---|---|---|---|---|---|---|---|---|---|---|
| Algeria | 631 | 1031 | 912 | 98 | 772 | 1163 | 330 | | 1425 | 6362 |
| Iraq | 809 | 1223 | 421 | 41 | 136 | 308 | 258 | 60 | 915 | 4171 |
| Sub Total | 1440 | 2254 | 1333 | 139 | 908 | 1471 | 588 | 60 | 2340 | 10533 |
| % | | | | | | | | | | |
| U.A.E. | 26 | 935 | 40 | 19 | 93 | 112 | 108 | 65 | 72 | 1470 |
| Saudi Arabia | 255 | 4099 | 479 | 73 | 283 | 284 | 378 | 280 | 589 | 6720 |
| Qatar | 9 | 324 | 14 | 7 | 32 | 39 | 38 | 22 | 25 | 510 |
| Kuwait | 11 | 2780 | 199 | 33 | 117 | 323 | 105 | 77 | 805 | 4450 |
| Libya | 132 | 2785 | 140 | 29 | 556 | 291 | 305 | 113 | 978 | 5329 |
| Oman | 44 | 199 | 1 | 2 | 59 | 10 | 8 | 2 | 42 | 367 |
| Sub Total | 477 | 11122 | 873 | 163 | 1140 | 1059 | 942 | 559 | 2511 | 18846 |
| % | | | | | | | | | | |
| Jordan | 75 | 9 | 43 | 7 | 26 | 100 | 48 | 55 | 149 | 512 |
| Bahrain | 3 | 200 | 14 | 5 | 7 | 17 | 6 | - | 51 | 303 |
| Tunisia | 471 | 113 | 207 | 31 | 130 | 500 | 116 | - | 417 | 1985 |
| Syria | 643 | - | 473 | 91 | 449 | 193 | 195 | - | 387 | 2431 |
| Lebanon | 207 | 290 | - | 42 | 95 | 658 | 157 | 77 | 560 | 2086 |
| Egypt | 2148 | 76 | 1279 | 106 | 278 | 644 | 354 | - | 1916 | 6801 |
| Morocco | 1065 | 166 | 817 | 184 | 209 | 1001 | 192 | - | 1303 | 4937 |
| Sub Total | 4612 | 854 | 2833 | 466 | 1194 | 3113 | 1068 | 132 | 4783 | 19055 |
| % | | | | | | | | | | |
| Sudan | 862 | - | 188 | 60 | 92 | 375 | 182 | - | 631 | 2390 |
| Somalia | 228 | 4 | 31 | 1 | 18 | 20 | 20 | 15 | 33 | 370 |
| Mauritania | 66 | 61 | 12 | - | 10 | 20 | 16 | - | 52 | 237 |
| Yemen A.R. | 182 | 3 | 19 | 1 | 23 | 59 | 15 | 9 | 58 | 369 |
| Yemen P.D.R. | 41 | - | 28 | 3 | 9 | 32 | 12 | 7 | 39 | 171 |
| Sub Total | 1379 | 68 | 278 | 65 | 152 | 506 | 245 | 31 | 813 | 3537 |
| % | | | | | | | | | | |
| Grand Total | 7908 | 14298 | 5317 | 833 | 3394 | 6149 | 2843 | 782 | 10447 | 51971 |
| % | | | | | | | | | | |

SOURCE: Compiled from Arab Monetary Fund Report 1983, Arab Countries National Accounts 1971-81, Arab Monetary Fund 1983.

APPENDIX 2.7 Arab Countries: Sectoral Contribution to GDP in 1979 (at factor cost and in million U.S. $, at current prices)

| Country | Agriculture Fishing & Forest | Mining & Fuel | Manufacturing | Electric Water & Gas | Construction | Commerce Rest. & Hotel | Transport Comm. & Storage | Finance Ins. & Bank | Services sector | GDP |
|---|---|---|---|---|---|---|---|---|---|---|
| Algeria | 2034 | 8852 | 3705 | 400 | 4209 | 4061 | 1366 | - | 5243 | 29870 |
| Iraq | 2353 | 19256 | 1707 | 168 | 1167 | 1134 | 1248 | 511 | 3164 | 30708 |
| Sub Total | 4387 | 28108 | 5412 | 568 | 5376 | 5195 | 2614 | 511 | 8407 | 60578 |
| % | | | | | | | | | | |
| U.A.E. | 178 | 12607 | 664 | 258 | 2447 | 1795 | 896 | 865 | 1465 | 21175 |
| Saudi Arabia | 1249 | 39341 | 3753 | 74 | 10344 | 4139 | 3798 | 1216 | 9764 | 73678 |
| Qatar | 32 | 3621 | 227 | 22 | 360 | 440 | 110 | 319 | 623 | 5754 |
| Kuwait | 60 | 15995 | 2096 | 96 | 760 | 1541 | 385 | 519 | 2948 | 24400 |
| Libya | 505 | 15493 | 628 | 135 | 2455 | 1294 | 984 | 657 | 3561 | 25712 |
| Oman | 93 | 2087 | 41 | 27 | 263 | 240 | 106 | 50 | 487 | 3394 |
| Sub Total | 2117 | 89144 | 7409 | 612 | 16629 | 9449 | 6279 | 3626 | 18848 | 154113 |
| % | | | | | | | | | | |
| Jordan | 145 | 92 | 313 | 34 | 235 | 411 | 209 | 323 | 509 | 2271 |
| Bahrain | 35 | 637 | 489 | 27 | 238 | 341 | 238 | 230 | 517 | 2752 |
| Tunisia | 973 | 775 | 817 | - | 534 | 1589 | 418 | - | 1103 | 6209 |
| Syria | 1747 | - | 2101 | - | 692 | 2414 | 710 | 660 | 1689 | 10013 |
| Lebanon | 294 | 449 | - | 187 | 117 | 973 | 264 | 129 | 1025 | 3438 |
| Egypt | 3614 | 2726 | 2357 | 146 | 924 | 2953 | 1418 | - | 2878 | 17016 |
| Morocco | 2851 | 705 | 2676 | 550 | 1267 | 3101 | 677 | - | 4085 | 15912 |
| Sub Total | 9659 | 5384 | 8753 | 944 | 4007 | 11782 | 3934 | 1342 | 11806 | 57611 |
| % | | | | | | | | | | |
| Sudan | 2607 | 7 | 389 | 110 | 330 | 1212 | 769 | 403 | 930 | 6757 |
| Somalia | 687 | 5 | 79 | 7 | 34 | 65 | 79 | 78 | 101 | 1135 |
| Mauritania | 162 | 56 | 35 | - | 21 | 110 | 48 | - | 104 | 536 |
| Yemen A.R. | 668 | 29 | 110 | 8 | 229 | 369 | 81 | 63 | 367 | 1924 |
| Yemen P.D.R. | 68 | 1 | 57 | 9 | 69 | 89 | 80 | 19 | 118 | 510 |
| Sub Total | 4192 | 98 | 670 | 134 | 683 | 1845 | 1057 | 563 | 1620 | 10862 |
| % | | | | | | | | | | |
| Grand Total | 20355 | 122734 | 22244 | 2258 | 26695 | 28271 | 13884 | 6042 | 40681 | 283164 |
| % | | | | | | | | | | |

SOURCE: Compiled from Arab Monetary Fund Report 1983, Arab Countries National Accounts 1971-81, Arab Monetary Fund 1983.

APPENDIX 2.8

Arab Countries: Sectoral Contribution to GDP in 1980 (at factor cost and in million U.S. $, at current prices)

| Country | Agriculture Fishing & Forest | Mining & Fuel | Manufacturing | Electric Water & Gas | Construction | Commerce Rest. & Hotel | Transport Comm. & Storage | Finance Ins. & Bank | Services sector | GDP |
|---|---|---|---|---|---|---|---|---|---|---|
| Algeria | 2566 | 13281 | 4477 | 446 | 4826 | 4980 | 1521 | - | 6315 | 38412 |
| Iraq | 2925 | 22193 | 2121 | 208 | 1451 | 1409 | 1552 | 635 | 3935 | 36429 |
| Sub Total | 5491 | 35474 | 6598 | 654 | 6277 | 6389 | 3073 | 635 | 10250 | 74841 |
| % | | | | | | | | | | |
| U.A.E. | 223 | 19088 | 1130 | 350 | 2653 | 2453 | 1006 | 1275 | 1889 | 30067 |
| Saudi Arabia | 1397 | 73059 | 5032 | 82 | 12862 | 5272 | 4512 | 1375 | 11908 | 115499 |
| Qatar | 41 | 5263 | 294 | 29 | 476 | 485 | 132 | 367 | 839 | 7926 |
| Kuwait | 64 | 18728 | 1627 | 92 | 814 | 1731 | 460 | 679 | 3371 | 27566 |
| Libya | 539 | 22327 | 805 | 164 | 3064 | 1520 | 1184 | 760 | 4008 | 34371 |
| Oman | 106 | 3547 | 65 | 86 | 322 | 542 | 118 | 84 | 692 | 5562 |
| Sub Total | 2370 | 142012 | 8953 | 803 | 20191 | 12003 | 7412 | 4540 | 22707 | 220991 |
| % | | | | | | | | | | |
| Jordan | 216 | 133 | 426 | 57 | 326 | 557 | 267 | 382 | 672 | 3036 |
| Bahrain | 39 | 1152 | 726 | 32 | 259 | 433 | 294 | 355 | 623 | 3913 |
| Tunisia | 1216 | 1127 | 1026 | - | 578 | 1843 | 457 | - | 1279 | 7526 |
| Syria | 2702 | - | 2700 | - | 783 | 2735 | 797 | 801 | 2807 | 13325 |
| Lebanon | 348 | 532 | - | 221 | 139 | 1153 | 313 | 152 | 1216 | 4074 |
| Egypt | 4896 | 4436 | 3063 | 173 | 1087 | 3568 | 1873 | - | 3661 | 22757 |
| Morocco | 3229 | 871 | 3051 | 601 | 1230 | 3393 | 793 | - | 4654 | 17822 |
| Sub Total | 12646 | 8251 | 10992 | 1084 | 4402 | 13682 | 4794 | 1690 | 14912 | 72453 |
| % | | | | | | | | | | |
| Sudan | 2705 | 8 | 432 | 141 | 392 | 1254 | 862 | 353 | 1043 | 7190 |
| Somalia | 787 | 6 | 91 | 8 | 39 | 70 | 91 | 90 | 113 | 1299 |
| Mauritania | 161 | 60 | 39 | - | 47 | 121 | 52 | - | 118 | 598 |
| Yemen A.R. | 758 | 33 | 144 | 14 | 220 | 451 | 95 | 76 | 455 | 2246 |
| Yemen P.D.R. | 65 | 1 | 61 | 8 | 53 | 101 | 70 | 22 | 159 | 540 |
| Sub Total | 4476 | 108 | 767 | 171 | 751 | 2001 | 1170 | 541 | 1888 | 11873 |
| % | | | | | | | | | | |
| Grand Total | 24983 | 185845 | 27310 | 2712 | 31621 | 34075 | 16449 | 7406 | 49757 | 380158 |
| % | | | | | | | | | | |

SOURCE: Complied from Arab Monetary Fund Report 1983, Arab Countries National Accounts 1971-81,

APPENDIX 2.9

Planned Investment by Economic Sector for 1970's

(million $ US)

| | Major Oil-Exporting Countries | Non-Oil Countries | Least Developed Countries | TOTAL |
|---|---|---|---|---|
| | 64.5% | 30.5% | 5.0% | 100% |
| Productive Sectors | 120796 | 57444 | 9438 | 187678 |
| Agricultural | (17496) | (12268) | (3760) | (33524) |
| Mining & Manufacturing | (52405) | (21136) | (2647) | (76188) |
| Contruction & Building | (30517) | (12018) | (2190) | (44725) |
| Electricity, Water & Gas | (20378) | (12022) | (841) | (33241) |
| | 62.8% | 30.0% | 7.2% | 100% |
| Distribution Sectors | 42882 | 20549 | 4887 | 68318 |
| Transportation & Storage | (35863) | (17095) | (4165) | (57123) |
| Trade | (7019) | (3454) | (722) | (11195) |
| | 84.81% | 12.3% | 2.9% | 100% |
| Service Sectors | 69667 | 10147 | 2320 | 82134 |
| Health & Education | (38925) | (5276) | (1207) | (45408) |
| Other Services | (30742) | (4871) | (1113) | (36726) |
| TOTAL | (233345) | (88140) | (16645) | (338130) |
| % | 69% | 26% | 5% | 100% |

SOURCE: Table 2/12, p.295
Joint Arab Economic Report 1981.

APPENDIX 2.10

## Non Oil Arab Countries
## Official Unrequited Transfer

| | Jordan | Egypt | Morocco | Somalia | Sudan | Tunisia | Syria | Yemen North | Yemen South | Maurintania | TOTAL |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1980 | 1308.7 | 36 | 114 | 142.6 | 17.8 | 101 | 1520 | 145.8 | 84.0 | 117.1 | 3587.0 |
| 1979 | 1055.6 | 49 | 43 | 58.1 | 1.3 | 59 | 1627 | 254.8 | 24.9 | 123.1 | 3295.8 |
| 1978 | 335.3 | 318 | 58 | 27.8 | 15.1 | 34 | 782 | 125.3 | 40.2 | 158.6 | 1894.3 |
| 1977 | 500.3 | 405 | 15 | 105.8 | 21.0 | 51 | 1142 | 114.1 | 55.0 | 127.5 | 2537.7 |
| 1976 | 353.2 | 624 | 6 | 39.7 | 20.9 | 56 | 402 | 102.7 | 46.3 | 152.8 | 1803.6 |
| 1975 | 409.5 | 986 | 34 | 100.3 | 46.7 | 42 | 654 | 116.3 | 10.1 | 81.8 | 2480.7 |
| 1974 | 252.1 | 994 | 30 | 48.2 | 18.4 | 26 | 416 | 53.3 | 0.6 | 69.4 | 1908.0 |
| 1973 | 186.5 | 633 | 33 | 25.9 | -1.7 | 41 | 364 | | 0.5 | 45.1 | 1327.3 |
| 1972 | 184.5 | 290 | 30 | 15.2 | 6.3 | 33 | 45 | | | | 604.0 |
| 1971 | 100.3 | 268 | 35 | 17.2 | -1.4 | 26 | 21 | | 1.0 | | 467.1 |
| 1970 | 110.8 | 304 | 37 | 12.2 | 1.5 | 35 | 3 | | | 8.5 | 512.0 |
| | 4796.8 | 4907 | 435 | 593.0 | 145.9 | 504 | 6977 | 912.3 | 262.6 | 883.9 | 20417.75 |

SOURCE: I.M.F. International Financial Statistics, 1982

APPENDIX 2.11

Non Oil Arab Countries
Official Unrequited Transfer

| | Jordan | Egypt | Morocco | Somalia | Sudan | Tunisia | Syria | Yemen North | Yemen South | Maurintania | TOTAL |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1980 | 664.8 | 2696 | 1004 | 57.3 | 209.0 | 286 | 137 | 1069.5 | 347.1 | -33.7 | 6437.0 |
| 1979 | 508.6 | 2213 | 8913 | 35.9 | 9.9 | 271 | 112 | 936.7 | 311.5 | -26.5 | 5263.1 |
| 1978 | 466.2 | 1773 | 702 | 78.1 | 1.3 | 204 | 95 | 910.1 | 254.8 | -25.6 | 4458.9 |
| 1977 | 420.8 | 896 | 546 | 2.2 | -.3 | 152 | 92 | 987.1 | 187.3 | -22.9 | 3260.2 |
| 1976 | 401.7 | 842 | 499 | 1.2 | -.6 | 128 | 53 | 675.9 | 119.3 | -28.4 | 2691.1 |
| 1975 | 172.1 | 455 | 482 | 1.9 | -1.2 | 131 | 52 | 270.2 | 58.8 | -22.7 | 1599.1 |
| 1974 | 82.4 | 310 | 299 | 3.5 | 4.9 | 106 | 44 | 135.5 | 42.8 | -12.7 | 1015.4 |
| 1973 | 55.6 | 123 | 211 | 2.7 | 6.3 | 91 | 37 | | 32.9 | -14.2 | 545.3 |
| 1972 | 27.2 | 110 | 107 | 1.8 | 3.5 | 53 | 39 | | 27.1 | | 368.6 |
| 1971 | | 38 | 74 | 2.1 | -.9 | 44 | 8 | | 43.8 | | 209.0 |
| 1970 | | 33 | 36 | 0.7 | -1.2 | 23 | 7 | | 52.1 | -5.9 | 144.7 |
| | 2799.4 | 9489 | 4851 | 187.4 | 230.7 | 148.9 | 676 | 4985.0 | 1477.7 | -192.6 | 25992.4 |

SOURCE: I.M.F. International Financial Statistics, 1982

APPENDIX 3.1

Branches and Head Offices of Commercial Banks in the peninsula countries in 1966

| | Saudi Arabia | U.A.E. | Qatar | Bahrain | Oman | Kuwait |
|---|---|---|---|---|---|---|
| British Bank of the Middle East | 3 | 4 | 1 | 2 | 2 | 6 |
| Eastern Bank | | 3 | 1 | 2 | | |
| Ottoman Bank | | 1 | 1 | | | |
| First National City Bank | 1 | 1 | | | | |
| Banque de lilndochine | 2 | | | | | |
| Algemene Bank Nederland | 2 | | | | | |
| National Bank of Pakistan | 1 | | | | | |
| Habib Bank | | 1 | | | | |
| Arab Bank | 6 | 1 | 1 | 1 | | |
| Banque du Cairo | 4 | | | | | |
| Banque Misr | 2 | | | | | |
| Banque de Liban | 1 | | | | | |
| Intra Bank | | | 1 | | | |
| Riyad Bank | 10 | | | | | |
| National Commercial Bank | 11 | | | | | |
| Qatar National Bank | | | 1 | | | |
| National Bank of Dubai | | 2 | | | | |
| Bank of Bahrain | | | | 1 | | |
| National Bank of Kuwait | | | | | | 9 |
| Commercial Bank of Kuwait | | | | | | 5 |
| Gulf Bank | | | | | | 3 |
| | 43 | 13 | 6 | 6 | 2 | 23 |

SOURCE: The Bankers Almanac and Year Book 1966-1967.

APPENDIX 3.2

Branches and Head Offices of Commercial Banks in Jordan in 1966

| BANK | OFFICE |
|---|---|
| Bank of Jordan | 12 |
| Cairo Amman Bank | 13 |
| Jordan National Bank | 9 |
| Arab Bank | 10 |
| Ottoman Bank | 8 |
| British Bank of the Middle East | 2 |
| Intra Bank | 5 |
| Rafidain Bank | 1 |
| | 60 |

SOURCE: The Bankers Almanac and Year Book 1966-1967.

APPENDIX 3.3

Ratio of Total Inter-Arab Trade to total external Trade

Figures in percent

| Country | 1971 | 1972 | 1974 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|
| Jordan | 26.45 | 22.67 | 21.65 | 23.02 | 22.91 | 26.28 | 23.64 |
| Emirates | 2.55 | 3.52 | 2.82 | 4.20 | 6.29 | 5.11 | 5.04 |
| Bahrain | 29.13 | 23.51 | 38.53 | 34.80 | 41.42 | 41.81 | 42.99 |
| Tunisia | 4.91 | 4.79 | 8.13 | 6.30 | 7.14 | 8.03 | 4.67 |
| Algeria | 2.04 | 2.08 | 3.67 | 0.12 | 0.15 | 0.35 | 0.04 |
| Saudi Arabia | 8.48 | 8.08 | 6.10 | 4.03 | 4.26 | 4.02 | 4.93 |
| Sudan | | 8.74 | 9.56 | 6.78 | 8.52 | 29.23 | 23.66 |
| Syria | 19.53 | 17.66 | 13.65 | 14.80 | 17.19 | 18.92 | 7.82 |
| Somalia | 25.08 | 25.71 | 20.78 | 35.08 | 21.45 | 19.77 | 21.10 |
| Iraq | 8.00 | 6.25 | 2.70 | 2.95 | 3.93 | 3.95 | 0.43 |
| Oman | 2.80 | 4.03 | 6.48 | 7.59 | 6.57 | 7.67 | 0.32 |
| Qatar | 4.86 | 7.90 | 3.38 | 1.83 | 3.84 | 3.78 | 3.81 |
| Kuwait | 3.19 | 3.32 | 3.44 | 6.38 | 6.19 | 7.48 | 3.43 |
| Lebanon | 23.94 | 24.45 | 26.01 | 29.63 | 26.65 | 24.98 | 25.06 |
| Libya | 1.77 | 2.17 | 1.64 | 0.95 | 0.52 | 0.56 | 0.30 |
| Egypt | 7.53 | 7.83 | 6.72 | 4.71 | 4.76 | 5.95 | 2.60 |
| Morocco | 3.69 | 3.89 | 6.59 | 6.73 | 10.67 | 13.87 | 16.21 |
| Muritania | | | | 0.87 | 1.07 | 0.75 | 0.34 |
| Yemen A.R. | 33.23 | 25.56 | 16.20 | 29.10 | 23.49 | 25.31 | 16.78 |
| Yemen P.D.R. | 25.81 | 19.46 | 24.82 | 20.47 | 24.26 | 37.56 | 3.88 |
| TOTAL | 7.2 | 7.1 | 6.4 | 5.6 | 5.9 | 6.1 | 5.3 |

SOURCE: External Arab Trade 1971-1981.

APPENDIX 3.4

Total inter-Arab Trade of member countries

Figures in million of U.S. dollars

| Country | 1971 | 1972 | 1974 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|
| Jordan | 65.2 | 71.0 | 139.3 | 413.3 | 541.7 | 780.0 | 935.7 |
| Emirates | 29.3 | 55.5 | 230.6 | 609.1 | 1296.2 | 1494.3 | 1506.5 |
| Bahrain | 166.3 | 166.4 | 924.0 | 1369.8 | 2055.7 | 2962.6 | 3641.9 |
| Tunisia | 27.6 | 37.5 | 167.6 | 207.2 | 331.0 | 459.0 | 300.4 |
| Algeria | 42.3 | 57.8 | 323.3 | 17.8 | 27.3 | 86.1 | 9.6 |
| Saudi Arabia | 364.7 | 460.5 | 2079.6 | 2349.2 | 3538.1 | 5316.7 | 7321.7 |
| Sudan | 55.8 | 60.9 | 101.4 | 117.1 | 141.0 | 619.4 | 529.3 |
| Syria | 123.7 | 146.0 | 274.8 | 520.6 | 854.8 | 1177.9 | 570.7 |
| Somalia | 24.4 | 30.9 | 42.5 | 122.1 | 113.3 | 131.6 | 127.7 |
| Iraq | 147.1 | 113.3 | 241.8 | 452.6 | 1236.3 | 1590.7 | 126.9 |
| Oman | 6.9 | 11.3 | 99.2 | 187.9 | 228.6 | 389.5 | 21.3 |
| Qatar | 19.3 | 42.1 | 60.8 | 64.2 | 185.6 | 223.0 | 209.1 |
| Kuwait | 100.8 | 125.5 | 430.0 | 957.1 | 1461.4 | 2015.1 | 825.4 |
| Lebanon | 219.8 | 301.7 | 1004.1 | 931.6 | 1119.3 | 1322.1 | 949.4 |
| Libya | 60.2 | 72.7 | 180.9 | 138.5 | 119.4 | 182.7 | 92.1 |
| Egypt | 128.9 | 134.9 | 259.8 | 398.9 | 270.4 | 470.3 | 312.0 |
| Morocco | 44.3 | 55.3 | 237.9 | 300.9 | 600.5 | 931.3 | 1079.8 |
| Muritania | | | | 4.2 | 6.5 | 5.5 | 3.0 |
| Yemen A.R. | 12.6 | 21.6 | 32.9 | 375.6 | 353.3 | 474.6 | 299.0 |
| Yemen P.D.R. | 67.2 | 30.8 | 128.9 | 127.1 | 241.0 | 680.0 | 58.8 |
| TOTAL | 1706.4 | 1996.6 | 6959.4 | 9664.8 | 14721.4 | 21313.0 | 18920.3 |

SOURCE: AMF External Arab Trade 1971-1982. 1983.

APPENDIX 3.5

Total external Trade Merchandise Exports & Imports

Figures in million of U.S. dollars

| Country | 1971 | 1972 | 1974 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|
| Jordan | 246.5 | 314.5 | 643.5 | 1795.2 | 2364.1 | 2968.1 | 3957.5 |
| Emirates | 1147.8 | 1578.3 | 8173.2 | 14509.9 | 20599.5 | 29262.5 | 29886.1 |
| Bahrain | 570.8 | 707.7 | 2398.3 | 3936.5 | 4963.1 | 7085.1 | 8471.4 |
| Tunisia | 563.2 | 780.4 | 2061.6 | 3287.1 | 4633.2 | 5724.7 | 6428.5 |
| Algeria | 2077.7 | 2777.5 | 8807.5 | 14996.8 | 18136.0 | 24488.4 | 21704.4 |
| Saudi Arabia | 4298.4 | 5695.9 | 34101.0 | 58263.7 | 83006.0 | 1322779.9 | 148597.9 |
| Sudan | 662.8 | 696.5 | 1061.1 | 1726.8 | 1656.1 | 2119.1 | 2237.2 |
| Syria | 633.5 | 826.7 | 2013.1 | 3518.4 | 4973.0 | 6226.3 | 7275.4 |
| Somalia | 97.3 | 120.3 | 204.7 | 347.9 | 528.0 | 665.7 | 605.2 |
| Iraq | 1839. | 1812.7 | 8970.8 | 15275.6 | 31491.9 | 40266.6 | 29595.5 |
| Oman | 245.1 | 279.6 | 1530.2 | 2475.9 | 3480.2 | 5076.6 | 6703.8 |
| Qatar | 397.1 | 532.6 | 1800.7 | 3501.9 | 4831.4 | 5905.4 | 5495.8 |
| Kuwait | 3162.3 | 3780.1 | 12514.7 | 15008.1 | 23611.9 | 26950.1 | 24059.8 |
| Lebanon | 918.0 | 1234.0 | 3860.4 | 3144.0 | 4199.8 | 5291.8 | 3787.9 |
| Libya | 3394.4 | 3345.8 | 11024.5 | 14509.6 | 23173.7 | 32489.7 | 31072.2 |
| Egypt | 1711.2 | 1722.7 | 3867.3 | 8463.9 | 5677.1 | 7906.7 | 12014.8 |
| Morocco | 1200.4 | 1421.0 | 3612.6 | 4469.3 | 5629.5 | 6715.7 | 6661.9 |
| Muritania | 153.6 | 178.2 | 372.3 | 477.9 | 608.7 | 725.8 | 896.2 |
| Yemen A.R. | 38.0 | 84.5 | 203.0 | 1290.7 | 1505.3 | 1875.6 | 1782.0 |
| Yemen P.D.R. | 260.3 | 158.5 | 519.4 | 620.6 | 993.1 | 1810.6 | 1517.0 |
| TOTAL | 23617. | 28047. | 10773.9 | 171619.8 | 246061.6 | 345832.4 | 352660.5 |

SOURCE: AMF External Arab Trade 1971-1981.

APPENDIX 3.6

## Arab Banks and financial institutions in London

| | Status | Parents Company's headquarters |
|---|---|---|
| Abu Dhabi Investment Authority | Liaison Office | Abu Dhabi |
| AFARCO Investment (Kuwait-London) | Branch | Kuwait |
| Allied Arab Bank (two offices) | UK-registered | London |
| Al-Rajhi Company for Islamic Investments | UK-registered | London |
| Al Saudi Banque (two braches) | Branch | Paris |
| Altajir Limited | UK-registered | Grand Cayman |
| Arab African International Bank | Representative | Cairo |
| Arab Bank (three offices) | Branch | Amman |
| Arab Banking Coporation | Representative | Manama |
| Arab Bank Investment Company | UK-registered | London |
| Arab international Finance Company | UK-registered | London |
| Arab Latin American Bank | Representative | Lima |
| Arinfi-Arab International Finance | UK-registered | London |
| Artoc Bank & Trust Bank of Credit | Representative | Kuwait |
| & Commerce International | Branch | Luxembourg |
| Bank of Oman | Branch | Dubai |
| Banque d'Affaires Franco-Arabes | Representative | Paris |
| Banque de la Mediterranee | Representative | Paris |
| Byblos Arab Finacial Bank (Belgium) | Representative | Brussels |
| Capital Guidance | UK-registered | Luxembourg |
| European Arab Bank | UK-registered | Luxembourg |
| Finarab Investment Company | Representative | Curacao |
| First Arabian Corportation | Branch | Luxembourg |
| Galadari Finance Company | UK-registered | Dubai |
| Gulf Bank, The | Representative | Kuwait |
| Gulf International Bank | Representative | Manama |
| International Resources & Finace Bank | Branch | Luxembourg |
| International Trade & Investment Bank | Representative | Luxembourg |
| Jammal Trust Bank | Branch | Beirut |
| Khalij Commerical Bank | Representative | Adu Dhabi |
| Kuwait Investment Office | Representative | Kuwait |
| MEA Investment Company | UK-registered | Luxembourg |
| National Bank of Abu Dhabi (two branches) | Branch | Abu Dhabi |
| National Bank of Kuwait | Representative | Kuwait |
| National Commerce Bank | Representative | Jeddah |
| Oriental Credit | UK-registered | Luxembourg |
| Qatar Investment Office | Representative | Doha |
| Qatar National Bank (two branches) | Branch | Doha |
| Rafidain Bank | Branch | Baghdad |
| Sarabex (money broker) | UK-registered | London |
| Saudi International Bank | UK-registered | London |
| Saudi Arabian Investment Company (Overseas) | Liaison Office | Jeddah |
| SCF Finance Company | UK-registered | Geneva |
| Sharjah Group Company | Representative | Kuwait |
| UBAF Bank Limited | UK-registered | Paris |
| UBAF Financial Services | UK-registered | London |
| United Bank of Kuwait | UK-registered | London |
| Yemen Bank for Reconstruction & Development | Representative | Sanaa |

SOURCE: Arab British Commerce. Arab banking and Insurance Special Issue March, 1981

APPENDIX 3.7

## Top 60 Arab Banks by Country

| Country | | Assets Less contra accounts | Deposits | Gross Revenue |
|---|---|---|---|---|
| Algeria | Banque Nationale d'Algeria | 11357 | 8492 | 405 |
| | Banque Exterieure d'Algeria | 7791 | 4842 | |
| | Credit populaire d'Algeria | 3291 | 2146 | |
| Bahrain | Arab Banking Corporation | 4788 | 3770 | 621 |
| | Gulf International Bank | 4507 | 4146 | 588 |
| | Bank of Bahrain & Kuwait | 1560 | 1392 | |
| | Gulf Riyad Bank | 1228 | 1151 | 148 |
| | National Bank of Bahrain | 1037 | | 69 |
| Egypt | National Bank of Egypt | 5724 | 3377 | 511 |
| | Bank Misr | 4017 | 3384 | 346 |
| | Banque du Cairo | 3947 | 3234 | 173 |
| | Arab African International Bank | 2994 | 2575 | 368 |
| | Bank of Alexandria | 2824 | 1977 | 251 |
| | Arab International Bank | 1918 | 1609 | 204 |
| France | Union de Banques Arabes et Franaises | 5847 | 5520 | 710 |
| | Banque Intercontinentale Arabe | 1769 | 1679 | 242 |
| | Al Saudi Banque | 1152 | n.a | 137 |
| | Union Mediterraneene de Banques | 1055 | n.a | 158 |
| Iraq | Rafidan Bank | 18064 | 15778 | 1250 |
| Jordan | Arab Bank | 8476 | 8118 | 999 |
| Kuwait | National Bank of Kuwait | 6940 | 6581 | |
| | Gulf Bank | 5340 | 5055 | |
| | Commercial Bank of Kuwait | 5132 | 4440 | |
| | Alahli Bank of Kuwait | 4492 | 4232 | |
| | Bank of Kuwait & the Middle East | 2647 | 2459 | |
| | Burgan Bank | 1958 | 1849 | |
| | Kuwait Finance House | 1247 | n.a | 121 |
| Luxemberg | Bank of Credit & Commerce International | 7345 | 6741 | 946 |
| | Compagnie Arabe et International | 2819 | 2576 | |
| | d'Investissement | 2319 | 2148 | |
| | European Arab Bank Group | | | |

APPENDIX 3.7 cont'd

Top 60 Arab Banks by Country

| Country | Institutions | Assets Less contra accounts | Deposits | Gross Revenue |
|---|---|---|---|---|
| Libya | Umma Bank | 5774 | 1181 | n.a |
| | National Commercial Bank | 3951 | 3019 | 132 |
| | Wahda Bank | 3004 | 2257 | 229 |
| | Jamahyria Bank | 2632 | 1396 | 124 |
| | Libyan Arab Foreign Bank | 2187 | 1717 | n.a. |
| | Sahara Bank | 1016 | n.a. | 74 |
| Morocco | Banque Morocaine du Commerce Exterieur | 1381 | 1243 | 109 |
| | Credit Populaire du Maroc | 1359 | 1172 | 107 |
| Peru | Arab Latin America Bank | 2089 | 1838 | 276 |
| Qatar | Qatar National Bank | 1509 | 1371 | 197 |
| Sauid Arabia | National Commercial Bank | 12171 | 9574 | 976 |
| | Riyad Bank | 7768 | 5568 | 813 |
| | Saudi Cairo Bank | 2388 | 1663 | n.a. |
| | Saudi American Bank | 2220 | 1883 | 341 |
| | Al Bank Alsaudi Alfaransi | 1815 | 1499 | 251 |
| | Al Bank Alsaudi Alholandi | 1604 | 1334 | n.a. |
| | Saudi British Bank | 1478 | 1278 | 196 |
| | Saudi Investment Banking Corporation | 1433 | 1348 | n.a. |
| | Arab National Bank | 1218 | n.a. | 117 |
| Spain | Banco Arabe Espanol | 1409 | 1279 | 212 |
| Syria | Commercial Bank of Syria | 4331 | 2493 | n.a. |
| Tunisia | Societe Tunisienne de Banque | 1862 | n.a. | 66 |
| U.A.E. | National Bank of Abu Dhabi | 6151 | 5163 | 766 |
| | Bank of Oman | 1690 | 1458 | n.a. |
| | National Bank of Dubai | 1122 | n.a. | n.a. |
| United Kingdom | Saudi International Bank | 3858 | 3570 | 497 |
| | U.B.A.F. Bank Ltd. | 1311 | 1183 | n.a. |
| | United Bank of Kuwait | 1186 | n.a. | n.a. |
| U.S.A. | Financial General Bank Shares | 2627 | 2201 | 307 |
| | U.B.A.F. Arab American Bank | 1088 | n.a. | 157 |

SOURCE: The Banker (December, 1982), p.132

APPENDIX 3.8

Arab countries : commercial banks assets

(in millions of USA dollars)

| COUNTRY | 1971 | 1981 | Average Annual Growth |
|---|---|---|---|
| Algeria | 2015 | 21905 | 22% |
| Iraq | 715 | | |
| | | | |
| U.A.E. | * 909 | 17834 | 28% |
| Qatar | 135 | 2281 | 26% |
| Kuwait | 2067 | 27004 | 24% |
| Saudi Arabia | 819 | 31004 | 35% |
| Libya | 818 | **13208 | 26% |
| | | | |
| Jordan | 231 | 3926 | 26% |
| Bahrain | 226 | 2553 | 24% |
| Tunisia | 741 | 4171 | 16% |
| Syria | 534 | 5760 | 22% |
| Oman | 100 | 1635 | 26% |
| Lebanon | 2005 | 10391 | 14% |
| Egypt | 3358 | 19684 | 16% |
| Morocco | 873 | 4587 | 15% |
| Sudan | 294 | 1990 | 17% |
| Somalia | 61 | 498 | 19% |
| Mauritania | 33 | 288 | 20% |
| Yemen A.R. | 59 | 910 | 25% |
| Yemen P.D.R. | 58 | 580 | 22% |
| TOTAL | 16051 | 170209 | 22% |

SOURCE: AMF <u>Money and credit in Arab countries 1971-1982</u> (Abu Dhabi, 1983)

Note: * 1983

** 1979

APPENDIX 3.9

Financial indicators: Arab countries

| Country | M1 percentage of GDP x 100 | | M2/ GDP x 100 | | Foreign assets (net) / Domestic Liquidity | | Total Deposit to GDP | |
|---|---|---|---|---|---|---|---|---|
| | 1981 | 1982 | 1981 | 1982 | 1981 | 1982 | 1981 | 1981 |
| Jordan | 58 | 58 | 99 | 104 | 41 | 30 | 64 | 68 |
| Emirates | 8 | 9 | 25 | 31 | 65 | 58 | 22 | 26 |
| Bahrain | 15 | 14 | 43 | 41 | 109 | 103 | 49 | 47 |
| Tunisia | 29 | 32 | 43 | 47 | 13 | 12 | 33 | 28 |
| Algeria | 54 | 61 | 60 | 68 | 15 | 10 | 29 | 36 |
| Saudi Arabia | 14 | 16 | 9 | 24 | 470 | 454 | 13 | 16 |
| Sudan | 34 | 35 | 40 | 42 | -60 | -61 | 22 | 16 |
| Syria | 39 | 35 | 44 | 40 | - 9 | | 29 | - |
| Somalia | 37 | 36 | 46 | 44 | 1 | -16 | 19 | 12 |
| Iraq | - | - | - | - | - | - | - | - |
| Oman | 9 | 11 | 19 | 25 | 109 | 92 | 14 | 17 |
| Qatar | 10 | 12 | 23 | 28 | 68 | 61 | 20 | 23 |
| Kuwait | 19 | 20 | 57 | 68 | 56 | 58 | 53 | 62 |
| Lebanon | 55 | 90 | 248 | 397 | 53 | 46 | 220 | 339 |
| Libya | 39 | 45 | 52 | 58 | 64 | 44 | 33 | 36 |
| Egypt | 30 | 32 | 62 | 68 | -10 | -6 | 40 | 45 |
| Morocco | 38 | 36 | 44 | 44 | - 3 | -9 | 26 | 26 |
| Mauritania | 22 | 19 | 29 | 26 | -14 | -54 | 20 | 20 |
| Yemen A.R. | 64 | 74 | 80 | 90 | 54 | 25 | 22 | 24 |
| Yemen P.D.R. | 95 | 93 | 118 | 120 | 24 | 18 | 47 | 50 |

SOURCE: AMF Money and credit in the Arab countries 1972-82. 1983.

AMF National Accounts of the Arab countries 1972-82. 1983.

APPENDIX 3.10

Financial Indicators for some developed and undeveloped countries

| Country | GDP per captia $ 1979 | M1/GDP 1979 | M2/GDP 1976 | 1977 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|---|
| France | 10,698 | 26 | 50 | 51 | 51 | 51 | 49 | 48 |
| Germany | 12,482 | 16 | 53 | 55 | 56 | 55 | 54 | 54 |
| Japan | 8,418 | 32 | 86 | 86 | 86 | 88 | 88 | 88 |
| United Kingdom | 7,184 | 15 | 36 | 34 | 34 | 33 | 33 | 39 |
| Argentina | 3,484 | 13 | 26 | 31 | 33 | 36 | 34 | |
| Cyprus | | 21 | 83 | 74 | 71 | 69 | 66 | |
| Greece | 3,588 | 18 | 61 | 64 | 66 | 63 | 64 | 70 |
| India | 170 | 17 | 32 | 34 | 38 | 41 | 40 | |
| Indonisia | 344 | 10 | 17 | 17 | 17 | 17 | 18 | 19 |
| Kenya | 345 | 23 | 29 | 33 | 34 | 36 | 31 | 30 |
| Tanzania | 229 | 28 | 30 | 28 | 28 | 37 | 43 | |
| Singapore | 3,752 | 28 | 64 | 62 | 62 | 64 | 68 | 72 |
| Turkey | 1,277 | 21 | 28 | 28 | 25 | 25 | 21 | 27 |
| Yugoslavia | 2,783 | 30 | 79 | 79 | 83 | 78 | 80 | |

SOURCE: IMF., IFS., various issues.

APPENDIX 3.11

Commercial banks' sources of funds as end of 1982 in percentage

| Country | Demand Deposits | | | Time and Savings Deposits | Credit from Central Bank | Foreign liabilit-ies | Capital Account | Total |
|---|---|---|---|---|---|---|---|---|
| | Official entities and private sector | Govern-ment deposits | Total | | | | | |
| Jordan | 19.6 | 5.0 | 24.6 | 39.5 | - | 27.5 | 8.4 | 100 |
| Emirates | 8.7 | 4.9 | 13.6 | 30.9 | 0.3 | 41.3 | 13.9 | 100 |
| Bahrain | 18.2 | 5.4 | 23.6 | 47.9 | - | 17.1 | 11.4 | 100 |
| Tunisia | 33.5 | - | 33.5 | 25.3 | 21.2 | 14.1 | 5.9 | 100 |
| Algeria | 45.2 | - | 45.2 | 11.1 | 27.7 | 3.8 | 12.2 | 100 |
| Saudi Arabia | 41.5 | 6.9 | 48.4 | 33.6 | | 11.7 | 6.3 | 100 |
| Sudan | 35.5 | - | 35.5 | 17.7 | 3.6 | 39.5 | 3.7 | 100 |
| Syria | 30.2 | 10.8 | 41.0 | 10.4 | 3.9 | 41.8 | 2.9 | 100 |
| Somalia | 34.8 | - | 34.8 | 17.8 | 37.0 | 10.2 | 0.2 | 100 |
| Iraq | 13.6 | 46.0 | 59.6 | 27.3 | - | 6.8 | 6.3 | 100 |
| Oman | 12.3 | 12.9 | 25.2 | 36.2 | - | 32.7 | 5.9 | 100 |
| Qatar | 24.1 | 3.9 | 28.0 | 43.5 | - | 22.2 | 6.3 | 100 |
| Kuwait | 9.8 | 4.2 | 14.0 | 32.0 | 2.7 | 45.1 | 6.2 | 100 |
| Lebanon | 9.8 | 1.4 | 11.2 | 67.6 | 0.2 | 17.1 | 3.9 | 100 |
| Libya | 50.9 | 7.1 | 58.0 | 19.1 | - | 17.7 | 5.2 | 100 |
| Egypt | 12.9 | 8.6 | 21.5 | 52.1 | 1.1 | 19.0 | 36.3 | 100 |
| Morocco | 59.4 | - | 59.4 | 22.3 | 10.1 | 4.5 | 3.7 | 100 |
| Mauritania | 26.1 | 3.1 | 29.2 | 15.7 | 13.1 | 35.9 | 6.1 | 100 |
| Yemen A.R. | 21.2 | - | 21.2 | 39.0 | - | 28.2 | 11.6 | 100 |
| Yemen P.D.R. | 33.0 | 11.3 | 44.3 | 38.4 | | 11.9 | 5.4 | 100 |

SOURCE: Calculated from Money and Credit in the Arab Countries 1972-82 1983.
Note 1 data for 1978
Note 2 all data for 1978
Note 3 data for 1980
Note 4 data for 1981

APPENDIX 3.12

Jordan's commercial banks credit facilities by sectors percentage distribution

| Sector | Average 1971-79 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|
| Agriculture | 3.4 | 3.7 | 2.7 | 2.8 | 2.5 |
| Industry & Mining | 12.1 | 15.9 | 12.4 | 12.7 | 13.5 |
| Construction | 20.9 | 21.4 | 28.0 | 24.4 | 26.3 |
| Transportation | 4.3 | 3.1 | 3.2 | 3.7 | 4.9 |
| General commerce & Trade | 39.8 | 36.3 | 31.3 | 32.2 | 26.9 |
| Financial & institutions | .5 | 1.9 | 1.3 | 2.2 | 2.5 |
| Municipalities and Public Corporation | 4.9 | 2.3 | 6.2 | 7.3 | 6.3 |
| Tourist and Hotel | 1.9 | 2.6 | 2.2 | 2.3 | 2.5 |
| Professional & Individuals | 7.1 | 8.4 | 8.4 | 7.8 | 10.5 |
| Others | 5.1 | 4.4 | 4.3 | 4.6 | 4.1 |
| | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

SOURCE: Central Bank of Jordan, Monthly Statistical Bulletin, Vol.12, No.4, and Vol.15, No.4, and Annual Report 1983, p.165.

APPENDIX 3.13

Bank credit in U.A.E. by economic activity % at 31st December

| Sector | 1975 | 1976 | 1977 | 1978 | 1979 March |
|---|---|---|---|---|---|
| Agriculture | 0.1 | 0.1 | 0.2 | 0.3 | 0.3 |
| Mining & Quarrying | 0.3 | 0.2 | 2.1 | 1.8 | 1.8 |
| Manufacturing | 5.8 | 5.6 | 5.7 | 4.9 | 4.7 |
| Electricity, Gas & Water | 2.1 | 1.9 | 2.1 | 3.8 | 3.6 |
| Construction | 24.6 | 25.9 | 32.4 | 33.5 | 34.1 |
| Trade: Retail & Wholesale | 51.1 | 48.0 | 40.1 | 36.7 | 36.6 |
| Transport & Communication | 1.4 | 2.6 | 1.9 | 2.0 | 1.9 |
| Government | 5.7 | 6.3 | 8.3 | 8.7 | 8.9 |
| All Others | 8.9 | 9.5 | 7.2 | 8.3 | 8.4 |
| | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

SOURCE: United Arab Emirates Currency Board Bulletin, Vol.4, No.2, (May 1978) Table A.11 and Bulletin Volume 5, No.2, (May 1979).

APPENDIX 3.14

Arab currencies: Exchange rates and exchange rate arrangements

| | Exchange Rate Arrangements as of April 30, 1985 | Exchange rates expressed in U.S. dollars per national currency unit or vice versa (period average) | | | |
|---|---|---|---|---|---|
| | | | 1978 | 1984 | Change % |
| Algeria | Basket | Dinars per U.S. dollars | 3.96 | 4.98 | -25.7 |
| Bahrain | Dollars | U.S. dollars per Dinar | 2.58 | 2.66 | +3.2 |
| Egypt | Dollars | U.S. dollars per pound | 2.55 | 1.42 | -79.6 |
| Iraq | Dollars | U.S. dollars per Dinar | 3.38 | 3.21 | -5.4 |
| Jordan | SDR | U.S. dollars per Dinar | 3.27 | 2.60 | -25.9 |
| Kuwait | Basket | U.S. dollars per Dinar | 3.63 | 3.38 | -7.2 |
| Lebanon | Independtly floating | Pounds per U.S. dollars | 2.95 | 6.51 | -120 |
| Libya | Dollars | U.S. dollars per Dinar | 3.38 | 3.38 | 00 |
| Mauretania | Basket | Ougiyas per U.S. dollars | 46.16 | 63.80 | -38.2 |
| Morocco | Managed floating | Dirham per U.S. dollars | 4.16 | 8.81 | -117.7 |
| Oman | Dollars | Riyal Omani per U.S. dollars | 0.34 | 0.34 | 00 |
| Qatar | Dollars | U.S. dollars per Riyal | 0.25 | 0.27 | +7.5 |
| S.Arabia | Dollars | Riyals per U.S. dollars | 3.40 | 3.52 | +3.5 |
| Somalia | Set of indicators | Shillings per U.S. dollars | 6.29 | 20.02 | -218.2 |
| Sudan | Dollars | U.S. dollars per pound | 2.66 | 0.77 | -246 |
| Syria | Dollars | Pounds per U.S. dollars | 3.92 | 3.92 | 00 |
| Tunisia | Basket | Dinars per U.S. dollars | 0.42 | 0.77 | -83 |
| U.A.E.s | Dollars | Dirhams per U.S. dollars | 3.87 | 3.67 | +5.2 |
| Yemen AR | Dollars | Riyals per U.S. dollars | 4.56 | 5.35 | -17.3 |
| Yemen PDR | Dollars | U.S. dollars per Dinar | 2.89 | 2.89 | 00 |

SOURCE: International Financial Statistics (June, 1985)

APPENDIX 4.1

## Development Banks in the region

| No. | Country & Name of the Institutions | Note |
|---|---|---|
| 6 | Jordan | |
| | Housing Bank | Founded 1973 |
| | Housing Corporation | |
| | Cities and Villages Development Bank | |
| | Agricultural Credit Corporation | Founded 1959 |
| | Industrial Development Bank | Founded 1965 |
| | Jordan Co-operative Organisation | |
| 3 | United Arab Emirates | |
| | Real Estate National Bank | |
| | Emirates Industrial Bank | |
| | Emirates Development Bank | |
| 1 | Bahrain | |
| | Housing Bank | Founded 1979 |
| 9 | Tunisia | |
| | Banque de Dévéloppement Economique de Tunisie | Established 1959 |
| | Banque Nationale de Dévéloppement Touristique | |
| | Societe Tuniso Seoudienne D'Investissement Et Du Dévéloppement | Established 1981 |
| | Banque Tuniso-Koweitienne De Dévéloppement | Established 1981 |
| | Banque Tuniso-Quatarie D'Investissement | Established 1982 |
| | Banque De Tunisie Et Des Emirates D'Investissement | Established 1982 |
| | Banque De Co-operation Du Maghreb Arab | Established 1981 |
| | Banque Nationale De Dévéloppement Agricole | Established 1983 |
| | Tunisian-Libyan Bank | Under Construction |
| 3 | Oman | |
| | Housing Bank | |
| | Oman Development Bank | Established 1976 |
| | Oman Bank of Agriculture and Fisheries | Established 1982 |
| 3 | Kuwait | |
| | Saving and Credit Bank | Established 1965 |
| | Kuwait Real Estate Bank | Established 1973 |
| | The Industrial Bank of Kuwait | Established 1973 |

Cont'd ....

APPENDIX 4.1 Cont'd

Development Banks in the region

| No. | Country & Name of the Institutions | Note |
|---|---|---|
| 4 | Egypt | |
| | The Principal Bank for Development & Agricultural Credit | Established 1976 |
| | Land Bank | Two Banks |
| | Industrial Development Bank | Established 1975 |
| | | Founded 1965 |
| 5 | Morocco | |
| | Caisse De Depot Et De Gestion | Founded 1959 |
| | Caisse Nationale De Credit Agricole | |
| | Credit Immonilier Et Hotelier | Founded 1920 |
| | Banque Nationale pour le Dévéloppement Economique | Founded 1959 |
| 1 | Mauritania | |
| | Fonds National De Dévéloppement | |
| 7 | Lebanon | |
| | Banque Nationale pour le Dévéloppement Industrial | Established 1973 |
| | Housing Bank | |
| | Agricultural Credit Bank | |
| | Finance Bank | |
| | Finance and Investment Bank | |
| | Bank of the Near East | |
| | Credit Bank of Agriculture, Industry and Real Estate | |
| 4 | Libya | |
| | Development Bank | |
| | Real Estate | |
| | The Agricultural Bank | |
| 4 | Yemen | |
| | Industrial Bank of Yemen | Established 1776 |
| | Agricultural Co-operative and Credit Bank | Established 1971 |
| | Housing Credit Bank | |
| | Credit Bank | |
| 1 | P.D.R.S. of Yemen | |
| | National Bank of Yemen | |

Cont'd ....

APPENDIX 4.1 Cont'd

Development Banks in the region

| No. | Country & Name of the Institutions | Note |
|---|---|---|
| 4 | Algeria | |
| | Banque De L'Agriculture Et Du Dévéloppement Rural | Established 1982 |
| | Banque Algerenne De Dévéloppement | Established 1963 |
| | Caisse Centrale De Co-operative Economique | Established 1968 |
| | Caisse Nationale D'Epargne Et De Prevogance | |
| 4 | Syria | |
| | Agricultural Bank | Founded 1924 |
| | Real Estate Bank | Founded 1966 |
| | Popular Credit Bank | Founded 1967 |
| | Industrial Development Bank | |
| 5 | Saudi Arabia | |
| | Saudi Agricultural Bank | |
| | Saudi Credi Bank | |
| | Public Investment Fund | |
| | Saudi Industrial Development Fund | |
| | Real Estate Development Bank | |
| 5 | Sudan | |
| | Agricultural Bank of Sudan | Founded 1957 |
| | Industrial Bank of Sudan | Founded 1961 |
| | Real Estate of Sudan | |
| | Saving Bank of Sudan | |
| | National Development Bank | Founded 1982 |
| 1 | Somalia | |
| | Somali Development Bank | Founded 1968 |
| 3 | Iraq | |
| | Real Estate Bank | Established 1949 |
| | The Industrial Bank | Founded 1940 |
| | Agricultural Co-operative Bank | |

APPENDIX 4.2

Development Financing Operations of Arab National and Regional Financing Institutions 1962-1983
(million dollars)

| Development Institutions | No. of Countries | No. of Operations | 1962-73 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | Total | % |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Islamic Development Bank | 36 | 276 | - | - | - | - | 119.34 | 188.70 | 498.73 | 475.39 | 649.05 | 519.83 | 571.21 | 3022.252 | 16.4 |
| Abu Dhabi Fund for Arab Economic Development | 40 | 83 | - | 64.29 | 44.18 | 163.73 | 138.82 | 215.95 | 145.14 | 100.61 | 69.88 | 65.68 | 25.76 | 1034.04 | 5.6 |
| OPEC Fund for International Development | 81 | 341 | - | - | - | 42.70 | 243.01 | 155.01 | 212.80 | 250.77 | 400.88 | 323.72 | 212.85 | 1841.74 | 10.0 |
| Saudi Fund for Development | 53 | 183 | - | - | 282.75 | 432.58 | 770.01 | 561.68 | 447.01 | 331.89 | 348.61 | 611.33 | 372.26 | 4158.15 | 22.5 |
| Iraqi Development Fund | 31 | 69 | - | 30.00 | - | 15.00 | 26.30 | 101.20 | 406.30 | 743.26 | 373.30 | 37.66 | - | 1733.02 | 9.4 |
| Arab Fund for Economic and Social Development | 16 | 129 | - | 114.89 | 193.44 | 331.59 | 362.60 | - | 70.23 | 111.72 | 148.40 | 232.75 | 309.74 | 1875.52 | 10.2 |
| Kuwait Fund for Arab Economic Development | 62 | 259 | 342.90 | 138.86 | 327.11 | 318.70 | 410.99 | 200.17 | 353.68 | 268.68 | 741.38 | 763.11 | 389.95 | 4255.52 | 23.0 |
| Arab Bank for Economic Development in Africa | 37 | 92 | - | - | - | 79.04 | 77.04 | 66.92 | 20.20 | 81.02 | 69.70 | 80.00 | 67.15 | 541.43 | 2.9 |
| Grand Total | 99 | 1432 | 342.90 | 348.04 | 847.48 | 1383.70 | 2148.14 | 1489.63 | 2154.09 | 2363.34 | 2801.20 | 2634.08 | 1948.92 | 18461.52 | 100.0 |
| % | | | 1.8 | 1.9 | 4.6 | | 11.6 | 8.1 | 11.7 | 12.8 | 15.2 | 14.3 | 10.5 | 100.0 | |

SOURCE: Coordination Secretariat, Arab Fund for Economic and Social Development; Development Financing of Arab National and Regional Financing Institutions as at End 1983, Kuwait, 1984.

APPENDIX 4.3

**Development Financing Operation to the end of 1982 Sectorial and Countries distribution**

(in million U.S. Dollars)

| Country | Transportation and Telecommunication | Power (Electricity & Gas) | Water & Sewage | Agriculture & Livestock | Industry & Mining | Others | Total | Percentage |
|---|---|---|---|---|---|---|---|---|
| Jordan | 210.47 | 240.85 | 107.02 | 55.64 | 224.02 | 185.00 | 1023.00 | 12.25 |
| Emirates | | | | | 10.00 | 5.13 | 15.13 | |
| Bahrain | 1.40 | 145.22 | | | 14.35 | 26.69 | 192.66 | 2.4 |
| Tunisia | 165.10 | 43.99 | 198.90 | 202.69 | 208.15 | 46.07 | 864.86 | 10.3 |
| Algeria | 128.61 | | | | 264.66 | 24.20 | 417.67 | 5.0 |
| Djubouti | 50.65 | 17.98 | | | 30.55 | 4.00 | 102.98 | 1.3 |
| Sudan | 329.01 | 100.36 | | 120.03 | 144.00 | 43.52 | 736.92 | 8.8 |
| Syria | 214.96 | 116.55 | 67.76 | 6.79 | 46.35 | 50.95 | 503.36 | 6.0 |
| Somalia | 53.82 | 125.22 | 23.98 | 169.88 | 10.80 | 40.90 | 423.60 | 5.0 |
| Iraq | | 7.34 | | | 10.56 | | 17.90 | |
| Oman | 77.74 | 218.06 | | | 28.62 | 24.39 | 348.81 | 4.1 |
| Lebanon | 59.20 | 32.54 | | | | 9.75 | 101.69 | 1.2 |
| Libya | 11.02 | | | | | | 11.02 | |
| Egypt | 373.72 | 135.59 | 62.07 | 25.38 | 147.02 | 18.99 | 762.77 | 9.0 |
| Morocco | 53.60 | 162.77 | 4.52 | 396.97 | 183.37 | 177.12 | 982.35 | 11.6 |
| Mauritania | 183.32 | 28.49 | | 80.78 | 230.21 | 104.86 | 627.66 | 7.4 |
| Yemen A.R. | 130.36 | 149.69 | 27.55 | 52.24 | 1.66 | 45.31 | 406.81 | 4.8 |
| Yemen P.D.R. | 130.92 | 266.65 | 113.21 | 85.07 | 37.30 | 291.11 | 924.22 | 10.9 |
| Total | 2173.70 | 1791.30 | 605.01 | 1195.43 | 1600.62 | 1097.95 | 8464.01 | 100.0 |
| % | 25.6% | 21.2% | 7.1% | 14.1% | 19.0% | 13.0% | 100.0% | |

SOURCE: Arab Monetary Fund, Joint Arab Economic Report 1983

APPENDIX 5.1

Islamic Banks in Arab Countries

| | Name | Est | Paid-up capital (Us$m) | Major shareholders (and notes) |
|---|---|---|---|---|
| Bahrain | Bahrian Islamic Bank | 1979 | 15 | Bahraini public and Government agencies. Kuwaint Finance House and Kuwaiti Government agencies. Dubai Islamic Bank (full banking licence) |
| | Masraf Faisal al-Islami (Bahrain) | 1983 | 20 | Dar al-Maal al-Islami (OBU licence) |
| Egypt | Banque Misr | 1980 | | Egyptian Government (Banque Misr has an Islamic department with separate accounts, but no separate corporate identity) |
| | Faisal Islamic Bank | 1977 | 21 | Egyptian nationals 51%, Saudi and other Muslims 49% (10 branches, offshore status) |
| | Islamic International Bank for Investment and Development | 1981 | 12 | Egyptian nationals, mainly non-resident (Offshore status, investment banking) |
| | Nasser Social Bank | 1972 | 5 | Egyptian Government (21 branches, social Welfare objectives) |

Cont'd ....

APPENDIX 5.1 Cont'd

| | Name | Est | Paid-up capital (Us$m) | Major shareholders (and notes) |
|---|---|---|---|---|
| Jordan | Jordan Islamic Bank for Finance and Investment | 1978 | 9 | Jordanian public ( 8 branches, full commercial licence) |
| Kuwait | Kuwait Finance House | 1977 | 30 | Kuwaiti public 51%, Kuwaiti ministries 49% (10 branches, banking investment and trading) |
| Saudi Arabia | Islamic Development Bank | 1975 | | Governmens of 41 Muslim countries (provides interest-free loans for social and economic development in Muslim countries and communities) |
| | ex-Al Rajhi Company for Currency Exchange and Commerce | 1983 | 172 | Al-Rajhi family (174 branches, foreign exchange dealings and remittances, recently granted licence for Islamic banking) |
| Sudan | Faisal Islamic Bank | 1978 | 9 | Sudanese nationals 40%, non-Sudanese 60% (7 branches, commercial and investment banking) |
| United Arab Emirates | Dubai Islamic Bank | 1975 | 14 | Lootah family, other UAE national (4 branches, including one in Cairo) |

SOURCE: Finacial Times, October 3, 1983.

APPENDIX 5.2

Islam's Banking Institutions in Non-Arab Countries

| | Name | Notes |
|---|---|---|
| Bahamas | Dur al-Maal al-Islami Trust | Holding company for DMI Group, with operating headquarters in Geneva, founded in 1981. Authorised capital $1bn ($308m paid-in) |
| Cyprus (Kibris) | Kibris Islamic Bank | Established 1982, paid-in capital $1m |
| Denmark | Islamic Bank International | Established in summer 1983, Kr 25m paid-in capital, mainly owned by Islamic Banking System Internatinal Holding SA of Luxembourg. First full licence for an Islamic bank in Europe |
| Guinea | Masraf Faisal Isami (Guinea) | Established mid-1983, subsidiary of DMI, authorised capital $20m |
| Iran | Iranian banking | All Iranian banks are now operating Islamically |
| Luxembourg | Islami Banking System International Holding SA | Shareholders from 27 Islamic countries including several Islamic banks |
| Malaysia | Bank Islam Malaysia | Established July 1983. Owned by federal Government (30%), religious councils (25%) and other state agencies. Capital M$100m |
| Niger | Masraf Faisal Islami (Niger) | Established mid-1983, subsidiary of DMI, authorised capital $20m |
| Pakistan | Pakistani Banking System | Plans for complete Islamicisation |
| Senegal | Masraf Faisal Islami (Senegal) | Established mid-1983, subsidiary of of DMI, authorised capital $20m |
| Switzerland | Dar al-Maal al-Islami DMI) SA Shari'a Investment Services, SA | Operating subsidiaries of Dar al-Maal al'Islami Trust |

Cont'd ....

APPENDIX 5.2 Cont'd

| | Name | Notes |
|---|---|---|
| Turkey | Masraf Faisal Islami (Turkey) | Subsidiary of DMI, authorised capital $20m, under formation |
| | Kuwait Finance House (Turkey) | Subsidiary of Kuwait Finance House, under formation |
| United Kingdom | Masraf Faisal Islami (UK) | Incorporated, with authorised capital$0.6m, application as licensed deposit taker submitted |
| | Al Rajhi Company for Islamic Investments | Established in 1981 as a subsidiary of the Al Rajhi Company for Currency Exchange and Commerce. Trade finance for internatinal companies |

SOURCE: The Financial Times, October 3, 1983, p.4

APPENDIX 6.1

Securities Transacted on AFM 1978 to 1983

| | Shares (in millions) | | Bonds (in thousands) | |
|---|---|---|---|---|
| | Number of Traded | Volume of Trading | Number of Traded Bonds | Volume of Trading |
| 1978 | 2.43 | 5.61 | | |
| 1979 | 6.53 | 15.84 | 117 | 780 |
| 1980 | 17.90 | 41.43 | 98 | 1660 |
| 1981 | 29.23 | 75.42 | 217 | 2300 |
| 1982 | 34.6 | 112.25 | 184 | 1940 |
| 1983 | 36.32 | 119.61 | 43 | 610 |

SOURCE: Amman Financial Markets, Various Reports,
Central Bank of Jordan Annual Report Various Issues

APPENDIX 6.2

**Government Securities and Corporations bonds, outstanding at the end of each year according the holders**

(in thousands of JDs)

| | Treasury Bills | | | Government bonds, Bearer and Registered | | | Public corporation bonds | | |
|---|---|---|---|---|---|---|---|---|---|
| | Central Banks | Commercial Banks | Other | Central Banks | Commercial Banks | Other | Central Banks | Commercial Banks | Other |
| 1969 | 4000 | 3770 | 630 | | | | | | |
| 1970 | 8285 | 3350 | 965 | | | | | | |
| 1971 | 12755 | 7320 | 925 | | 1256 | 1744 | | | |
| 1972 | 5040 | 12525 | 2685 | 1180 | 3250 | 3570 | | | |
| 1973 | 8305 | 13010 | 1685 | 2526 | 4014 | 5460 | | | |
| 1974 | 15800 | 10570 | 1630 | 5284 | 4344 | 10372 | | | |
| 1975 | 9450 | 17990 | 1560 | 1507 | 6679 | 14226 | | | |
| 1976 | 18360 | 11200 | 5440 | 80 | 10871 | 21049 | | | 2000 |
| 1977 | 15005 | 20925 | 2070 | 5551 | 9527 | 25922 | | 1400 | 600 |
| 1978 | 1025 | 47395 | 580 | 7901 | 11754 | 29345 | 360 | 9255 | 1385 |
| 1979 | 10895 | 40850 | 6255 | 9780 | 16670 | 29550 | 650 | 8937 | 1413 |
| 1980 | 31495 | 31400 | 3105 | 17405 | 14421 | 29174 | 10713 | 9238 | 49 |
| 1981 | 41440 | 32520 | 540 | 22634 | 17679 | 29691 | 46 | 21360 | 744 |
| 1982 | 52630 | 35015 | 855 | 33448 | 17036 | 28516 | 4644 | 19893 | 1613 |
| 1983 | 32845 | 63470 | 185 | 34319 | 19644 | 31037 | 5855 | 18250 | 2045 |

SOURCE: Central Bank of Jordan
Monthly Statistical Bulletin
Vol.12, No.4
Vol.13, No.7
Vol.18, No.10
Vol.20, No.4

APPENDIX 6.3

## Kuwaiti Share Holding Companies

| Period | Volume of Traded Shares 1000 | Overall Stock Price Index January 1, 1976=100 |
|---|---|---|
| 1976 | 176.297 | 235.2 |
| 1977 | 60.001 | 191.8 |
| 1978 | 164.771 | 258.9 |
| 1979 | 169.220 | 311.4 |
| 1980 | 143.716 | 313.3 |
| 1981 | 246.694 | 489.6 |
| 1982 | 162.427 | 509.4 |

SOURCE: Central Bank of Kuwait
Quarterly Statistical Bulletin
Various Issues

APPENDIX 6.4

Volume of Traded Kuwaiti Dinar Bonds in Primary and Secondary Markets

(in million KD)

| Period | Primary | | Secondary |
|---|---|---|---|
| | Number of Issue | value | |
| 1974 | 1 | 5.0 | |
| 1975 | 8 | 47.5 | |
| 1976 | 13 | 76.0 | |
| 1977 | 7 | 31.0 | |
| 1978 | 16 | 125.0 | 140.4 |
| 1979 | 13 | 106.0 | 90.1 |
| 1980 | 1 | 7.0 | 43.3 |
| 1981 | 5 | 34.0 | 106.4 |
| 1982 | 8 | 53.0 | 125.0 |
| 1983 | 4 | 4.0 | 142.6 |

SOURCE: Arab Company for Securities Trading

APPENDIX 6.5

Lebanese Treasury Bills

(in Millions Pounds)

| Period | Issues | Amortiz-ation | Debt Outstanding |
|---|---|---|---|
| 1977 | 527.40 | | 527.40 |
| 1978 | 3024.60 | 2498.35 | 1053.65 |
| 1979 | 2432.35 | 2320.15 | 1165.85 |
| 1980 | 4045.05 | 2734.85 | 2476.05 |
| 1981 | 11067.23 | 8633.64 | 4909.64 |
| 1982 | 24936.34 | 17567.26 | 12278.72 |
| 1983 | 19309.00 | 17815.25 | 17364.74 |

SOURCE: Bank of Lebanon
Quarterly Bulletin

APPENDIX 6.6

## Basic Development Indicators

| | Average annual rate of inflation % 1960 - 70 | 1970 - 81 |
|---|---|---|
| Algeria | 2.7 | 13.4 |
| Egypt | 2.6 | 11.1 |
| Iraq | 1.7 | - |
| Jordan | - | - |
| Kuwait | - | 18.2 |
| Lebanon | 1.4 | 14.6 |
| Libya | 5.2 | 17.3 |
| Morocco | 2.0 | 8.2 |
| Saudi Arabia | - | 24.3 |
| Sudan | 3.7 | 15.9 |
| Syria | 2.6 | 12.0 |
| Tunisia | 3.6 | 8.2 |
| U.A.E. | - | - |
| Yemen AR | - | 15.6 |
| Yemen PDR | - | - |

Source: World Development Report, World Bank, Washington, 1983, pp.10-11 in summary edition.

APPENDIX 7.1

## Offshore Banking Units

1. Offshore banking Units (OBUs) established in Bahrain must be full branches of the parent bank or must satisfy the Bahrain Monetary Agency (BMA) of the commitment of the parent bank to its office.

2. OBUs must be fully staffed, operational branches whose staff are actively engaged in the business which is written in the books of the branch. Permission will not be given for brass plate operations in which the business is written elsewhere and booked into Bahrain solely as an accounting device.

3. OBUs will not be allowed to deal in any way with residents of Bahrain except for the Government, its Agencies, the fully licensed banks and, as an exception, to participate in the financing of development projects approved by the BMA.

4. OBUs will not be allowed to offer chequing account services but will otherwise be free to offer all banking services to non-residents of Bahrain of all classes, Governments, banks and non-banks.

5. OBUs will not be required to maintain any reserves with the BMA or observe any formal liquidity ratios.

6. OBUs will be required to supply regular monthly statistical information including a balance sheet to the BMA and to satisfy the BMA if called upon to do so of their ability to meet their obligations as they fall due.

7. OBUs will be required to submit to the BMA a balance sheet and profit and loss account of their OBU operation audited by auditors approed by the BMA within 90 days of the year end and in due course file a copy of their Group's published accounts.

8. An annual licence fee of $25,000 is payable to the BMA for an OBU licence; no taxation on OBU profits is at present planned or proposed by the Government of Bahrain.

9. Existing fully licensed banks may apply for an OBU licence for their non-resident business. The BMA will wish to be satisfied that adequate arrangements are made for separate accounting records.

**APPENDIX 7.2**

## Bahrain Banking

| Bank | Opening Date | Number of Staff |
|---|---|---|
| *British Bank of the Middle East. Hong Kong | 1944 | 292 |
| *National Bank of Bahrain. Bahrain | 1957 | 439 |
| *Arab Bank. Jordan | 1960 | 120 |
| United Bank, Pakistan | 1969 | 64 |
| *Habib Bank, Pakistan | 1969 | 70 |
| *Citibank, U.S.A. | 1970 | 200 |
| *Chase Manhattan Bank, U.S.A. | 1971 | 15 |
| Bank Melli Iran, Iran | 1971 | 49 |
| *Bank of Bahrain and Kuwait | 1971 | 405 |
| Banque du Cairo, Egypt | 1972 | 25 |
| *Bank Saderat Iran, Iran | 1974 | 16 |
| Rafidan Bank, Iraq | | |
| *Banque Paris, France | 1975 | 40 |
| *Algemene Bank Nederland, Netherland | 1974 | 75 |
| *National Bank of Abu Dhabi, U.A.E. | 1977 | 50 |
| Ali-Ali Commercial Bank, Bahrain | 1978 | 180 |
| Bahrain Islamic Bank, Bahrain | 1979 | 60 |
| Bahrain Saudi Bank, Bahrain | 1984 | |
| Grindlays Bahrain Bank, Bahrain | 1984 | 50 |
| Chartered Bank, U.K. | 1920 | |

Note: * has offshore banking licence

## Offshore Banking Units

| Bank | Status of licence | Number of Staff Bahrain |
|---|---|---|
| Al Bahrain Arab African Bank. Egypt | OBU | 82 |
| Algemene Bank Nederland. Netherlands | OBU | 75 |
| Allied Banking Corp. Philippines | OBU | 5 |
| Al Saudi Banque. France | OBU | 30 |
| ALUBAF Arab International Bank. France | OBU | 44 |
| American Express International Banking Corp. US | OBU | 60 |
| Arab Asian Bank. Bahrain | OBU | 51 |
| Arab Bank. Jordan | OBU | 120 |
| Arab Banking Corp. Bahrain | OBU | 180 |
| Arab International Bank. Egypt | OBU | |
| Arab Investment Company. Saudi Arabia | OBU | 25 |
| Arab Solidarity Bank. Bahrain | OBU | 9 |
| Arlabank International. Bahrain | OBU | 42 |
| Bahrain International Bank. Bahrain | OBU | 28 |
| Bahrain Middle East Bank. Bahrain | OBU | 58 |
| Ball. Luxembourg | OBU | |
| Banca Nazionale del Lavoro. Italy | Rep | 4 |
| Banco de Vizcaya. Spain | OBU | 2 |
| Banco di Roma. Italy | Rep | 1 |
| Banco do Brazil. Brazil | OBU/Rep | 8 |
| Banco do Commercio&Industria de São Paulo.Brazil | OBU | 7 |
| Banco do Estado de São Paulo. Brazil | OBU | 6 |
| Banco Esterior de Espâna. Spain | Rep | 3 |
| Banco Itau. Brazil | Rep | |
| Bank Bumiputra Malaysia | OBU | 18 |
| Bankers Trust. US | OBU | 28 |
| Bank Negera Indonesia. Indonesia | Rep | 5 |
| Bank of America. US | OBU | 50 |
| Bank of Bahrain & Kuwait. Bahrain | OBU | 405 |
| Bank of Baroda. India | OBU | 11 |
| Bank of Credit & Commerce International. Luxembourg | OBU | 31 |
| Bank of Nova Scotia. Canada | OBU | 14 |
| Bank of Oman. Oman | OBU | 19 |
| Bank of Tokyo. Japan | OBU/Rep | 28 |
| Bank of Saderat. Iran | OBU | 31 |
| Banque Indosuez. France | OBU | 43 |
| Banque Nationale de Paris. France | OBU | 28 |
| Banque Paribas. France | OBU | 23 |
| Barclays Bank International. UK | OBU | 38 |
| Baring Brothers. UK | Rep | 2 |
| Bayerische Vereinsbank. Germany | Rep | 2 |
| Canadian Imperial Bank of Commerce. Canada | OBU/Rep | 5 |
| Chase Manhattan Bank. US | OBU | 120 |
| Chemical Bank. US | OBU | 36 |
| Citibank. US | OBU | |
| Commerzbank. Germany | Rep | 2 |
| Continental Illinois. US | OBU | 22 |
| Crédit Commercial de France. France | OBU/Rep | 19 |

Cont'd ....

Cont'd

## Offshore Banking Units

| Bank | Status of licence | Number of Staff Bahrain |
|---|---|---|
| Crédit Suisse. Switzerland | OBU/Rep | 31 |
| Dai-ichi Kangyo Bank. Japan | Rep | 5 |
| Daiwa Bank. Japan | Rep | 4 |
| Deutsche Bank. Germany | Rep | 5 |
| Dresdner Bank. Germany | Rep | 5 |
| European Arab Bank (Middle East). Luxembourg | OBU | 17 |
| First City National Bank of Houston. US | Rep | 2 |
| First National Bank of Boston. US | Rep | 2 |
| Arab Bank (Middle East). Luxembourg | OBU | 14 |
| Fuji Bank. Japan | Rep | 4 |
| Grindlay's Bank. UK | OBU | 13 |
| Grindlay's International Bank. UK | OBU | 8 |
| Gulf International Bank. Bahrain | OBU | 311 |
| Gulf Riyad Bank. Bahrain | OBU | 39 |
| Habib Bank. Pakistan | OBU | 69 |
| Havil Bank. Korea | OBU | 11 |
| Hokkaido Takyshoku Bank. Japan | Rep | 4 |
| Hong Kong & Shanghai Banking Corp. Hong Kong | OBU | 18 |
| Industrial Bank of Japan. Japan | Rep | 5 |
| Interfirst Bank Dallas. US | Rep | 2 |
| International Commercial Bank of China. Taiwan | Rep | 1 |
| Irving Trust. US | Rep | 1 |
| Korea Development Bank. Korea | Rep | 5 |
| Korea Exchange Bank. Korea | OBU | 25 |
| Kredletbank. Belgium | OBU | 14 |
| Kuwait Asia Bank. Bahrain | OBU | 52 |
| Kyowa Bank. Japan | Rep | 4 |
| Lloyds Bank International. UK | OBU | 47 |
| Long-Term Credit Bank of Japan. Japan | Rep | 4 |
| Manufacturers Hanover Trust. US | OBU/Rep | 48 |
| Marina Midland Bank. US | Rep | 2 |
| Massaraf Faysal Al-Islami of Bahrain. Switzerland | OBU | 22 |
| Midland Bank. UK | OBU | 15 |
| Mitoshibishi Bank. Japan | Rep | 4 |
| Mitsui Bank. Japan | Rep | 5 |
| National Bank of Abu Dhabi. Abu Dhabi | OBU | 50 |
| Natinal Bank of Bahrain. Bahrain | OBU | 20 |
| National Bank of Greece. Greece | Rep | 2 |
| National Bank of Pakistan. Pakistan | OBU | 12 |
| National Westminster Bank. UK | OBU | 25 |
| Netherlandshe Middenstronds Bank. Netherlands. | Rep | 3 |
| Nippon Credit Bank. Japan | Rep | 4 |
| Overseas Trust Bank. Hong Kong | OBU | 13 |
| Royal Bank of Canada. Canada | Rep | 3 |
| Sanwa Bank. Japan | Rep | 5 |
| Saudi European Bank. France | OBU | 16 |
| Saudi National Commercial Bank. Saudi Arabia | OBU | 46 |

Cont'd ....

Cont'd

## Offshore Banking Units

| Bank | Status of licence | Number of Staff Bahrain |
|---|---|---|
| Scandinavian Bank. UK | OBU/Rep | 28 |
| Security Pacific National Bank. US | OBU | 8 |
| Skandinaviska Enskilda Banken. Sweden | Rep | 2 |
| Société Générale. France | OBU | 30 |
| Standard Chartered Bank. UK | OBU | 37 |
| State Bank of India. India | OBU | 49 |
| Summitomo Bank. Japan | Rep | 7 |
| Summitomo Trust & Banking. Japan | Rep | 4 |
| Swiss Bank Corp. Switzerland | OBU/Rep | 40 |
| T.C. Zirsat Bankasi. Turkey | Rep | 2 |
| Texas Commercial Bank. US | Rep | 3 |
| Toyo Trust & Banking. Japan | Rep | 4 |
| Union Bank of Switzerland. Switzerland | Rep | 6 |
| Union de Banques Arabes et Francaises (UBAF). France | OBU | 30 |
| United Bank of Kuwait. Kuwait | OBU | 9 |
| United Gulf Bank. Bahrain | OBU | |
| Wardley Middle East. Hong Kong | Rep | 2 |
| West Pack Banking Corp. Australia | Rep | 5 |
| Yapi ve Kredi Bankasi. Turkey | OBU | 4 |
| Yasuda Trust & Banking. Japan | Rep | 4 |

Cont'd

## Investment Companies

| Bank | Status of licence | Opening Date | Number of Staff Bahrain |
|---|---|---|---|
| Al BARAKA Islamic Investment Bank. Bahrain | | 1984 | 20 |
| Arab Investment Banking Corp (INVESTCORP). Bahrain | | 1982 | 40 |
| Bahrain Kuwait Investment Group. Kuwait | | 1982 | 1 |
| Bahrain Investment Company. Bahrain | | 1977 | 16 |
| Bahrain Islamic Investment Company. Bahrain | | 1981 | 4 |
| Ball. Luxembourg | | 1976 | 58 |
| Citibank. US | OBU | 1975 | 195 |
| E.F. Hutton International. US | | 1980 | 18 |
| Marril Lynch International | | 1977 | 30 |
| Nomura Investment Banking (Middle East). Japan | | 1982 | 46 |
| Sumitomo Finance (Middle East). Japan | | 1983 | 7 |
| Trans Arabian Investment Bank. Bahrain | | 1977 | 29 |
| United Gulf Bank. Bahrain | OBU | 1981 | 79 |
| Yamaichi International (Middle Eat). Japan | | 1983 | 19 |
| | | | 542 |

## Securities Houses

| Bank | Status of licence | Opening Date | Number of Staff Bahrain |
|---|---|---|---|
| Daiwa Securities. Japan | Rep | 1982 | 8 |
| New Japan Securities. Japan | Rep | 1984 | 8 |
| Nikko Securities. Japan | Rep | 1981 | 4 |
| Nippon Kangyp Kakumaru. | Rep | 1984 | 6 |
| Wako Securities. Japan | Rep | 1982 | 6 |
| | | | 32 |

## Foreign Exchange

| Bank | Status of licence | Opening Date | Number of Staff Bahrain |
|---|---|---|---|
| Charles Fulton (Gulf). UK | | 1977 | 14 |
| Kirkland - Whittaker. Bahrain | | 1979 | 11 |
| Marshalls (Bahrain). UK | | 1976 | 23 |
| R.P. Martain (Bahrain). UK | | 1976 | 18 |
| Tullet and Tokyo (Bahrain). UK | | 1979 | 16 |
| United Arab Broking Co. UK | | 1982 | 15 |
| | | | 97 |

NOTE: OBU Offshoe Banking Licence
Rep Representative Office

SOURCE: The Banker, July 1984, pp.93-102

APPENDIX 7.3

Forward purchases and sales of OBU's (U.S.$m) in Bahrain as on December 31st 1976-82

| Currency | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|---|---|
| Forward Purchases | | | | | | | |
| U.S. $ | 291 | 990 | 1490 | 1937 | 3557 | 3953 | 6,339 |
| Regional Currencies | 153 | 988 | 1654 | 1415 | 1839 | 2822 | 4,511 |
| Others | 97 | 327 | 609 | 1020 | 3402 | 2692 | 2,745 |
| Purchases = Sales | 541 | 2305 | 3753 | 4372 | 8798 | 9467 | 13,595 |
| Forward Sales | | | | | | | |
| U.S. $ | 250 | 1285 | 2103 | 2430 | 4978 | 4958 | 6,785 |
| Regional Currencies | 109 | 726 | 1002 | 834 | 827 | 1682 | 3,292 |
| Others | 182 | 294 | 648 | 1108 | 2993 | 2827 | 3,518 |

SOURCE: Bahrain Monetary Agency.

APPENDIX 7.4

Maturity Analysis of Assets and Liabilities of OBU's
as on December 31 of each year (percentage)

| Maturities | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|---|---|
| Assets | | | | | | | |
| Up to 1 month | 31.6 | 41.1 | 36.8 | 37.2 | 38.3 | 41.9 | 41.0 |
| Over 1 month to 1 year | 50.4 | 45.9 | 51.2 | 48.5 | 49.5 | 42.9 | 51.7 |
| Over 1 year | 18.0 | 13.0 | 12.0 | 14.3 | 12.2 | 15.2 | 17.3 |
| Assets & Liabilities | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| Up to 1 month | 61.8 | 60.9 | 53.3 | 51.6 | 46.7 | 48.7 | 48.8 |
| Over 1 month to 1 year | 37.4 | 38.1 | 45.1 | 46.2 | 50.6 | 48.5 | 47.1 |
| Over 1 year | 0.8 | 1.0 | 1.6 | 2.2 | 2.7 | 2.8 | 4.1 |

SOURCE: Compiled from Bahrain Monetary Agency Data.

APPENDIX 7.5

OBU's Assets and Liabilities, 1970-82 Geographical Classification

| End of Period | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|---|---|
| Assets | | | | | | | |
| Arab Countries | 40.0 | 45.0 | 49.8 | 53.1 | 52.7 | 48.9 | 49.1 |
| North America | | 3.0 | 1.1 | 1.7 | 1.7 | 1.9 | 2.4 |
| Western Europe | 18.1 | 24.8 | 22.6 | 24.9 | 26.0 | 26.1 | 24.2 |
| Offshore Centres | 20.0 | 12.0 | 12.6 | 8.0 | 6.7 | 7.6 | 7.8 |
| Others | 21.9 | 15.2 | 13.9 | 12.3 | 12.9 | 15.5 | 16.5 |
| Assets & Liabilities | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| Arab Countries | 41.4 | 52.5 | 49.7 | 58.1 | 64.6 | 67.1 | 66.8 |
| North America | 3.4 | 2.6 | 8.0 | 3.0 | 1.0 | 1.3 | 2.1 |
| Western Europe | 36.6 | 31.8 | 29.9 | 28.3 | 24.8 | 21.9 | 20.8 |
| Offshore Centre | 15.0 | 9.8 | 7.9 | 6.9 | 6.2 | 5.7 | 7.4 |
| Others | 3.6 | 3.3 | 4.5 | 3.7 | 3.4 | 4.0 | 2.9 |

SOURCE: Compiled from Bahrain Monetary Agency Data.