OP-ED/DOCUMENTS

Financial Reform In The Middle East: Defining Objectives And Measuring Results

By Andrew Cunningham

Andrew Cunningham is Managing Director for Middle East and Balkan Programs at the Financial Services Volunteer Corps, a not-for-profit organization whose mission is to promote and facilitate the emergence of efficient financial systems in transitioning economies. He can be contacted at acunningham@fsvc.org.

When Queen Victoria of Britain suggested to her prime minister that the solution to Britain's economic ills of the time might lie in reform, he is said to have recoiled in horror. "Reform, Ma'am?" he said, "But aren't things bad enough already?"[1] Thankfully, there are no longer any Middle East leaders who would echo the prime minister's words. All publicly espouse reform as the route to stronger economies, improved government finances, and the creation of new jobs.

But behind the rhetoric, different people mean different things when they speak about financial reform. For some, the aim is to create a privately-owned, market-driven financial system which replicates those seen in the US and Europe. For others, reform goes no further than improving the efficiency of financial transactions (reducing the time taken to clear checks, for example), and the creation of modern financial infrastructure (such as establishing a stock exchange). For this second group, financial reform does not extend to more fundamental and thorny questions of ownership and control – privatizing commercial banks, and ensuring that key institutions such as central banks enjoy independence.

Neither point of view is helpful to those tasked with designing and implementing a program of financial reform. A reform program which leaves ownership and control in the hands of the government is unlikely to achieve much more than a superficial and temporary improvement in financial sector efficiency. But to say that the objective of financial reform is to create systems which replicate those in the west is simplistic and unhelpful – it ignores the political and social factors which limit the ability of even the most committed reformers to execute fundamental policy changes; and it fails to recognize that reform will always be a halting, uneven and multi-dimensional process in which real benefits will occur well before the financial sector starts to resemble those in the west.

What is possible, however, is to identify the key components of a modern financial sector – for example, "central banking", "capital markets" – and then ask two questions. First, "What do we expect these components to look like in a well-functioning financial system which is not only stable and robust, but also can act as a catalyst for strong economic performance?" Second, "How can we measure whether, and to what extent, the financial sector is moving in that right direction?"

Differing Priorities

We must accept that the priorities and sequencing of reform will differ from country to country. Although reform would logically begin with the central bank, then focus on commercial banks, before addressing the need for capital markets, political and social constraints, or the particular circumstances of individual countries, may force a different sequencing. Privatization of the largest state-owned banks is often highly sensitive, with the result that governments are often able to privatize only some of the banks, leaving a semi-state-owned system in place while they move on to other policy areas. Creating a stock market in an underdeveloped economy may appear pointless, but the process of creating one brings with it benefits such as improved corporate governance and disclosure, and a more robust accountancy profession, all of which are important underpinnings for financial markets. If governance, disclosure and accountancy are weak, moves to create a stock market may provide a much needed impetus for change.

We can categorize the key components of a financial sector as:

- Central banking, including monetary functions and banking supervision.
- Commercial banking.
- Capital markets, both equity and debt.
- Broader financial infrastructure, such as leasing, insurance, and pensions.
- The financial enabling environment, such as the legal and regulatory infrastructure, accounting, and professional associations.

In answer to our first question above – what should these sectors look like in a well-functioning financial system? – the table below identifies the key features of each financial market component.

Financial Market Component	**Key Features In Well-Functioning System**
Central Banking*	• Central Bank is legally independent with a clearly defined role. (Objectives could include, "achieving a low inflation", "stability of the financial system." • Monetary policy is actively managed, central bank conducts open market operations, a yield curve exists for government debt. • Financial institutions regulated by the central bank are generally strong and well managed; action is being taken to deal with insolvent institutions. • Banking supervision is "risk based" rather than "compliance based." • Payment and clearing systems are fast, efficient and inexpensive (whether managed by the Central Bank or by the private sector).
Commercial Banking	• Banks are privately owned, not government owned. • Banks strategies are driven by a desire to be profitable and generate a good return for investors. • Banks are generally economically solvent and profitable. • Banks are managed in line with international norms (issues include risk management, accounting standards, governance).
Capital Markets	• Capital markets can be, and are used as a vehicle through which private companies raises capital, and the government privatizes companies which it owns. • Strong standards of disclosure, surveillance and enforcement. • Liquid stock markets offering a range of products and trading strategies. • Liquid fixed income markets, offering a range of products and maturities. • Independent research and analysis by banks and brokers; and informed press reporting.
Broader financial infrastructure	• Leasing products, offered either by banks or by specialized leasing companies • Mortgage loans, offered either by banks or by specialized mortgage lenders. • Insurance companies which are privately-owned, solvent and profitable, offering both life insurance and non-life insurance. • Existence of privately-owned pension funds.
Financial enabling environment	• Laws and regulations which take into account how modern financial markets work. • Judges and lawyers who understand financial markets and business practices. • Enforceability of financial and commercial judgments. • Existence of a collateral registry. • Existence of a credit bureau. • Strong accounting profession. • Active professional associations which act as industry advocates and provide professional training (for example, a bankers' association). • Informed, accurate and sensitive press coverage of financial matters.

* It does not matter whether all financial sector regulation is consolidated under a single institution (as it is under the Financial Services Authority in the UK or the Central Bank of Bahrain) or whether the tasks are divided between several bodies. The important point is that all financial market activity falls under some sort of efficient regulator.

Answering the second question posed above – how to measure whether the financial system is moving the right direction – often appears easy. Central bank independence should be visible in the form of a law granting that independence. A collateral registry either exists or it does not.

Yet it is not enough simply to "tick the box". A law granting independence to the central bank may not have much effect on the way banking is conducted if "old guard" officials with a civil service mentality are left in charge. A collateral registry will not increase the availability of bank credit if the process of registration is cumbersome or, worse, if banks know that the process of collateral enforcement will take years in the courts.

What is needed is a range of measurable indicators which will show whether the financial system is becoming more capable of acting as a catalyst for strong economic performance.

Private Banks' Financial Strength

The importance of privatization lies in the belief that private banks are generally financially stronger than government owned banks (and so do not burden the state budget with the need for constant capital injections) and more effective at directing credit to productive industries, as opposed to those which are deemed by the government to be strategically important (for which read "politically" important). So while the relative size of state-owned and privately-owned banks is a common and not unreasonable way to measure the progress of financial reform, measuring the share of loans extended by privately owned banks is a far more sensitive indicator of the power of the financial system to drive economic growth. Better still, is an analysis of whether such banks are using their resources to extend credit to the private sector – to judge that we calculate the proportion of private sector credit re-distributed by banks in the form of private sector loans.

In Yemen, where ownership of the banking system is mixed between the government and the private sector, only about 30% of bank deposits are deployed as loans, while large amounts are placed in government bonds or abroad with foreign banks – a clear indication that the banking system is not discharging its role as an engine of economic growth.

In the case of capital markets, sound regulation, strong standards of disclosure and accounting, and the availability of a wide range of equity and debt products are the prerequisites for a market which can be used to raise capital and attract investors. The result should be seen in the number of local companies raising money on the stock exchange, and the number of local and foreign investors willing to buy their shares. So, for example, the fact that in 2006, 18 newly established Jordanian companies made offerings on the Amman Stock Exchange, compared to only seven in 2005, is a clear indication that the exchange was playing a greater role in the mobilization of capital. And the fact that in 2007 non-Jordanians made net investments of JD466mn on the Exchange – higher than any previous year – shows that Jordanian companies are increasingly able to attract funding from regional and international investors.[2]

A mortgage finance law, a land registry, publicly-licensed professionals trained in appraising the value of real estate, and a legal system which will enforce mortgage contracts are prerequisites for the emergence of a residential mortgage market which will enable citizens to buy their own homes and pass them on as assets to the next generation. But the only measure of whether these prerequisites are effective, as opposed to just being "in place," is the size and growth of mortgage loans actually extended by banks.[3]

In practice, indicators that financial reform is taking hold can be distilled into a small number of metrics. The table below gives examples of such key metrics, and explains their significance.

Metric	Why It Matters
Monetary Environment	
Rate of inflation should be low and stable.	Central bank has the tools and the policy skills to maintain a stable monetary environment.
Exchange rate should be reasonably stable and based on market value of the currency.	As above.
Banking Sector Supervision	
Number of bank failures or banks declaring losses.	Central bank is effectively supervising the banking system, anticipating trends and preventing banks from assuming excessive risk.
Banking Sector	
Credit extended by private sector banks should be increasing as a percentage of total credit, as the banking sector is privatized.	Private sector banks tend to make better credit decisions than state-owned banks. Credit extended by private sector banks is therefore likely to have greater long-term economic impact than credit extended by state owned banks.
Ratio of private sector credit to private sector deposits should be increasing.	The loan to deposit ratio shows the extent to which banks are fulfilling their key function of recycling money from those who have it to those who need it. If the government is crowding out private sector borrowers, for example through exces-

	sive issuance of Treasury bills, or if the lending environment is poor, for example due to a weak legal system, then this ratio will be low.
Debt Capital Markets	
Volume of corporate debt issuance.	A strong corporate bond market provides borrowers with an alternative to bank finance; and because bond markets are more transparent than bank credit, for a bond market to exist, basic standards of disclosure must exist.
Equity Capital Markets	
Volume of IPO issuance.	Strong IPO issuance indicates that small business owners are able to raise capital to expand their businesses.
Volume of secondary market issuance.	Strong secondary market issuance indicates that medium sized businesses can raise additional capital for further expansion.
Percentage of "free float" in the market.	If large companies are majority owned by the government, the possibility of trading their shares will be limited. It is not enough for a market to have a large total capitalization – the shares need to be tradable.
Other Financial Markets	
Volume of leasing business written.	Leasing enables the lending to retain ownership of the asset, and so it is a particularly relevant method of financing in markets where legal recourse against borrowers is unsure.
Volume of insurance premium written by privately-owned insurance companies.	Insurance companies not only provide a valuable financial product (insurance) but because they have long-term liabilities they are also avid purchases of long-term assets. Insurance companies play a key role in the development of medium and long-term bond markets. Pension schemes also purchase long-term assets, for the same reason.
Volume of mortgage loans extended.	In addition to the social benefit of having people own their homes, and so accumulating an asset against which they can borrow or which they can pass on to the next generation, mortgages stimulate the development of long-term debt markets – mortgages are long-term assets, which banks try to finance by issuing long-term liabilities (the bonds with the insurance companies mentioned above want to buy).

Clearly the list given in the table is an oversimplification, and omits many significant elements of a financial reform process, such as the use of International Financial Reporting Standards in corporate reporting. But its value lies in the measurability of the indicators which it uses and in the close relationship which those indicators have to economic activity. A further advantage is that most of the metrics cited are based on information which is generally in the public domain.

Ultimately, financial reform must contribute to an increase in economic prosperity. Yet economic growth, higher personal income, and more jobs are dependent on many factors which lie outside the areas influenced by financial reform. Higher oil revenues, rather than the effects of any financial reform, are driving an increase in per capita gross domestic product in Libya. Demographic growth in a country such as Egypt may dilute the effect of strong economic performance and job creation. As a result, it is difficult to attribute short term improvements in macro-economic indicators to the effects of financial reform – or indeed to any other single area of policy, such as increased literacy or improved sanitation.

But over the long term, it should be possible to make a connection between broader, deeper and more efficient financial markets and increasing economic prosperity. More efficient financial markets in Libya would enable higher oil revenues to feed through into the mass of the population more quickly, fueling a stronger and broader economic base. More sophisticated monetary policy in the Gulf States might be able to prevent them importing inflation via currencies pegged to the dollar.

An efficient, market-based financial system will never be able to shoulder the burden of creating a prosperous economy alone. External factors, such as natural disasters or falling commodity prices, can have an impact on prosperity which is far more dramatic in the short term than the well-paced march of economic reform. Internal factors, such as low levels of literacy and poor sanitation will hold back an economy no matter how dynamic its financial policy making may be. But over the long term, steady progress on financial reform leads to an economy which directs resources more efficiently to those who can use them effectively.

Notes:

1. The remark is attributed to Lord Palmerston in various contexts. Palmerston was Prime Minister from 1855-58 and from 1859-65.
2. Statistics are taken from Annual Reports of the Jordan Securities Commission and the Amman Stock Exchange.
3. In view of the current difficulties in western mortgage markets, we should perhaps add "repayment rates" as another indicator.