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DEVELOPMENT OF FINANCIAL MARKETS IN THE ESCWA REGION

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Preface

This study has been prepared by the Economic Development Issues and Policies Division of the Economic and Social Commission for Western Asia (ESCWA) in implementation of activity No. 32f8D04, entitled "Development of Financial Markets in the ESCWA Region", of the Commission's programme of work and priorities for the period 1998-1999. The study has benefitted from the information provided by the member countries and comments by several of the staff members in the Economic Development Issues and Policies Division. It has also benefitted from a number of useful studies by the International Monetary Fund and other United Nations Organizations. We thank them all.

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Executive Summary

The decline in available financial resources for development in the ESCWA region during the past few years is a result of the drop in oil revenue in the GCC countries[1] and the spillover from these countries to other ESCWA member countries. It has forced the latter to face the challenge of stepping up their efforts to mobilize and allocate larger domestic and external financial resources for development. Consequently, as in the case of other developing regions, policy makers in the ESCWA region are devoting more attention to the development of financial markets in their countries. The objectives of this policy include the mobilization of larger domestic financial savings, the inflow of more non-debt-creating foreign financial resources, and the channelling of these resources to their most productive use. In addition to its contribution to the reduction of financial imbalances, the policy emphasis involves the build-up and broadening of a solid institutional base, improving the functioning of financial market signals, and enhancing regulatory and supervisory regimes.

The process of financial market development in the ESCWA region and the integration of these markets into the international financial system is considered to be less advanced in most ESCWA member countries, especially when compared with the financial markets in several countries in Latin America and East Asia. The need to exploit the potential offered by financial markets assumes greater importance in view of the possibility of downward pressures on foreign aid and grants to the financially needy countries in the region, and of greater competition among the developing countries for foreign direct investment as well as portfolio investment. The need seems also to be consistent with the increasing emphasis in the region on the private sector as the main engine for economic development and growth.

The financial sector in ESCWA member countries is dominated by commercial banks. The securities markets in these countries are relatively small,[2] despite the fact that the ESCWA region contains some of the developing regions' largest institutional investors in the international financial markets. For example, total capitalization in the region's formally operating financial markets,[3] reflecting mainly loan rather than risk finance, was estimated at around US$ 105 billion at the end of 1998,[4] compared to the region's private and public sector foreign assets holdings, estimated at around US$ 500 billion. Moreover, foreign participation, even in the relatively "lucrative" government bond markets, is practically non-existent. Similarly, there have been few direct placements of equities of ESCWA member countries in foreign financial markets. Moreover, the use of market-based risk management instruments by ESCWA member countries has been narrow, despite the limited degree of export diversification.

Although considerable differences exist across the region in the importance of financial markets, notably equity markets; the supply of corporate securities, including shares, papers and bonds, has remained generally limited, both in absolute terms and relative to the size (i.e., the GDP) of the economies of ESCWA member countries.

This development reflects several factors constraining demand for and supply of equities, including the closed, family-owned nature of many companies in member countries. Moreover, in most ESCWA member countries, public sector enterprises continue to play a dominant role in a wide range of economic activities. Thus, the number of effectively quoted companies in most of the countries has been relatively small, while shares available for trading have been limited and the financial markets have, in general, remained thin and illiquid.

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[1] The Gulf Cooperation Council (GCC) countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates.

[2] In terms of capitalization, number of quoted companies, volume and value of trade, as compared with securities markets in Latin America and East Asia.

[3] These are Bahrain, Egypt, Jordan, Kuwait, Lebanon, Oman and Saudi Arabia. Qatar stock market, which started formal operation in early 1999, has been excluded, owing to lack of data.

[4] Down by around 20 per cent from 1997 (US$ 131 billion).

repeatedly been proposed in most ESCWA member countries during the past few years. This has been in the context of sustained implementation of financial sector reforms and, more generally, policies aimed at liberalizing the economies and reducing their financial imbalances. Reform efforts, however, still need to be further improved to achieve the objectives of the financial markets for greater mobilization and allocation of domestic and external financial resources for development.

Historically, the financial sector (including the financial markets) in many ESCWA member countries (especially those with more diversified economies[5]) was characterized by strict controls over rates of return, and administrative allocation of credit through the banking system and specialized public sector financial institutions. In recognition of the adverse impact on the overall process of financial intermediation—in the mobilization of domestic as well as external financial resources—some countries have considered measures to liberalize the financial sector. These measures include greater price flexibility, reduction of preferential credit facilities, and a move towards indirect monetary control instruments.

However, the development of financial markets in the region and the extent of relations between these markets and the international financial markets continued to be adversely affected by both domestic and foreign investors' concerns regarding structural inadequacies in the legal and regulatory framework. The impact of financial sector reforms aimed at addressing these inadequacies has differed among these countries due to two sets of factors:

1. Progress in the implementation of market-enhancing measures, such as:

(a) Improvements in trading, reporting and accounting systems;
(b) Strengthening of legal procedures;
(c) Removal of fiscal distortions which discourage equity financing.

2. Progress in the broader programme of economic and financial liberalization, particularly in the areas of:

(a) Liberalization of regulations governing foreign direct and portfolio investment, including ownership, market access, and repatriation of capital, dividends and profits;

(b) Privatization of public sector enterprises;

(c) Liberalization of the domestic investment regime, including the dismantling of government monopolistic and oligopolistic structures.

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[5] ESCWA member countries with more diversified economies are Egypt, Iraq, Jordan, Lebanon, Syrian Arab Republic, West Bank and Gaza Strip and Yemen.

Introduction

ESCWA member countries appear to be challenged by the mobilization of larger amounts of financial resources to finance the development of their economies, sustain high economic growth rates and improve the performance of their social sectors. Policy makers in these countries are, therefore, devoting more attention to improving the operation of domestic financial markets. Their decisions aim to improve the process of mobilization and allocation of financial resources, reduce financial imbalances, strengthen and broaden the institutional base of the financial markets, improve the functioning of the signals of these markets and strengthen their legal and regulatory framework.

However, the development of financial markets in the ESCWA region during the past few years has opened a new era of mobility of financial resources in the region, whereby flows of private financial resources (i.e., private capital) have assumed an increasing role as a source of finance for these markets. A noticeable feature of this private financial transfer is that the flows of financial resources are increasingly channelled through the securities markets, with portfolio investment becoming an important component of private financial flows. This new pattern of flows of financial resources has been influenced by a number of factors, most particularly by the increasing liberalization of the financial markets and the noticeable trend in their globalization.

Integration of the region's financial markets into the global financial system would bring both substantial benefits and risks to the markets. As to the benefits, the integration would allow ESCWA member countries to raise additional foreign savings to finance investment. It would foster the development of financial institutions and markets, promote the transfer of technological know-how in the area of financial management, and improve corporate governance through better disclosure and accounting standards. Regarding the risks, recent experience of emerging markets in other developing regions has shown that rapid integration into the global financial system carries the risk of financial crisis and disruption. Moreover, capital mobility could reduce the economic and financial policy autonomy of the countries concerned, thus exposing their domestic economies to market sentiment.

Private capital flows in the region are considered to have become more volatile, as member countries increasingly rely on domestic short-term borrowing, either through bank lending or issuance of short-term bonds. Also, portfolio investment is considered to have contributed to the increase in the volatility of capital flows, since investors can easily sell their assets on the securities markets. The occurrence of "boom-bust cycles" through overexposure and sudden generalized withdrawal of foreign investment can cause major disruption to the financial systems of ESCWA member countries, not only through drastic changes in liquidity, but also through changes in asset prices, which rapidly transmit the shock waves of financial crisis from one country to another.

Portfolio investment, as a source of finance, has gained significance in the ESCWA region during the past few years. In those countries with more diversified economies, such as Egypt and Jordan, this development has been encouraged by privatization policies which enable foreigners to invest in privatized companies. In the other group of ESCWA member countries, those of the GCC, the development was encouraged by increased liberalization of the financial markets, including the easier entrance of foreign investors to the markets.

However, the management of capital flows still needs to address a number of questions within the framework of an economic policy agenda. The following are examples of these questions:

(a) How can more stable capital flows be attracted to ESCWA member countries? Would this be a matter of retaining market confidence through, for example, good fundamentals; or would more interventionist measures be needed to manage capital flows?

(b) To what extent should ESCWA member countries strengthen their domestic financial markets, particularly the banking sector, before opening to foreign investment?

(c) What can ESCWA member countries do to reduce the volatility of capital flows?

In addressing these and other similar questions, it is necessary to reach a better understanding of issues such as the determinants of investors' behaviour in the region, the influence of portfolio investment on the development of the region's financial markets, and the role of these markets and their fundamentals in explaining investment volatility.

The objective of the study is to review the development of financial markets in the region and its impact on the economic development in ESCWA member countries.

Chapter I deals with the status and role of financial markets in the region and how a number of factors, such as business environment and the legal and regulatory framework, determine them. Financial market regulation, implying functions, objectives and approaches, are the subject of Chapter II. Chapter III deals with the global perspectives of ESCWA financial market regulation. Establishing a framework for financial market development requires that issues be dealt with satisfactorily: chapter IV is the subject of these issues. The role of the banking sector *vis-à-vis* the financial market is an issue that should be considered when adopting a strategy for the development of the market: chapter V offers a detailed analysis of this issue. In-depth analysis is made of financial market development and the mobilization of savings in chapter VI. An assessment of the interrelationship between portfolio investment and the development of financial markets in the region is made in chapter VII. Chapters VIII and IX examine the development of equity and bond markets, respectively, in the region: both markets have gained prominence during the past few years.

Including in the study an Agenda for the development of financial markets in the region was found necessary, particularly since the study not only analyzes the development of financial markets in the region but also aims to help ESCWA member countries look into the future of this development: chapter X deals with these issues. The closing chapter of the study is chapter XI, with conclusions and recommendations and elements for a plan of action that could be initiated by ESCWA member countries.

I. STATUS AND ROLE OF FINANCIAL MARKETS IN THE ESCWA REGION[6]

The process of deregulation and globalization of financial markets has brought about significant changes in international financial markets. Direct monetary and financial control policies have been replaced by indirect ones in many developing countries. The segmented and rather manipulated domestic financial markets have been replaced by an increasingly integrated global market. For governments and corporations alike finance has become equity finance instead of debt or loan finance.

A major factor behind this development in the financial markets has been the financial innovation. Swaps, options, futures and portfolio insurance, in addition to hedging techniques and instruments, have all increased substitutability of investment assets and mitigated risk, thereby enlarging the stock of tradable investments and financial instruments and adding depth to the international financial markets.

Another major factor has been the drive toward securitization of various obligations. The securitization has, indeed, allowed financial institutions to shift risk to ultimate investors and has given them the ability to handle a much larger volume of transactions, to develop new products and to secure economies of scale (box 1).

Finally, the blurring of demarcation lines, the growth of universal banking, the elimination of exchange controls, and the advance in communication technology, have allowed the various market participants to operate simultaneously in different markets and transact in huge volume at reduced cost, thus further increasing capital mobility.

Both deregulation and globalization of financial markets have made ESCWA member countries with open economies less insulated, and have subjected them to disturbances and shocks that are not a result of domestic factors. In the region's indebted countries, capital flight has become a serious problem. In those of the GCC, usually considered as surplus countries, it has, at times, caused abrupt disruption in the normal functioning of financial markets. Nevertheless, financial markets in many ESCWA member countries are developing toward becoming important channels for the mobilization and allocation of financial resources. Their contribution to financing private and public sector investments, however, is still mostly in the form of loan rather than risk finance, which normally contributes only a modest share to business finance, but thereby enlarges the capital base for further debt finance.

As a consequence, excessive corporate indebtedness has risen with public sector deficits (i.e., government deficits), even in the GCC countries which usually generate surplus funds beyond the absorptive capacity of their economies. This indebtedness of corporates has constrained economic activity, in addition to increasing the need to consolidate the financial structure of businesses in ESCWA member countries. Furthermore, it has prompted an awareness of structural imbalances within the domestic financial intermediation mechanisms. Development of the financial markets in the region therefore represents a challenge in the face of both globalization of international financial markets and the domestic need for re-establishing financial balance.

Most ESCWA member countries have taken action in recent years to develop their domestic financial markets. They have adopted policies to improve the business environment; correct the legal and regulatory framework of the securities markets and produce comprehensive securities laws, with a unified set of objectives similar to those of many market-oriented economies:

(a) To mobilize savings through equity and long-term debt investment opportunities in both the public and private sectors; and to curtail capital flight by providing competitive financial instruments and attracting foreign portfolio capital;

[6] This chapter relies in some parts on the material in the International Monetary Fund publication entitled "Financial Policies and Capital Markets in Arab Countries", 1994, pp. 54-87.

(b) To facilitate access to capital funds by newer businesses, and to spread the risks of long-term investment projects in order to contribute to lower-cost equity capital and help stimulate private sector investment and production growth;

(c) To broaden the ownership base of enterprises through wide distribution of equity shares.

In practice, however, not all ESCWA member countries have been successful in attaining these objectives. The determining factors relate to the type of development strategy being followed and to ensuring the business and regulatory environment.

Box 1. Securitization

The term "securitization"[a/] refers to the process whereby finance is raised through the issuance of debt and equity securities, which are tradable on financial markets. Securitization thus implies that the investor or lender is holding a tradable claim on the borrower or the issuing company and can sell it any time on the markets. This contrasts with bank loans, which are assets and usually held to maturity by traditional financial institutions.

Securitization is partly the result of easier access to information by a greater number of players in the markets, thus reducing barriers to entry. It also contributes to a reduction in the cost of capital raised by economic entities. The increasing role of institutional investors is responsible for the strong development of the securities markets. In addition, the unbundling of different market risks through the trading of increasingly complex financial derivatives further deepens the securitization process.

While securitization and globalization of financial markets can widen the range of sources of finance and provide better access to international financial markets at lower cost, this access remains restricted to a small number of borrowers. Another challenge is the greater potential for volatility in investment flows and the resulting wide fluctuations in asset prices. The greater volatility in those prices carries the risk of larger losses and may threaten the viability of some market participants. Furthermore, risk of contagious spreading of financial crisis is high, as market prices can also transmit shocks rapidly from one market to another.

Securitization of capital flows has other implications. Except in the case of hedge funds, which can be highly leveraged (relying on bank loans to finance their investments), portfolio investors usually absorb losses due to falling emerging stock and bond markets out of their own funds. This does not pose a systemic threat to the stability of the international financial system, since losses are ultimately spread among a large number of private investors. Moreover, investments in emerging markets are very often but a small portion of the portfolio of large investment funds. The possibility of widespread redemption of investment fund shares by panicked small investors is further reduced by the nature of certain underlying contractual obligations, such as those related to closed-end funds.[b/] These allow for losses either to be reversed or spread over a longer-term holding period. Although portfolio losses do not carry the risk of destabilizing the international financial system, there is, nevertheless, a need for transparency in investment activity, especially in the case of hedge funds; there is also a need for stronger capital adequacy regulations for investment banks and institutional investors.

Another implication for market borrowers is that reliance on portfolio investment can make the adjustment process quite rapid following a liquidity crisis, as funds are withdrawn in a short time. In addition, debt renegotiation in respect of portfolio investment in bonds is more difficult to organize, given the wide dispersion of bond holders. On the other hand, the experiences of Mexico and East-Asian countries (most particularly the Republic of Korea, Malaysia and Thailand) have shown that, in a situation of ample global liquidity, and as long as fundamentals are deemed acceptable by investors, portfolio investment is rapidly resumed as expectations of capital gains are encouraged by low stock prices.

Source: United Nations Conference on Trade and Development (UNCTAD); Trade and Development Board, Commission on Investment, Technology and Related Financial Issues; Expert Group Meeting on "The Growth of Domestic Capital Markets, Particularly in Developing Countries and its Relationship with Foreign Portfolio Investment", Geneva, 27-29 May 1998 (TD/B/Com.2/EM.4/2).

a/ The term is used here in its broader sense. Originally it was used narrowly to mean the process by which traditional bank assets, mainly loans or mortgages, are converted into negotiable securities. In its broader sense, securitization means the tendency of financial transactions to be conducted on securities markets and suggests disintermediation of the banking system as investors and borrowers bypass banks and transact business directly.

b/ Closed-end funds are not required to meet redemption requests and do not therefore need to liquidate their investments at short-notice. Consequently, closed-end country funds can be expected to take a longer-term view and are thus less likely to contribute to market volatility resulting from large and sudden sales of securities which can occur with open-end funds.

A. BUSINESS ENVIRONMENT

Historically, the business environment and the size of securities markets in ESCWA member countries have been shaped by the role of government in economic activities and the institutional infrastructure of financial intermediation.

1. *Predominance of the government role*

The government role has been predominant in determining the level of economic activity in all ESCWA member countries. This situation was dictated, according to each individual country, by either the requirements of transition after the independence, or the level of government control of economic resources and activities; and by the abrupt accumulation of huge financial resources by the government and its various departments and agencies. The need to implement economic and social development programmes has further strengthened the role of government.

This development resulted in two major sets of opposing implications for savings, investments and resource allocation and, hence, capital accumulation and economic development structures. On the one hand, government involvement in economic activities has helped to develop the infrastructure, whose development otherwise may have been delayed. It also paved the way for more rapid growth in the private sector. On the other hand, this government role adversely affects the aggregate volume of national savings for a number of reasons: increased public expenditure on government services, mostly underpriced and subsidized, raises aggregate demand, and hence consumption of these services, which in turn leads to a lower rate of aggregate savings. This also creates certain distortions in the price system making resource allocation less than optimal, and thereby rekindling inflationary pressures adversely affecting the level of aggregate savings.

2. *Predominance of the banking sector*[7]

The financial structure in ESCWA member countries is dominated by commercial banks. Traditionally, these confine their lending to short-term trade financing. The issuance of securities instead of bank loans as a principal financing vehicle has become more urgent in recent years. The change in attitude is caused by the drive for privatization that is gaining momentum in a number of ESCWA member countries. As a result, the overall business environment has improved reasonably during the past few years, although not to the fullest extent possible in view of the often incomplete institutional and regulatory structures.

B. LEGAL AND REGULATORY FRAMEWORK

If the political and socio-economic conditions necessary for securities markets to emerge and to grow are not in place, it would be unrealistic to expect that laws and regulations could create and guarantee the successful development of such markets. However, at a given level of market potential, the introduction of a legal and regulatory framework can have a catalytic effect.

Another side of the argument is that without an adequate legal and regulatory framework, financial markets in general tend to remain shallow, uninformed, frequently informal, lacking transparency and more exposed to the undesirable consequences of unchecked speculation.

Some of the existing company laws in a number of ESCWA member countries date back many years. They do not, in fact, take into account more advanced provisions necessary for the dynamics of modern business and financial market structures. They may even contain provisions that affect these markets negatively.

The widespread lack of comprehensive securities market laws and regulations has impaired the emergence of financial markets in some ESCWA member countries. It has even caused a number of these

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[7] For further details see chapter V.

financial markets to develop in an undesirable manner, calling for costly corrective measures. Although the situation differs from one ESCWA member country to another, for analytical purposes, however, the countries may be divided into four distinct groups in respect of the stage of development of their legal and regulatory framework and financial markets:

(a) In Iraq and the Syrian Arab Republic, the Governments have opted for State monopoly of economic resources and activities during the past three decades. This has ruled out an eminent private sector corporate business activity; an issue necessary to justify and support the development of financial markets. In recent years, however, the Governments of both countries have started showing an active interest—to varying degrees—in the promotion of private sector enterprise. However, the two countries still need to establish the appropriate legal and regulatory framework necessary for the promotion of a solid and healthy business environment and an optimal allocation of resources.

(b) In Yemen and the West Bank and Gaza Strip, considered to be the least developed countries in the region, a great need still exists for strong macro-economic foundations in terms of size and diversification of production, completeness of the institutional framework, and policy sophistication—all of which are regarded as prerequisites for the development of a financial market. However, both countries are progressively enacting better economic and financial legislation and adopting appropriate adjustment policies to mobilize domestic savings, improve the business environment, and remove distortion in the pricing system. In time, such policies are bound to lay the necessary foundations for the development of financial markets.[8]

(c) In the GCC countries, significant strides have been made during the past two decades toward the development of proper legal and regulatory framework. These countries are open economies, usually with financial resources plus. They exercise no exchange restrictions or other controls on capital flows. Bahrain, Kuwait and Oman have long established stock exchanges; that of Qatar was established only in 1999; Saudi Arabia has introduced an electronic trading system managed by the country's central bank, the Saudi Arabian Monetary Agency, and the stock market in the United Arab Emirates though still informally operative, is expected to be formally set up before the end of 1999.

(d) In Egypt, Jordan and Lebanon, the institution of legal and regulatory framework is relatively complete. The Alexandria and Cairo Stock Exchanges are nearly a century old, although they have been forced by shifts in development strategy goals to lead a dormant existence until recently. The Amman Financial Market, in mid-1999 renamed the Amman Bourse, is considered—along with the Kuwaiti Stock Exchange—to be one of the pioneers of modern legal and regulatory framework in the region. The Lebanese market, although showing signs of maturity, is still in the early stages of development.

ESCWA member countries are considered to have reasonable potential to emerge as active financial markets. There are wide differences, however, in their respective legal and regulatory framework. Company laws exist in all ESCWA member countries, but some laws do not offer adequate protection to outside shareholders. In contrast, only in Egypt, Jordan and Kuwait do markets operate under comprehensive financial market law; others, such as Saudi Arabia and the United Arab Emirates, have not yet adopted such laws. Considering the above, the current legal and regulatory framework in ESCWA member countries can be summed up as follows:

(a) Primary markets are organized in nine ESCWA member countries: Bahrain, Egypt, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia and the West Bank and Gaza Strip. They are partially organized in only one country: the United Arab Emirates;

(b) Secondary markets are organized in eight ESCWA member countries. Saudi Arabia has opted for a more discrete mechanism. Consultations have been underway for some time between the various parties concerned in the United Arab Emirates to pave the way for the establishment of an organized secondary market;

[8] For the West Bank and Gaza Strip, the issue remains subject to political developments.

(c) Other likely candidates for the development of a financial market are Iraq, the Syrian Arab Republic and Yemen.

All stock markets operating at present in the region have taken the form of legally and financially independent bodies, with a board, committee or commission, appointed at a high level of authority. The task assigned encompasses the functions of promoting and regulating the activities of the financial market, including the setting-up of companies, the listing of requirements, trading procedures, and clearing and settlement mechanisms.

The laws and regulations governing the various markets may differ in approach, but they all aim to mobilize savings, provide finance for corporations of both the private and public sectors, and safeguard the interests of both shareholders and traders. The problem areas in these markets generally relate, in varying degrees, to the enforcement of accounting standards, the quality of information disclosure, and the protection of small investors from insider trading and other malpractices.

C. COMPARISON OF FINANCIAL MARKETS IN THE ESCWA REGION

1. *Operational aspects*

Awareness of investment opportunities in the securities markets is growing steadily in practically all ESCWA member countries. Only in a few of these countries, however, has this awareness and interest crystallized into a committed, discerning and growing pool of investors.

Some of the main constraining factors, especially in the GCC countries, have been high volatility in market prices, undesirable practices and structural inadequacies that frequently have led to a severe erosion of investor confidence and occasionally hampered sustained growth in the markets. Not surprisingly, supply and demand factors are unbalanced in a region as diverse as the ESCWA region, but the classical limiting factors can be identified in most cases. Qualitative aspects of the nature of supply and demand, such as the quality and price of company issues and excessive speculation for short-term capital gain, are cause for some concern. Some countries have dealt with these problems more effectively than others. Securities finance represents a further challenge for carefully coordinated development strategy. Supervision and promotion of market activity mostly falls within the responsibility of ministerial departments rather than constituting the specific objective of a separate, autonomous agency, as in the case of the Egyptian Capital Market Authority and the Amman Bourse Commission.

Both the primary and secondary markets vary greatly in their institutional aspects. Intermediated primary issue activity is largely identified with the banking systems and frequently lacks an approach that is specifically oriented toward the securities market. Only in a few cases (for example, Jordan, Kuwait and Egypt) has the emergence of specialized institutions been encouraged in order to improve the quality of issues and professionalism in their placement.

Consequently, the supply of securities remains inadequate both in absolute terms and relative to the size of the GDP of the countries in question. This is largely due to the state of the ownership of companies in ESCWA member countries, where the companies are mostly closed and family-owned; hence their reluctance to go public. Indeed, the number of quoted companies in these markets is relatively small, and the number of shares available for trading is limited. This has encouraged investors to take a "buy and hold" attitude. As a result, most financial markets in the ESCWA region remain thin.

2. *Market size*

At the end of 1998, the number of listed companies in ESCWA member countries with formally operating stock markets (Bahrain, Egypt, Jordan, Kuwait, Lebanon, Oman and Saudi Arabia) was 1354 with total market capitalization of around US$ 105 billion, compared with 994 listed companies only five years ago (in 1993) with a total market capitalization of around US$ 39 billion (table 1). However, relative to GDP, stock markets in the ESCWA region are way behind compared with the rest of the world. The ratio

was only around 30 per cent in 1998, compared with an average of around 40 per cent in other developing regions and 75 per cent in developed countries.

Furthermore, there is a great discrepancy between ESCWA member countries' securities markets themselves, with (for example) a market capitalization to GDP ratio in 1998 of around 28 per cent in Egypt and 25 per cent in Saudi Arabia. In absolute terms, Saudi Arabia had the biggest securities market, with a total capitalization of US$ 42.6 billion for 74 listed companies in 1998, followed by Egypt with total capitalization of US$ 24.5 billion for 861 listed companies and Kuwait with total capitalization of US$ 18.4 billion for 78 listed companies. Also in comparative terms for the average capital per company, however, Saudi Arabia comes first with an average capital of US$ 575.6 million per listed company, followed by Kuwait (US$ 235 million), Lebanon (US$ 200 billion) and Bahrain (US$ 162 million). The relatively high average capital per company for Lebanon is attributed to the capital of one listed company, namely Solidere, amounting to about two thirds of total market capitalization of Lebanon's stock market.

TABLE 1. STOCK EXCHANGES IN THE ESCWA REGION:[9] MARKET CAPITALIZATION AND NUMBER OF LISTED COMPANIES, 1993 AND 1996-1998

(Billions of US dollars)

	1993		1996		1997		1998	
	Market capitalization (MC)	Number of listed companies (NLC)	MC	NLC	MC	NLC	MC	NLC
Bahrain	4.4	30	5.0	37	7.8	40	6.8	42
Egypt	2.6	656	14.2	646	20.9	650	24.5	861
Jordan	3.4	103	4.6	98	5.5	139	5.9	150
Kuwait	10.0	39	21.1	60	27.2	74	18.4	78
Lebanon	..	..	2.4	6	2.9	8	2.4	12
Oman	1.5	88	2.8	97	7.3	119	4.5	137
Saudi Arabia	17.3	78	45.9	70	59.4	71	42.6	74
Total	39.0	994	96.0	1014	131.0	1101	105.1	1354

Source: The figures are extracted and calculated from: Arab Monetary Fund, Arab Financial Database, quarterly bulletin, various issues (Arabic).

In 1998, the listed companies in the GCC countries, shown in table 1, represented about 69 per cent of total market capitalization in the ESCWA region. However, the ratio may change downwards when the privatization programmes under way in other ESCWA member countries are completed.

In general, the current state of securities markets in most ESCWA member countries is not representative of the potential size that may be reached by these markets. This is especially the case for those countries implementing economic structural adjustment and reform programmes.

[9] Including only formally operating stock markets.

II. FINANCIAL MARKET REGULATION: FUNCTIONS, OBJECTIVES AND APPROACHES

A serious regulatory effort is generally a precondition for the efficiency, transparency and credibility of financial market operations. These are usually based on information. The amount of the information and its accuracy, timeliness and completeness is, in part, a function of the standards set by the government and self-regulatory organizations, and the seriousness with which these standards are enforced.

A. FUNCTIONS OF FINANCIAL MARKET REGULATION

The regulation of financial markets, especially of new or emerging markets, serves both "disciplinary" and "development" roles. The two roles should be viewed as complementary, and the emphasis given to one or the other by the regulators of any ESCWA member country will vary over time. Regulatory functions can be thought of as covering three types of activities, each with both a disciplinary and a developmental dimension.

The first function of a regulatory framework is to define the key features of the financial system and the role of the financial market institutions within that system. At the broadest level, the regulatory process defines the basic structure of the system, such as debates between the advocates of "universal" banking and the partisans of a separately organized and regulated finance industry. As markets become more developed, regulators find it necessary to define the basic standards for new types of market activities, such as mutual funds or clearing and settlement organizations, and the institutions that will be eligible to engage in these businesses.

The second of these functions is to provide incentives to market participants to engage in constructive behaviour, such as conforming their businesses with "best practices" or investing in the development of new market institutions and instruments. The emphasis on disclosure, whether by financial intermediaries or by issuers, should place a substantial portion of the disciplinary role in the market place. Market participants often modify their behaviour to avoid having to make damaging disclosures or because they want to publicize positive information. Requiring a particular activity to be performed by market participants could aim, for example, to encourage the development of a new type of institution or financial instrument. For example, requiring that public issues of securities must be rated by a licensed agency aims to stimulate the emergence of private rating agencies.

The third type of regulatory activity is the one that immediately comes to mind when one thinks of "regulation" to provide disincentives against behaviour that would be destructive to the market. This type of regulatory activity is particularly important in the financial sector, since this sector is characterized by systematic risk, that is, the risk of contagion for the entire sector from insolvency or collapse of a single institution or market. Disincentives against misbehaviour, such as self-dealing or market manipulation, are also necessary due to the special problems of information asymmetry (for example, the unequal access to information) in the financial sector.

Although taking advantage of information asymmetry may be quite rational in the near term for a single economic sector, its long-term effects on the credibility of the market can dramatically reduce the number of investors and issuers willing to participate in the market. This will seriously impede market development and the attractiveness of the finance industry as a business.

B. OBJECTIVES OF FINANCIAL MARKET REGULATION

The special characteristics of the financial sector just mentioned—systemic risk and information asymmetry—underpin the principal regulatory objectives that must be balanced by securities regulators. These objectives are: market integrity, fairness and efficiency.

1. *Market integrity*

This objective includes a number of regulatory activities that minimize systemic risk and encourage participation in the market, such as:

(a) Prudential measures to safeguard the solvency of individual financial institutions, thereby maintaining confidence in the financial system as a whole and protecting individual savers;

(b) The encouragement of an effective and stable payments system, to reduce the accumulation of significant counterpart risk, improve the ability of individual financial institutions to manage their risk exposures, and discourage contagion or financial panic;

(c) Prevention of fraud, manipulation, insider trading and other such market abuse that threatens market integrity. Although such abuse cannot be completely eliminated, rules for its prevention are, however, a valuable deterrent and their absence would result in more abusive behaviour that would endanger the market.

2. *Fairness*

This objective is a regulatory concern, not only for political and social reasons, but also as a means to protect the market competitiveness and integrity. For example, competition within the financial system should be encouraged by allowing easy entry, operation and exit for participants. Moreover, measures should be taken to curb monopoly power by preventing market domination by larger participants. Fairness also includes concerns about providing access to appropriate financial assets for smaller and less sophisticated investors and protecting them against abuse by participants with greater market power.

3. *Efficiency*

This objective is key to the ability of the financial sector to perform its principal function of pooling and allocating financial resources to economically viable businesses. As most ESCWA member countries are opening their economies and adopting a more market-based approach to the development and operation of industrial enterprises, the allocation of capital and credit to industry must be responsive to new and shifting economic opportunities. Both the developmental and disciplinary roles of financial market regulation can contribute to better organized and more efficient financial markets. The efficiency of the financial market in ESCWA member countries suffers, however, from both excessive regulation and lack of adequate regulation. It is important that regulations make their necessary contribution but also that they do not become an end in themselves (box 2).

The objectives of regulations are not always easy to reconcile. In fact, the difficulty in structuring a regulatory system lies in the often contradictory goals of maintaining market integrity, fairness, and efficiency. A case in point is the degree of competition in the market. Although "fairness" might be enhanced by permitting any person to engage in a type of business, the goal of "market integrity" might depend in restricting participation on the basis of minimum capital, demonstrated expertise and operating history. In other cases, "efficiency" considerations may be the determining factor. The constantly shifting emphasis in a country's regulatory objectives will always be a delicate balance for securities regulators.

C. APPROACHES OF FINANCIAL MARKET REGULATION: DIRECT REGULATION VERSUS SELF REGULATION

In virtually all financial markets in the region, there is a degree of both direct government regulation and self-regulation by the finance industry. As part of the dual trend of more reliance on market forces and the expansion of domestic financial markets in the region, it is becoming more prevalent to formalize the respective regulatory responsibilities of the government and the finance industry.

Box 2. Financial market efficiency

A financial market is efficient if it fully and correctly reflects all relevant information in determining prices of securities. In other words, in a free and competitive market, the prices of financial securities should generally reflect all publicly-available information; and these prices should adjust rapidly to new information. Thus, there are two aspects to market efficiency: the type of information to which the market is reacting, and the speed with which the market reacts to that information. It is expected that in an efficient market, prices are assumed to reflect all available information at any given time; the current price of an asset would be a good estimate of its intrinsic value, owing to competition among market participants.

In a world of uncertainty, however, the intrinsic value cannot be properly determined. Hence, there will be differences of opinion among market participants as to the value of each share, so that actual prices will wander around the intrinsic value. Financial market hypotheses usually indicate that competition among investors ensures that these discrepancies are not too large to be profitably used. In a dynamic economy, intrinsic values can themselves change as a result of new information. In case new information is gradually known to market participants, successive price changes will exhibit dependence. However, if the adjustment to new information is "instantaneous", successive price changes will be independent.

Direct or State regulation means that the government assigns the regulatory role to one or more public agencies that set rules for the market and enforce their application. Whether financial market regulation is in the hands of an independent entity or within one or more ministries, it is an integral part of the executive authority and under the control of the government.

Self-regulation, on the other hand, refers to the situation whereby regulation of the financial markets is to a large extent left to market participants, who themselves determine the rules to apply and how to monitor and enforce compliance. For example, regulation of the securities markets could be left primarily in the hands of the stock exchange, whose members would draft their own rules and regulations, governing not only trading on the exchange but also the qualifications of members and the business standards that members must meet.

There are virtues and drawbacks to both approaches. Self-regulation allows the market rules to respond to the real demands of participants, but the self-regulatory body may sacrifice market integrity for short-term gains when the interests of members and their clients come into conflict.

Self-regulatory financial institutions are considered to be the best source of innovation in market practices; but they may also be anti-competitive, in that they sometimes act like "guilds", promoting the vested interests of their members: they may, for example, try to fix prices, restrict access of new entrants and oppose changes in the financial sector structures that could threaten the short-term interests of their members. If government regulators have the necessary political and budgetary support, they are often better positioned than self-regulatory organizations to overcome the problems of vested interests and introduce necessary changes to the securities markets. Governments may often be handicapped, however, by lack of financial and human resources to develop detailed technical policies and finance industry standards and to directly supervise and control market activity.

III. GLOBAL PERSPECTIVES ON ESCWA FINANCIAL MARKET REGULATION

The last fifteen years up to 1997 brought with them a period of significant growth of financial markets in the region. Between 1985 and 1997, the capitalization of financial markets in the region increased by about 10 times, to around US$ 131 billion in 1997.[10] The markets nearly doubled their share of world equity market capitalization from around 0.3 per cent to around 0.7 per cent. Trading volume in 1997 was around 15 times the 1985 level and the number of listed companies in these markets represented about 0.6 per cent of the approximately 160,000 listed companies worldwide.

Growth in the size of financial markets in the region has been accompanied by a process of deregulation and liberalization. This trend is especially noticeable in areas such as foreign investment, particularly in Egypt, Jordan and Lebanon. Foreign investment, both portfolio and direct, is beginning to become important in these countries, which have been facing a shortage of financial resources as manifested by their budget deficits and external balance of payments.

In the past, a primary source of financial resources for these and other ESCWA member countries with more diversified economies was in the form of remittances from the GCC area and aid and grants from the developed countries. However, with the drop in the oil revenue of the former and the recession and deep economic disturbances in the latter, these sources have shrunk considerably. Therefore, it has become important for these countries to attract other sources of finance. Moreover, as a result of the debt crisis, bank lending to many ESCWA member countries fell drastically and left a void which needed to be filled.

Since financial markets in the region compete with each other for the scarce supply of investment funds, regulatory policies have evolved in response to the growing recognition that investment will head in the direction of those countries which have the fewest barriers to entry and exit and which offer the most rewards in the form of after-tax returns.

At the same time, most ESCWA member countries have realized the importance of developing their own securities markets, primarily to channel their domestic savings but also to reassure foreign investors of the economic and financial viability of the country.

Furthermore, ESCWA member countries have recognized the benefits to be reaped from globalization of financial markets and their enhanced integration. They are unwilling to forgo these benefits and are keen to be in line with international standards, regulations and norms. For example, in the area of clearing and settlement, a number of financial markets in the region (for example, Bahrain, Egypt, Jordan and Oman) have adopted or are in the process of adopting the recommendations of the Group of Thirty (G-30) and the International Organization for Standardization in order to standardize procedures and improve the overall quality of clearing and settlement.

Along with the process of deregulation and liberalization, another change in the financial sectors of ESCWA member countries has been the increasing importance of non-bank financial intermediaries, such as investment and insurance companies and brokerage firms. These institutions and their participation in the securities markets have raised regulatory issues that go beyond traditional concerns with the performance and standing of commercial and investment banks.

However, deregulation and liberalization of markets does not mean that regulations would simply be removed. It means that restrictions on entry, operation and exit are relaxed to allow wider market participation. For foreign investors, an effective and efficient regulatory environment that meets international standards is a primary concern. For example, price information, trading fairness, efficiency and liquidity as

[10] In 1998, however, capitalization of formally operating financial markets in the ESCWA region dropped by around 20 per cent to US$ 105 billion. Preliminary figures for the first quarter of 1999, however, indicated a rise in total capitalization of these markets to around US$ 108.5 billion.

well as other issues, such as the clearing settlement mechanisms of the host country, all contribute to reducing the risks of investing in a foreign market.

In addition, although most ESCWA member countries have embarked on a process of financial sector reform, there are wide disparities between these countries regarding the extent to which liberal regulatory policies have replaced government controls in their financial markets. Some countries, such as Jordan and Lebanon adopted a system of "relatively" open economies a long time ago; others, such as Egypt, began deregulation only in the early 1990s and are now in the process of easing rules and regulations.

Table 2 provides a comprehensive overview of financial market liberalization in ESCWA member countries in terms of entry to these markets, capital and dividend repatriation, withholding taxation rates, market information and investor protection.

As can be seen from the table, stock markets of all ESCWA member countries, except Iraq, Kuwait and Qatar, are open to foreigners, both through direct investment and equity funds. The stock markets of Kuwait, Saudi Arabia and the United Arab Emirates are, however, open only through portfolio funds.

A favourable development in most ESCWA member countries has been free entrance to the stock markets and free repatriation of capital and dividends by foreign investors. However, countries such as Bahrain, Egypt, Jordan and Oman still require registration procedures to ensure repatriation rights. Moreover, these four countries restrict foreigners to certain classes of stocks designated for foreign investors. Kuwait, Saudi Arabia and the United Arab Emirates limit investment in stocks to approved foreign investors only. Foreigners with free access to financial markets in ESCWA member countries are exempt from paying withholding tax. Availability of market information and the extent of investor protection are considered to be satisfactorily in accordance with international standards.

TABLE 2. LIBERALIZATION INDICATORS OF STOCK MARKETS IN THE ESCWA REGION

	Open		Closed		Repatriation of					
	To foreign investors	Through funds	To foreign investors	Exit	Capital	Dividends	Withholding taxation rates	Market information	Investors protection	No stock market
Bahrain	x	x			x	x	0	x	x	
Egypt	x	x			x	x	0	x	x	
Iraq			x							
Jordan	x	x			x	x	0	x	x	
Kuwait		x			x	x	0	x	x	
Lebanon	x	x			x	x	0	x	x	
Oman	x	x			x	x	0	x	x	
West Bank and Gaza Strip	x	x			x	x				
Qatar			x							
Saudi Arabia		x			x	x	0	x	x	
Syrian Arab Republic										x
United Arab Emirates		x			x	x	0	x	x	
Yemen										x

IV. A FRAMEWORK FOR FINANCIAL MARKET DEVELOPMENT IN THE ESCWA REGION

Over the past ten to fifteen years, there has been a major change in economic thinking and development strategy in almost all ESCWA member countries. The essence of the change has been to move away from government controls; and to direct economic activities toward policies and practices allowing market forces to work and encouraging the private sector to be the prime mover of economic growth. Policies of government control of the economy, suppression of market forces and discouragement of the private sector have proved to be obstacles to economic development.

Recognition of the importance of financial markets as being central to the creation of an efficient and competitive economy, is a key aspect of this change. Countries which have decided to rely on market signals to direct the allocation of productive resources need efficient financial markets to realize the benefits of independent, market-based economic decision-making. Although some progress has been made in establishing and developing financial markets in the ESCWA region in recent years, this progress has been uneven. A number of ESCWA member countries has made substantially greater progress than others; and the measures taken to further the development of their financial markets have varied. A number of principles are considered to be fundamental to an adequate framework for financial market development in the region.

A. STABLE POLITICAL ENVIRONMENT

Investors are very sensitive to political uncertainty. If a country is in turmoil, there is little interest in establishing a stock market. If a market exists, trading activity and stock prices are usually in decline. One reason is that investors need security first; another is that political disruption nearly always affects economic activity since companies postpone investments and scale down their growth projections. In such an environment, new share issues are not needed because companies are not expanding; nor are they well received by investors because of unwillingness to invest in financial assets.

B. STABLE ECONOMIC ENVIRONMENT

Perhaps the most fundamental requirement for a healthy and well-developed financial market is an appreciated economic policy environment. Long-term resources can be mobilized and invested only in an environment of stability and reasonable certainty about the future. Fiscal and monetary policies that promote stability are vital to the efficient functioning of financial markets. The development of financial markets requires that interest rates be determined by market forces and that financial decision-making should occur on the basis of independent judgment based on commercial criteria. Fiscal and monetary discipline is very important to ensure that the public sector does not crowd out the private sector by offering terms that the latter cannot match. Governments in a number of ESCWA member countries have chosen to finance their budget deficits by mobilizing funds at high, tax-free interest rates. Such policies are considered to have discouraged financial market development, since private issues of capital could not offer competitive returns.

C. ADEQUATE TAX FRAMEWORK

For financial markets to grow in a balanced manner, tax policies should not discriminate against any one class of financial instruments. If instruments are treated equally for tax purposes, the financial market will determine their prices on the basis of their appeal to savers and investors. Tax policies often distort this process. A prime example of this type of distortion is the double taxation of dividends. In some ESCWA member countries (for example, Egypt and Jordan) whereas interest on borrowing is tax deductible, dividends are not. Thus, dividends are taxed both at company and shareholder level. This means that the company must pay a higher rate of return to the investor to compensate for this additional tax burden. This makes equity financing more expensive and, therefore, less attractive as compared to debt financing. Similarly, taxes on capital gains often discourage equity investment. Rationalization of the tax regime is often a first step in promoting active financial markets.

D. ADEQUATE DEMAND FOR SHARES (ROLE OF INSTITUTIONAL INVESTORS)

In a number of ESCWA member countries (e.g. Bahrain, Egypt, Kuwait and Jordan), State-owned institutional investors play a dominant role in the financial markets. This works against long-term development of the market, because such investors usually operate on a "non-market" basis, enjoying advantages not available to others. Moreover, these investors can be used to exercise government influence over the private sector. On the other hand, private institutional investors, both contractual savings institutions such as pension funds and insurance companies and collective investment vehicles such as mutual funds, can have an important role in developing domestic financial markets.

In most financial markets in the region, there is a large number of small, widely dispersed investors who are unlikely to be able to safeguard their interests as shareholders. Institutional investors can effectively represent the collective interest of such shareholders. Institutional investors which accumulate large resources serve as an important source of demand for equities and other financial instruments and can stimulate the market.

E. ADEQUATE SUPPLY OF SHARES

The availability of an adequate number of shares for trading is often a greater constraint in the development of an active financial market than is the number of investors. Too few shares may initially deter investors from entering the market and, at a later stage, when trading is active, can result in violent price movements. Another potential problem frequently encountered in developing a financial market is the lack of "float" or the percentage of company capital available for trading on the stock market to "outside" investors, since it is not closely held by the original or other major owners. A number of tax and other incentives can be used to stimulate the supply of shares into the market:

(a) Tax exemption for capital gains on shares for investors in public companies;

(b) Tax exemption (or capital tax exemption up to a certain amount) for dividends; corporate income usually is already taxed and a withholding tax on dividends or their inclusion in taxable income amounts to double taxation;

(c) A lower corporate tax for public sector companies in comparison with private sector companies;

(d) Special tax credits or deductions for individuals (and possibly companies) investing in shares of public sector companies.

F. ADEQUATE ACCOUNTING AND AUDITING STANDARDS

Financial information may not be accurate or comparable from company to company without the adoption and enforcement of accounting standards which are generally accepted. If foreign investments are to be encouraged, accounting practices need to be in line with internationally accepted accounting principles.

G. PRESENCE OF INTERMEDIARIES

In order for a market to operate, intermediaries for buyers and sellers should exist. These include underwriters, dealers, brokers, research firms and investment banks. Commercial banks should not have complete hold over the financial system and the corporate sector.

H. ADEQUATE MARKET INFRASTRUCTURE

The basic infrastructure should include payment and clearing systems, securities trading and information dissemination facilities, clearance and settlement arrangements, and back office support systems. This is perhaps one of the most critical but relatively less-emphasized areas of financial market development in ESCWA member countries. Fortunately, the importance of infrastructure is being recognized in many of

these countries, which are now making major investments to upgrade their facilities by using advanced computer-based systems and by adopting the latest technology.

I. ADEQUATE LEGAL FRAMEWORK

Assessing the regulatory environment of any country's financial market is a key factor in the decision to invest in that market. The ground rules embodied in laws and regulations, and the capacity and seriousness of both the government and self-regulatory bodies to enforce these rules, affect the ability of portfolio managers to realize key objectives, such as increasing returns, minimizing transaction costs and managing risks.

Laws and regulations that have an impact on the financial markets of a number of ESCWA member countries, such as Egypt and Jordan, are not limited to those administered by the local commission of the financial market. Factors contributing to an adequate environment for investment in these countries include the ease of enforcing basic contractual and property rights, corporate governance practices and shareholder rights embodied in corporate statutes, and rules regulating the structure of industrial and financial ownership. The latter include competition policies and controls over self-dealing and other conflicts of interest that protect the financial market from being dominated by a cozy set of insiders. Foreign portfolio investors also have special regulatory concerns not shared by domestic investors, such as taxation and currency rules that directly affect their ability to remit capital and profit.

V. THE ROLE OF THE BANKING SECTOR IN FINANCIAL MARKET DEVELOPMENT

One of the thorny issues often raised in debates over the financial strategy that should be adopted for developing a financial market is the role the banking sector should play *vis-à-vis* the financial market, since both constitute important alternative channels of finance that can be either competitive, and therefore, substituting for one another, or complementary.

With appropriate government support, some specialized banks[11] in a number of ESCWA member countries have been able to provide long-term debt finance on less-costly terms than would a bond market. This policy has contributed to a shift in favour of debt financing over equity financing, thereby resulting in a less secure pattern of corporate finance and a less efficient allocation of savings.

However, the issue confronting most ESCWA member countries in this regard concerns the role of the banking sector at large in the development of the financial markets. It also concerns government policies and practices that might be needed to define or influence this role. In other words, should the government promote a global market mechanism whereby banks operate as securities market agents or fiduciaries in such a market; or would it be healthier for the institutions of the securities market to remain independent and thus separate from banks?

Supporters of universal banking (box 3) in ESCWA member countries argue that the extensive bank branch network in the countries allow for economies of scale and more efficient distribution of securities, although there is fear that this may lead to an unhealthy concentration of economic power, a lack of specialization and entrepreneurship, and conflict of interest. It is recognized, however, that during the early stages of financial market development, an active and dominant role for banks in the securities market is both desirable and unavoidable. As these economies develop, however, specialization and competition among banks and securities market firms would better serve the market by providing a wide variety of liquid instruments with more diverse risk and reward opportunities for savers, borrowers and investors alike.

Following is an outline of the interrelationship between the banking sector and the development of financial markets in the ESCWA region.

A. THE SUPPLY AND DEMAND FOR SAVINGS

If ESCWA member countries are to generate sufficient savings to finance development, it is important that they adopt policy measures that could help to raise the level of both private and public savings. There is, indeed, room for reversing the existing situation of public dissavings in most ESCWA member countries: this could be done by stemming the growth of unproductive, uneconomic and distorting public expenditure and by pursuing appropriate tax policies. Such fiscal policies, coupled with other measures, such as market-determined interest rates, flexible or realistic exchange rates, and financial intermediation and banking reforms, are crucial in providing the necessary incentives for increasing private savings.

Available data on the region indicate that the average savings ratio amounted to around 14 per cent (US$ 63.8 billion) of the combined GNP of US$ 455.8 billion in 1997. The region's investments for that year amounted to around US$ 96.3 billion, whereas its balance of payments' current account showed a surplus of US$ 15.3 billion.[12] Although these figures suggest that it would have been possible for ESCWA member countries to finance US$ 63.8 billion of the US$ 96.3 billion of their investments from domestic sources, such a conclusion would simply be misleading, since it overlooks the fact that financial intermediation between these countries is largely carried out through the international financial markets, access to which is highly competitive. One of the main factors limiting financial intermediation between ESCWA member countries (regional intermediation) is the prevailing imbalance between the demand for and the supply of capital at different maturity levels.

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[11] These include, for example, housing banks, industrial development banks, agri-banks and other forms of cooperative banks.

[12] The figures are extracted and calculated from the Joint Arab Economic Report, 1998.

Box 3. Universal banking and financial market development

Universal banking which is wholesale and retail banking in one, is a combination of commercial and investment banking. In the ESCWA region where financial markets are still in the development process, commercial banks are generally the most important medium for mobilizing private savings. In most ESCWA member countries, the problem is not one of an actual shortage of savings but that of the absence of efficient financial markets that converse accumulated capital into productive investment. The liberalization of the banking sector in the direction of universalization could improve the process of mobilization and allocation of financial resources. Within such a system, the banks would be able to grant loans to companies by issuing securities that could enable the local saver to invest directly in the capital of local enterprises. In other words, this system would work as a vehicle for widening the share ownership and the distribution of wealth. Once the companies that have been granted loans acquire a "solid reputation" in the market, the banks would be in a position to directly invest part of their assets in these companies (portfolio investment) under strict rules similar to those in force in developed financial markets.

With regard to the efficiency of financial markets in the process of mobilization and allocation of financial resources within the framework of a system of universal banks, ESCWA member countries would indeed benefit significantly from the universalization of banks and the economies of scale that result. Whereas specialization in banking usually leads to diminishing operating costs in developed markets, this is not the case in ESCWA's emerging markets, where the size of the banking sector and the economy are relatively small. Consequently, specialized banks (for example, investment banks) in ESCWA member countries are extremely sensitive to fluctuations in the level of economic activity. They also have to bear heavy fixed costs which are more easily absorbed by a bank offering a wide range of services. A bank specializing in a particular sector runs the risk of having its activities seriously curtailed and seeing its fixed costs rising swiftly, if the sector in which its activities are based experiences a slow-down.

A universal bank, on the other hand, can face up to such a situation more easily owing to the better distribution of its capital and resources in diversified activities, such as providing mortgages, loans to individuals and industrial loans; having holdings in companies; engaging in portfolio management; issuing credit accounts, consumer banking services, etc. These diversified activities help the universal bank to survive an economic slowdown; they are usually provided at a lower cost than those offered by a specialized bank, owing to the economies of scale generated by the use of a common labour force and other inputs.

Demand for investment funds in ESCWA member countries is mostly of a long-term nature, whereas the supply of funds is, in contrast, attracted by the liquidity and the relatively more limited risk of short-term financial instruments in the market. The discrepancy between demand and supply of funds in the region is aggravated by the limited complementarities and coordination between financial markets. Although efforts are being made through joint ventures and other means to reach economic harmonization and coordination of these economies, the long-term solution is considered to be in the development of financial markets that can bridge the existing gap between supply and demand within and among the countries of the region, and thus bring about a more reasonable regional financial balance.

Available data on banking in the ESCWA region indicate that the stock of total savings and time deposits in member countries' commercial banks at the end of 1997 amounted to around US$ 155 billion.[13] The main instruments for savers were the traditional savings deposits and time deposits. Demand for savings, as reflected by the credit extended by the banking sector to the private sector, amounted to around US$ 130 billion (excluding financing of government budget deficits).[14] This credit was in the form of traditional loans guaranteed by some collaterals as opposed to bonds or other financial instruments.

In contrast to the banking sector, the supply of instruments (borrowing) in the financial markets reflects by-and-large government budget deficits and business equity offerings. As in the case of indirect intermediation, the demand for such instruments (lending) reflects the amount of available savings. Government budget deficits are typically financed through direct borrowing from the banking system, including the central bank. However, raising capital through public offerings of equity shares has increased

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[13] Excluding Iraq and the West Bank and Gaza Strip, owing to lack of data.

[14] International Monetary Fund, International Financial Statistics, May 1999.

significantly during the last few years in most ESCWA member countries. This development may explain the scarcity of financial instruments in their financial markets and the predominance of the banking sector as a source of both short-term credit and long-term finance.

In this situation, the banking sector in the region needs to be assured of a higher degree of liquidity in the event of major deposit withdrawals; and deposit holders require an appropriate degree of guarantee. This emphasizes the need to expedite the development of financial markets in the region to mobilize savings through equity and long-term debt instruments and to allocate them to productive investment opportunities in both the public and private sectors.

Development of financial markets in the region and the efficient mobilization and allocation of financial resources are now all the more important and relevant, because of the impact of the ongoing economic structural adjustment programmes in most ESCWA member countries and the demand for investment funds. Since the required volume of funds is well beyond the recognized parameters of private savings, the burden may have to fall on public savings. This is not a cause for alarm. On the contrary, it may well put the economies of ESCWA member countries on the right course of sustained development and growth, as it would call for a rationalization of public spending and reduction of government intervention in the economy, i.e. allowing market price signals to operate freely.

Examples of public expenditure that always need to be critically reviewed as to the real need and the sustainability of their levels, are military expenditure, and subsidies and programmes that have outlived their purposes. The alternative would be an increased imbalance in the supply and demand of savings which could only lead to a further higher real interest rates with its undesirable impact on debt servicing, investment, growth, employment and income; that is to say on the "economic destiny" of the society as a whole.

B. ASSET-LIABILITY MANAGEMENT

The objectives of depositors and those of bank shareholders are incompatible in the short run. This incompatibility resides in the unavoidable conflict between the objectives of liquidity and profitability present in every bank transaction. The conflict is thus the central issue which the technique of asset-liability management seeks to resolve.

This technique implies the coordination and balance between the sources of funds (capital, demand and time deposits and debentures) and the ultimate uses of these funds (loans and investments). The process involves the reconciliation of the banks' need to generate the liquidity necessary for meeting the normal process of deposit withdrawals, the demands on lines of credit extended, and the requirements of the regulatory authorities with an acceptable level of revenues (box 4).

Although the banking sector in the region has endeavoured in recent years to deal with pressing problems such as provisioning and debt restructuring, new problems have arisen, stemming from capital convergence standards and the changing economic climate, which have emphasized more than ever before the need for adopting the technique of asset-liability management.

Box 4. Banking supervision and financial market development

Development of financial markets in the region usually aim to achieve three major objectives, at the national, regional and international levels: first, the effective build-up and efficient allocation of domestic financial resources; second, the provision of safeguards and buffers against shocks, and an adequate response to crisis; and, third, the provision of a smooth and steady flow of foreign savings. The first objective does not necessarily imply financial liberalization, which under certain circumstances, such as in the absence of regulatory safeguards, could lead to disastrous results. It may, however, imply financial restructuring. Regarding the second objective, safeguard measures would entail a system of deposit insurance, a lender of last resort, emergency credit lines, and the holding of adequate official reserves including a new orientation in the management of foreign exchange reserves in the light of more mobile capital flows.

Box 4 (*continued*)

However, achieving the three objectives requires sound banking supervision that could prevent the occurrence of asset bubbles. Although such occurrence cannot be eliminated completely, the high cost of sound banking supervision is still lower than the cost that may result as a consequence of poor banking supervision. To attain sound banking supervision, five preconditions must be met:

(a) Sound and sustainable macroeconomic policies;

(b) A well-developed public infrastructure which should include a system of business laws, well-defined accounting principles and rules, independent audits and a secure and efficient payment and clearing system for the settlement of financial transactions;

(c) Effective market discipline, that depends on an adequate flow of information to market participants; appropriate financial incentives to reward well-managed financial institutions; and arrangements that ensure that investors are not insulated from the consequences of their decisions;

(d) Procedures for the efficient resolution of problems in banks;

(e) Mechanisms for providing an appropriate level of systemic protection (or public safety net).

However, banking supervision could not, and should not, provide an assurance that banks would not fail. In a liberal economy, failures are a part of risk-taking. Implementation is the most critical aspect. It represents a process that by its nature could be a long one, depending on the initial conditions prevailing in any member country. The core principles would be a set of guidelines, aimed to provide a general framework for effective banking supervision, which should be supplemented at the level of each ESCWA member country in the light of the country-specific conditions and risks. In some ESCWA member countries, such as Bahrain, Jordan and Kuwait, much of the legal and institutional framework necessary for the effective implementation of the guidelines already exists, and full implementation could take place relatively quickly. In others, such as Egypt and Lebanon, the process might require a number of major changes that could take longer, including the implementation of appropriate legal changes (to provide for contract law, property rights, collateral arrangements and insolvency and bankruptcy arrangements), and steps to increase the availability of skilled market practitioners in the areas of law, accounting, credit analysis and risk management, and private sector apparatus (including credit rating agencies and private analysts).

Supervision is expected to cover all banks and financial institutions in the region, including offshore banks and financial institutions. It should be carried out by the central banks of member countries. Moreover, a system of deposit insurance should be established despite the risk of moral hazard that it could give rise to. However, a number of issues should be incorporated in the design of such a system: fee-based contributions, public funding and government guarantees.

In addition to the issues related to banking supervision in particular and the legal framework of the financial system in general, a prudent and well-sequenced liberalization process of the financial system should be pursued in order to minimize financial turmoil. However, liberalization of capital flows is expected to precede liberalization of the domestic financial system, which should then be followed by capital account liberalization.

C. THE CHALLENGES

Historically, international financial transactions have grown apace with international trade and direct investment. However, the last 10 to 15 years have witnessed a phenomenon that has altered both the nature and the volume of international financial transactions and made the process of interdependence more pronounced. This phenomenon, called the "globalization of financial markets", links the domestic and international financial markets.

As a result of the new technological, information and communication facilities, which enable worldwide transactions throughout the hour, financial exchanges are outweighing trade as the major source of international capital movement in a ratio estimated at 40 to 1. Foreign exchange transactions alone are reaching approximately US$ 1.5 trillion a day.

Similarly, the world-wide maintenance of orderly and stable exchange rates and multi-lateral systems of payments between different countries is now primarily determined through the market forces generated by private financial institutions in international currencies and financial markets.

The impact of globalization on individual ESCWA member countries depends on the availability and magnitude of savings and the existence and degree of openness of their domestic financial markets. Although the GCC countries possess sizable financial resources and their economies are open, in the sense that there are no exchange restrictions or other controls on capital flows, they are yet to fully develop the financial instruments required by the highly competitive and highly sophisticated global market environment. ESCWA member countries will remain unable to take full advantage of and participate in a globalized international financial system as long as their own domestic financial markets remain at an embryonic stage of development.

The importance of sound macroeconomic policies for building up efficient financial markets cannot be overemphasized. The significant public sector deficits in several ESCWA member countries and the consequent price-cost distortions, particularly administered interest rates and the potential for general inflationary pressures, are certain to make investment returns non-competitive, with the returns generated elsewhere in the international financial markets, and to perpetuate the misallocation of savings. A major challenge ESCWA member countries are facing in this regard is the formulation and implementation of appropriate macroeconomic policies.

However, the globalization of financial markets could be viewed as partly the outcome of a progressive process of liberalization in domestic financial markets worldwide. Deregulation has occurred not only in the countries of the European Union but also in the United States, where many of the basic banking regulations have been amended, and, to some extent, in Japan which has undertaken a comprehensive review of its financial legislation and made a number of changes and amendments. This is in addition to deregulation in a number of other countries outside the membership of the Basle Committee.

Deregulation has raised a key question as to the role that banks should play in financial market development in the region: whether the banks in an ESCWA member country with a financial market should promote a deregulated financial environment where banks operate as securities market institutions or fiduciaries, or whether it would be more efficient and healthier to have securities market institutions independent and separate from banks.

Proponents of deregulation argue that the extensive bank branch network ensures competition and allows for economies of scale and more efficient distribution of securities among market participants. The opponents point out that diffusion of responsibility leads to weakening of specialization and entrepreneurship while generating negative effects associated with conflict of interests. Banks as underwriters or brokers, may be tempted to encourage their borrowing customers to use the financing method which is most convenient to the bank at the time, rather than to use that method which may be most beneficial to the borrower. As portfolio managers, banks may also be tempted to orient trust account purchases to acquire equity interests which best serve their banking business, and not necessarily the best interests of their clients.

In the region, where the financial markets are at an early stage of development (emerging markets), the active role of banks in the securities markets is perhaps both desirable and inevitable. However, at a later stage in the development of the region's financial markets, this role would be questioned. Nevertheless, most ESCWA member countries with operative financial markets have opted to pass legislation which encourages strong, independent equity markets. Another major objective of the legislation has been to eliminate interlocking between major corporate and bank interests because of the possible impact on the solvency and efficiency of the financial system. Certain ESCWA member countries have also established independent capital market authorities (Egypt) or securities commissions (Jordan) to implement the regulations and supervise market activities. Thus, the present situation represents a dichotomy between reality and legislation. That too, is a challenge.

VI. FINANCIAL MARKET DEVELOPMENT AND THE MOBILIZATION OF SAVINGS[15]

An efficient legal, administrative and institutional framework and structure of a financial market could benefit the economies of ESCWA member countries in the following way:

(a) Increase the aggregate value of savings;
(b) Improve the allocation of financial resources;
(c) Increase the aggregate volume of investments.

To reap these benefits, two main prerequisites are considered necessary: first, the financial instruments must be tailored to the needs of investors, i.e. the introduction of these instruments to the market must be justifiable. Second, the financial instruments must be capable of absorbing a greater volume of real resources if they are to have a positive effect on net income. The first prerequisite, which would offer savers a wide range of choices (for example, the ownership of financial assets) would lead on to the second. The attraction of the instruments in terms of services offered—yield, risk and liquidity—would encourage a reduction of consumption (i.e. expenditure) in favour of savings. Moreover, such instruments would respond positively to a number of propositions, such as:

(a) Whether the combination of the features of the instruments make them as attractive as, or more attractive than any "new" financial assets;

(b) Whether there is a propensity for savers to invest in financial instruments with these features;

(c) If this is the case, whether the financial instruments would tempt savers to reduce their spending on consumption in order to invest more of their income in them.

In view of this, it could be said that the development of a financial market would lead to a rise in aggregate savings at the same time as it monetizes the economy. Therefore, the rise would mainly be due to the effect of money and financial instruments issued by the concerned institutions in the market.

Regarding (a) above, namely the attraction of financial instruments, a financial instrument is as attractive as the criteria of its return, liquidity and risk make it. The criteria, however, depend on a set of circumstances that are related to the issuer of the instrument and the state of the financial market, with the latter being reflected in the degree of its integration in the economy, and its perfection, together with its structure. Other circumstances are related to financial, economic and political issues, the financial conditions of the borrowers and ultimately the policy of the monetary authorities.

As to the issue of risk of financial instruments, it is expected that where savers have little basic grounding in economics, and where there is an imperfect market, the element of risk in investing in financial instruments is higher than in investing in short-term financial assets or in assets that could be managed more easily, such as term deposits.

In the case of bond issues, the risk element can be reduced by pitching the prices of the issues, nominal interest rate, redemption value and terms on similar lines to the terms and conditions of long-dated savings deposits. Yet given the relatively longer life of bonds, the risk element tends to increase in all of its components, i.e. the repayment capacity of the issuers (financial risk), the loss in principal caused by increases in the current level of interest rates (interest rate risk), and change in the value of money (monetary risk). However, the resale value of bonds is always dependent on their marketability; this is connected with the efficiency of the secondary market. The financial risk depends on the issuers; it is higher with instruments issued by private borrowers than with those issued by financial institutions. The financial risk is

[15] This chapter has benefitted extensively from the ESCWA publication entitled "Financial Markets and Investment Promotion in the ESCWA Region", (E/ESCWA/DPD/1990/2), 1990.

negligible where financial instruments are issued by the government in local currency. In this case, only unwillingness to repay may cause insolvency.

These differences still prevail even when only the largest borrowers are in a position to place the instruments on the market. It is difficult to reduce this risk by diversifying portfolios according to the type of issuer, as only a limited choice is available. This is particularly significant in view of the fact that, in the relatively developed ESCWA's financial markets, the specialization of intermediaries is extremely limited, and the intermediaries generally have little incentive to raise funds by issuing bonds, as savings deposits are a more simple and economic way of collecting money from savers.

In view of the above, it could be said that financial instruments, especially securities, have a higher degree of risk than other financial assets, particularly money and quasi-money, and that the highest risk lies in securities issued by private borrowers. Given these differentials, it follows that the rate of return on securities should be higher than on other financial assets, especially bank deposits, and that they should vary according to the type of the issuer.

In addition, given that securities may be objectively attractive, it is necessary to ascertain whether savers have a propensity to invest in them, above all bearing in mind that investment decisions tend to be subjective by nature; hence the definition of "objective" attraction is not very apt.

In the region's financial markets, there are virtually no institutional investors who manage securities investments on a collective basis in the form of mutual funds and investment trusts. Distributive techniques also tend to be underdeveloped. In the absence of bodies specializing in dealing in shares and other securities, this activity would then be carried out by individuals mostly, commercial banks, and its satisfactory implementation would depend on the banks' degree of organization, the extent of their branch networks, and their willingness to promote the business of securities. As a result, where there are no effective organizations for channelling savings into the securities market or for providing individual savers with investment advice, investment in and management of securities is carried out directly by the units in surplus.

Higher real deposit rates of interest lead to a rise in financial savings and, subsequently, to an increase in the relative importance of financial intermediation in the savings-investment process. The greater use of financial intermediation channels improves the overall efficiency with which savings funds can be allocated. The resulting higher average return on investment leads to a rise in the rate of economic growth. In turn, the higher growth causes a rise in national savings. Hence, financial conditions have an important indirect effect on savings.

Following the discussion above, a higher portion of financial savings implies that financial intermediation has a larger scope, which in turn enhances the allocation of financial resources for investment purposes and economic growth.

A system of low-administered interest rates may be favoured because it can be a means of pursuing various policy objectives, such as:

(a) Promoting investments;
(b) Redistributing wealth in favour of lower income groups;
(c) Keeping down the cost of financing budget deficits.

However, the objectives could be counter-argued as follows:

(i) Regarding the promotion of investments, investment decisions are influenced to a large extent by non-interest factors, especially expectations about the future development of the economy. Furthermore, in an inflationary environment, low interest rates may not spur fixed investment because investors could find it more profitable to use cheap credit to increase their stocks. Moreover, the provision of cheap funds may relieve borrowers from the pressure of evaluating

and implementing investment projects. Finally, cheap funds tend to favour capital-intensive investments, which might be counter-productive to employment policies.

(ii) Concerning the redistribution of wealth, low interest rates tend, in rural areas, to favour large-scale financing, partly because of malpractices in credit-rationing procedures. Furthermore, low interest rates discriminate against small savers because these savers have no choice but to "invest" their savings with financial institutions offering deposit-bearing low interest. High income savers usually have many options with regard to their investment portfolios. They can invest their funds domestically as well as internationally. Moreover, low interest rates tend to perpetuate the large share in the market of the non-institutional financial sector: credit rationing combined with artificially low interest rates could crowd out many would-be borrowers with high liquid investment projects which could be in a position to pay higher market-related interest rates. In such a situation, many small borrowers resort to non-institutional lending for the short-term financing of their working capital.

(iii) As to the financing of budget deficits at a lower cost by securing lower interest rates, a government could find it difficult to switch to market rates, i.e. "non-artificial" interest rates, before the financial situation has improved.

VII. PORTFOLIO INVESTMENT AND DEVELOPMENT OF FINANCIAL MARKETS IN THE ESCWA REGION

Given the changing structure of financial markets in the region, portfolio investment has begun in the past few years to assume an important role as one source of external finance for the region's financial markets. In ESCWA member countries, such as Egypt, Jordan and Oman, the development of the financial markets has also allowed domestic savings to be increasingly channelled through these markets.

Although most ESCWA member countries appear to encourage long-term portfolio investments, they are concerned about the high volatility of this type of investment. Their concern seems based on views related to the role of portfolio investors in the development of the recent financial crisis in a number of emerging financial markets, particularly in East Asia. On the one hand, it was shown that portfolio investors, particularly in United States mutual funds, appeared to have reacted to the East-Asian crisis in a measured fashion. Shareholders in United States' emerging market mutual funds withdrew modest portions of their investments on a steady basis; and the purchases and sales by portfolio managers, although correlated with returns, appeared to have been quite limited in comparison to the degree of market volatility. On the other hand, there was indication that the sudden general withdrawal of investments during the crisis from countries which appear to have good economic fundamentals caused major disruption in domestic financial systems through drastic changes in liquidity and sharp declines in stock market prices.

To cope with such volatility of portfolio investment, a number of ESCWA member countries, e.g. Egypt, Jordan and Bahrain, have proposed the application of new measures, at both country and regional levels. These measures include:

(a) Encouraging the establishment of closed-end funds as opposed to mutual funds. This is because investments in closed-end funds are relatively stable, as they are not bound by redemption obligations;

(b) Issuing Global Depository Receipts and other similar financial instruments. Such instruments would contribute to the development of the region's financial markets, since they reduce the volatility of investment flows;

(c) Provision of special incentives to foreign investors to encourage them to hold their portfolio investments for a minimum period. These incentives are, however, expected to be provided across ESCWA member countries or on a regional basis so as to ensure their effectiveness. Egypt and Jordan have adopted a system of differentiated tax treatment according to the duration of the investment. However, since these tax incentives might not be effective in encouraging long-term investment as new information could trigger sales despite such incentives, it is expected that tax incentives and a minimum holding period would be equally applied by these countries to both foreign and domestic investors;

(d) Mobilization of domestic savings through appropriate legislation and incentives in order to minimize dependence on foreign capital. In this regard, the development of a domestic institutional base, such as pension funds and mutual funds would help to increase the domestic savings rate;

(e) Regional monetary cooperation would help to minimize a misalignment of currencies in the region, thus reducing the risk of speculative attacks. The creation of a common currency basket peg for ESCWA member countries could reduce the occurrence of competitive devaluations. Moreover, there would be merit in adopting, initially on a regional basis, common standards and rules on financial reporting, corporate disclosure, business ethics and enforcement;

(f) Stability of the real exchange rates at an appropriate level could be a key element in encouraging sound investment as it would send the right signals to investors. A certain degree of nominal exchange rate flexibility would remove the implicit guarantee against exchange rate system, especially when it was very costly, for example, for both Egypt and Jordan, to defend their fixed exchange rates. Excessive exchange rate instability could be detrimental to foreign trade and could increase the cost to companies which have to protect themselves against exchange rate fluctuations.

As noted earlier in this chapter, portfolio investment is increasingly important as one of the sources of finance for ESCWA member countries. However, as the domestic financial systems of these countries become more sophisticated, the distinction between foreign direct investment and foreign portfolio investment may become blurred since direct investors can use financial engineering techniques to convert foreign direct investment into a more liquid form of investment, for example portfolio investment. This, however, would not eliminate the fundamental differences in the characteristics of foreign direct investment and portfolio investment: the former implying a long-term commitment, the latter attracted by capital gains derived from the price movements of securities.

Portfolio investment in financial markets is affected by purchases of bonds and equities issued by governments or companies. During the past 10 to 15 years, government bonds in the ESCWA region were issued almost for the sole purpose of financing government budget deficits, while the majority of equities which were issued in the domestic financial markets and partly purchased by non-local investors, were issued either to raise funds for domestic companies or to establish such companies. In recent years, however, companies in such countries as Egypt, Jordan, Lebanon and Saudi Arabia have started tapping international financial markets through listing on major foreign stock markets and issuance of Global and American Depository Receipts. Foreign portfolio investors would therefore be attracted to ESCWA member countries by a thriving corporate sector and growing stock markets in these countries.

Development of financial markets in the region is expected to take place in the context of a generalized policy of developing a diversified financial system which would cater for the different needs of borrowers and investors. Financial markets would allow diversification of company ownership (particularly in the privatization process), more efficient risk sharing, and a healthier financial structure for corporations by improving their debt/equity ratios. Furthermore, financial markets would play another role monitoring the corporate sector through asset prices. In an efficient financial market, asset prices play a signalling role for capital allocation and corporate control. As asset prices "usually" reflect the information available on the market, it is important that timely and accurate information reach market participants who should be able to analyze it. Excess price volatility, which does not reflect the volatility of fundamentals, will undermine the signaling role of asset prices (box 5).

In turn, a healthy banking sector is a *sine qua non* for the development of financial markets, not least because banks play an essential role in the payment and settlement process in the transaction of securities.

Portfolio investment can contribute to the development of financial markets in the region in a number of ways: First, by providing an additional supply of capital to supplement domestic savings. Portfolio investment usually contributes to a reduction in the cost of capital, thereby stimulating a greater supply of securities and fostering the expansion of the corporate sector. Second, by adding liquidity to the financial markets, portfolio investment could reduce the volatility which results from the thinness of the markets. Third, portfolio investments could improve corporate governance insofar as foreign investors demand higher disclosure standards. Fourth, portfolio investments could strengthen the financial markets, as foreign investors usually ask for timely and quality information, minority shareholder protection, and adequate market and trading regulations. Fifth, portfolio investment could encourage the development of new institutions and services (such as asset management and investment banking services and custody services), transfer of financial technology and training of local personnel. All of this would contribute to the strengthening of the financial sectors in ESCWA member countries and support a competitive financial market which would mitigate over-reliance on bank lending (and improve the debt/equity structure of local companies).

Box 5. Markets and fundamentals: causes of volatility

The structural changes in international financial markets, notably the securitization process and the growing influence of mutual funds, could lead to more volatility of capital flows. However, it would not necessarily be the case that higher volatility would result therefrom, if the economic environment were stable.

The 1990s have witnessed a surge in private capital flows to emerging markets, but also repeated episodes of widespread and profound financial crisis: in Mexico in 1994-1995 and in East Asia in 1997-1998. The East-Asian crisis spread more widely and had a greater impact on the world economy than the Mexican crisis. Both crises started with a speculative attack on currencies. The crisis on foreign exchange markets spread rapidly to the stock markets, and the risk of contagion was high since the transmission of crisis was rapid (through asset prices).

Defence of currencies rapidly depleted the countries' foreign exchange reserves. A sharp liquidity crisis ensued, as sources of short-term capital were abruptly cut. In the case of Mexico, the crisis stemmed mainly from non-renewal by portfolio investors of short-term bonds issued by the Government (tesobonos). In the case of the East-Asian countries, the crisis was caused by banks' refusal to rollover short-term credits to private sector borrowers.

In both cases there has been an accusation of pro-cyclical behaviour by portfolio investors (mutual funds and hedge funds) which has contributed to exacerbating the liquidity crisis. In particular, the role of hedge funds in intensifying speculative attacks on currencies has been much discussed in international financial circles. However, it has been asserted elsewhere that emerging market funds did not shift investment in a manner that would exacerbate price savings. It is understood, however, that investment funds quite frequently bought shares when prices were falling and sold in rising markets, thus contributing to stabilizing markets.

Indeed, portfolio investment is capable of rapid recovery after the first shock waves. In Mexico, there were substantial outflows of portfolio investment during the last quarter of 1994 and the first three quarters of 1995; by the last quarter of 1995, portfolio investment had largely recovered, and it increased substantially in 1996 and the first half of 1997. Likewise, portfolio investment showed signs of recovery in some East-Asian countries at the beginning of 1998. The rally on Asian stock markets helped to strengthen those countries' currencies.

During the East-Asian financial crisis, portfolio investment showed high volatility. In a situation of currency depreciation, and in the absence of suitable hedging mechanisms to reduce price or currency risks, portfolio investors withdrew their investments in a panic. In so doing, they exacerbated the decline in currency and asset prices. As asset prices declined, opportunities for profit increased, especially as the liquidity crisis was dampened and fundamentals improved.

Volatility of capital flows is thus associated with boom-bust cycles of domestic markets. It is important, therefore, to understand the mechanisms and causes of these cycles in order to identify appropriate policies for dealing with problems created by unstable flows.

Fundamentals and policy dilemma

Frequent financial crisis can be a manifestation of the thin margin of policy manoeuver that developing countries and countries in transition are facing in the global context of liberalization of trade and capital flows. Two particular policy dilemmas are worth mentioning in relation to the discussion on the causes of financial crisis:

Capital flows and fundamentals

In a world of mobile private capital, the volume of capital flows will depend on a number of factors, most particularly the level of domestic interest rates (as compared with foreign interest rates) and strong fundamentals (as compared by strong growth prospects which would allow higher returns on capital, as well as by strong export growth which would guarantee the availability of foreign exchange to reward foreign capital). A high level of domestic savings will also be a guarantee for potential cushioning of any temporary reversal of capital flows. In addition, a stable macroeconomic environment will help to reduce the risks of asset price fluctuations.

However, in the context of ample liquidity on international financial markets, capital tends to overflow into a few countries which appear to have strong fundamentals (high GDP and export growth, a high level of domestic savings, and macroeconomic stability). Excess capital inflows can create problems which are the seeds of future financial crisis:

Box 5 *(continued)*

(a) Real currency appreciation which will weaken export competitiveness;

(b) Excess liquidity in the financial system which might lead to asset bubbles in the property and stock markets, or excessive lending to risky or unproductive projects. If the banking and financial regulations and supervision are weak and if corporate governance is poor, excess liquidity will rapidly result in financial difficulties affecting local banks and corporations, especially if domestic interest rates have to be subsequently raised in order to attract capital flows.

The dilemma is how countries receiving large inflows of capital can prevent these inflows from creating conditions that can lead to currency crisis, and whether it is possible to determine what is a sustainable level of capital inflows.

Capital mobility, exchange rate and domestic monetary autonomy

The second policy dilemma concerns the choice of exchange rate policy. It is very difficult to maintain simultaneously free movement of capital, domestic monetary autonomy and a fixed exchange rate. For example, many countries have chosen a fixed exchange rate as a monetary anti-inflation anchor. The stability of the exchange rate might encourage more capital inflows, which, if not sterilized, will increase the money supply, and through an inflationary effect, appreciate the real exchange rate. Fixed exchange rates might also encourage heavy borrowing in foreign currencies, in circumstances where the domestic interest rates are higher than foreign rates, especially when domestic borrowers do not foresee any exchange rate risk.

However, a flexible exchange rate system can create other types of problems. In this case, the exchange rate will fluctuate with movements in capital flows and can undermine the allocation of resources to the sector of tradables. Moreover, if the reversal of capital flows is large enough (sometimes for reasons external to the domestic economy), the exchange rate may go into a self-reinforcing slide.

Speculative attacks and contagion

The attacks on the currencies of Mexico and the East-Asian countries resulted from the perception by markets of an overvaluation of their currencies due to persistently high current account deficits (at least in the cases of Mexico and Thailand). The suddenness and magnitude of the attack and the deep currency depreciation which followed are signs of the high volatility of capital flows. In the wake of the currency crisis, stock markets were immediately depressed, making another negative impact on the economy.

It has been asserted that speculative attacks on currencies merely bring forward the need for policy adjustment on the part of affected countries and that speculators merely function as early spotters of problems that countries need to address anyway. In a few cases, it has been noted that by taking early adjustment measures, countries have managed to minimize the impact of speculative attacks. Nevertheless, the magnitude of such attacks and the abrupt adjustment process which followed imposed high costs on the economies affected and on the international community, as enormous amounts of reserves and additional liquidity (provided by the international financial community) were needed in order to defend the currencies, and economic and social hardship endured by the local population.

Rapid contagion of neighbouring countries also occurred. The great susceptibility to contagion might result from a number of factors:

(a) A regional effect (because neighbouring countries are classified in the same risk category or because of the expectation that exchange rates will be changed under the pressure of competitiveness or because of strong intraregional trade and financial links);

(b) Similar economic structure or policy characteristics;

(c) Weak economic fundamentals;

(d) Market imperfections: the investors' first reaction is to withdraw from emerging markets in a panic, despite the existence of good economic fundamentals.

Source: United Nations Conference on Trade and Development (UNCTAD), Proceedings of an Expert Group Meeting on "The Growth of Domestic Capital Markets, Particularly in Developing Countries and its Relationship with Foreign Portfolio Investment", (TD/B/Com.2/EM.4/2), Geneva, 27-29 May 1998, pp. 36-52.

Nevertheless, portfolio investment can generate more volatility of asset prices on domestic financial markets. For example, the period that followed the worldwide upsurge in private capital flows in 1993 was marked by an increase in the volatility of stock market prices in most of the emerging markets that received significant flows of foreign portfolio investment. Although it was not completely clear that this increase in volatility was entirely due to an increase in the participation of foreign portfolio investors in these emerging markets, in some countries, a positive correlation between foreign portfolio equity investment and volatility of stock market prices was observed. This could be explained by the fact that large inflows and outflows of portfolio investments could have an important impact on domestic asset prices, particularly in insufficiently developed financial markets, such as those in the region.. An increase in asset price volatility would increase the risk premium and thus the cost of capital on the domestic financial market. It might even trigger a liquidity crisis, thus stifling development of the financial market as there would be fewer companies willing to be listed. Moreover, volatility would weaken the role of asset prices in allocating capital to the most productive uses.

A possible response to counterbalance the influence of portfolio investors would be to develop a strong domestic institutional investor base. Domestic institutional investors, which could mobilize significant amounts of financial resources, could act as a market stabilizer in the event of a massive liquidation of assets by portfolio investors.

Alongside the short-term volatility of asset prices, the volatility of financial flows could manifest itself in the form of boom-bust cycles accompanied by wide fluctuations in asset prices. This would cause a serious economic recession when the asset bubble bursts. In a situation of massive reversal of foreign portfolio investments, this would depress domestic asset prices and make another negative impact on the health of the domestic financial system, where financial institutions could face liquidity squeezes and serious financial losses. Moreover, borrowing costs would increase and higher volatility would entail great economic uncertainty which would further depress the economy and affect the development of the financial markets.

VIII. DEVELOPMENT OF EQUITY MARKETS IN THE ESCWA REGION

Notwithstanding their relatively limited development to date in most ESCWA member countries, there is increasing recognition among policy makers in these countries of the beneficial role of equity markets in enhancing mobilization and allocation of financial resources for development. Considering the experience of emerging markets in other developing regions, two broad types of preconditions appear to be of significance for the development of equity markets in the region. The first implies that the macroeconomic conditions are conducive to the development of the private sector. The second foresees that the structures of the equity markets would be strengthened through appropriate policies in the areas of information and accounting mechanisms, market regulation and supervision, property rights, pricing efficiency, and taxation regimes.

Given the considerable economic potential of ESCWA member countries and the valuation adjustments in emerging equity markets in other developing countries, there would appear to be favourable prospects, a priori, for significant mobilization of funds from domestic, regional and external investors. Indeed, not only are there implications of a significant amount of portfolio funds in the developed countries that could be moved into these markets, there is also a pool of ESCWA member countries' offshore savings that could be expected to be reflected in inflows to equity markets in the region.

Despite differences in the perception of economic development and growth among ESCWA member countries, there are indications that several of the factors that contributed to the development of financial markets in other developing areas are present in the region. Hence, the efforts being made by many ESCWA member countries in recent years to implement fiscal and monetary reforms, reduce inflationary pressures, and strengthen performance of the external sector. Moreover, a number of countries, such as Egypt and Lebanon, have experienced significant private capital inflows as well as reverse currency substitution.

The above indicates that from a macroeconomic perspective, the key factors determining the development of financial markets in the region is mainly the domestic macroeconomic stance of the countries of the region. This stance is expected to remain the key issue in influencing investors' perceptions of credit and transfer risk. To this end, appropriate aggregate demand management policies would have to be accompanied, with greater emphasis, by structural reforms, so as to enhance the supply responsiveness of the region's economies, thereby reducing their vulnerability to unanticipated exogenous shocks and improving their social sector performance.

Furthermore, the above also indicates that ESCWA member countries need a set of policies aimed specifically at increasing demand for and supply of equities. Even if there are few developed countries' style of share offerings in ESCWA member countries, financial markets in the region could receive a boost from a privatization process.

Other policies would entail improving the efficiency of intermediation; reducing tax-induced distortion; improving the flow of information; and strengthening market surveillance. Basically, the policies must be directed at establishing the conditions for clear property rights, having effective settlement and custody systems; implementing transparent trading practices with a level playing field among financial instruments; and providing for appropriate capital and dividend repatriation.

To this end, company laws and stock market regulations need to be clarified and overhauled in most ESCWA member countries. Share transfer procedures also need to be simplified. In a number of ESCWA member countries, action is needed to reduce distortion arising from the differentiated tax treatment of financial instruments. There is also need for a comprehensive review of factors affecting the participation of non-residents.

In this regard, the lessons from Egypt are instructive. As in a number of emerging markets in other developing countries, a significant feature of the development of the Egyptian financial market has been the willingness of the authorities to encourage foreign investors to participate in the support of broadening the equity market and in channelling financial resources to productive investments. The Egyptian Capital Market Authority, which governs activities in Egypt's capital market, has eliminated limits on foreign

holdings in listed companies. This policy has been extended to privatized public sector companies. Since 1996, stock dividends to both domestic and foreign shareholders have been tax-exempt. Tax rates on capital gains of foreign investors have been reduced so that the same rates and regulations apply as for domestic investors. Also, stock and bond markets have been opened to foreign investors with guaranteed repatriation of proceeds, so that shares can be sold and proceeds and dividends repatriated without restrictions.

The Egyptian Capital Market Law which was promulgated in June 1992 and became effective in April 1993, has revamped the legal framework for the securities market, thereby facilitating the participation of foreign investors in the market, and allowing competition in the provision and pricing of market services. For example, in order to increase confidence on the part of investors, provisions have been made which forbid insider trading, concerning trading practices and price manipulation. Companies issuing new securities to the public are also required to apply international accounting standards. In addition, regulatory framework and arbitration procedures have been improved significantly as a result of the establishment of the Capital Market Authority as an independent body entrusted with all matters related to the development or regulation of the securities market. Considerable operational improvements are also underway in both primary and secondary markets.

IX. DEVELOPMENT OF BOND MARKETS IN THE ESCWA REGION

Bond markets in the region are still in the early stages of development. The value of issues outstanding is still modest, estimated at around US$ 120 billion, mostly in government debt instruments denominated in local currencies. The bond markets, however, are expected to gain significance by added depth and versatility in the coming few years. The increasing need for long-term capital borrowed at fixed rates to spend on infrastructure would enhance this development. The objectives of institutional investors to make higher yields on their funds invested in emerging markets, to which a number of markets in the region are added, would further enhance the development. This evolution would complement the region's fast-developing equity markets and provide a fresh source of financing for private and public projects. It would also encourage the creation of new risk management instruments, such as interest rates, futures and options, while adding to the scope of central banks to conduct monetary policy through open market operations.

The bond markets are expected to become an important source of finance for corporates and governments in some ESCWA member countries such as Egypt, Jordan, Saudi Arabia and Oman. From the point of view of the borrowing governments of these countries, the bond market finance increases the flexibility of debt management and allows for terms and conditions different from those available in the loan markets. Governments choose bonds since they tend to be cheaper than bank loans and give access to new pools of funds outside the banking sector. In the bond markets, the governments are able to access funds which are more suitable to the financing of large and capital-intensive projects, since bonds typically have a longer maturity than bank loans and amortize in one bullet payment. Moreover, the majority of bonds have a fixed coupon which most borrowers prefer since it facilitates longer-term financial planning and protects them from unanticipated interest rate changes.

Bonds are also considered attractive instruments to investors because they enable them to diversify their portfolios away from equities into fixed income securities. For banks, the issuance of bonds provides the opportunity to generate new sources of funds of longer maturities and at fixed rates.

The emergence of bond markets in the region is linked to financial liberalization in a number of ESCWA member countries. Until the late 1980s, the banking sector in many of these countries was repressed by extensive controls on interest rates and credit allocation (direct monetary control). In recent years, however, financial sector reforms in many ESCWA member countries have dramatically transformed the financial environment of the region, giving a boost to the development of bond markets. Several prerequisites for the development of bond markets have been put in place recently. Investment banks have been established at national and regional level to act as intermediaries between borrowers and investors and provide underwriting and trading services. International rating agencies have also begun to position themselves in the region and several regulatory reforms have been introduced, though more still needs to be done. Although the standard of reporting has improved, financial markets in the region are still a long way behind those in developed countries as concerns transparency.

The growth of private bond markets in the region is expected to be stimulated by a number of factors, among which are: first, governments of most ESCWA member countries are in the process of incorporating public sector enterprises for the purpose of privatizing them. Since the intention is not to shed ownership control during the initial phase of privatization, public sector enterprises would be encouraged to meet their financing needs mainly by issuing bonds in the domestic financial markets; second, fast-growing companies tend to prefer bond financing to equity financing, as the former allows owners to retain greater control over corporate decisions; third, excessive long-term lending by commercial banks could lead to asset and liability maturity mismatches, and the adoption of risk-based capital adequacy requirements could restrict banks' ability to finance private fixed investments. Corporates will be drawing more on the region's bond markets to meet future financial requirements.

A noticeable, though slow, increase has taken place in the bond markets in the region during the last 10 to 15 years. Nearly all ESCWA member countries issue government bonds and treasury bills. The trend began in the mid-1980s, when several of these countries started operating under budget deficits financed mostly by domestic funds. Currently, there are bond markets in Bahrain, Egypt, Jordan, Kuwait, Lebanon, Oman and Saudi Arabia, with discount facilities adding liquidity to the bonds as well as the treasury bills.

However, ESCWA member countries have yet to develop long-term bond markets. Although concerned legislation in most of the countries allows their central banks to issue bonds of seven to ten years' maturity, most of the bonds issued remain at the shorter end of the maturity profile. Consequently, corporations in the region do not have access to medium and long-term debt financing to leverage their balance sheets and grow. Few corporate bonds have so far been issued in ESCWA member countries namely in Bahrain, Egypt, Jordan, Kuwait and Lebanon. It is obvious that investors have not yet realized that the optimal corporate financing structure has nothing to do with the use of debt versus equity, but rather with the timing of the debt or equity financing under consideration, and how the funds will be used for growth, acquisition, restructuring or recapitalization.

In most ESCWA member countries, corporate sector financing exists mainly in the form of loans solicited directly from banks, often in the form of overdraft facilities. However, financial sector reforms being undertaken by a number of ESCWA member countries are expected to encourage greater issuance of debt securities to finance public and private sector activities, thus leading to increased significance of this market. The reasons anticipated for this development include the new capital adequacy requirements and the imposed exposure limits on bank lending. These regulations could force the banks to be more careful in their allocation of capital and are likely to raise the cost of loans for borrowers, thus encouraging corporate borrowers to switch from banks to domestic and, eventually, international debt and equity markets to meet their long-term financing needs.

In some ESCWA member countries, a large number of companies are family-owned and managed. Although these companies are invariably in need of long-term funds to grow and expand their operations, the owners are often reluctant to finance these needs through a public equity offering, since this would result in a dilution of their ownership. Once their financial conditions are rendered more transparent, the use of the corporate bond market (as an alternative to equity finance) would provide a viable source of medium- and long-term funds, at the same time allowing the original owners to maintain their stakes in the equities of the companies.

The viability of public and private sector borrowing in the domestic bond market, through the issuance of debt instruments, has already been tested in a number of ESCWA member countries. Development of the markets for these instruments is expected to follow in the coming years. It should be possible, therefore, to increase the volume of various public and private sector bonds and other financial instruments, fine-tune their flow into the primary and secondary markets, refine their prices and increase their maturities.

A developed bond market would eventually give birth to a corporate bond market, an interest futures market and, when large enough, to an interest rate options market. Public sector, or government bonds will provide a benchmark for rating and pricing of corporate bonds. Without the benefits of a sovereign bond, corporates would find it very difficult to price their own issues properly.

Given that all ESCWA member countries need large amounts of financial resources for the development of infrastructure and industry, the number of bond issues in these countries is likely to increase. Would-be-borrowers realize that the financial markets are interested in lending, while the resources of the banks are finite. The process may not be fast, but the successful bond deals of the last few years are expected to encourage more governments and companies to be part of the process.

A major factor inhibiting the growth of bond markets in the region is the lack of efficient institutional and legal infrastructure. There are only a few financial institutions in the region that have the expertise to price, underwrite and sell a corporate bond issue; and the legal mechanism whereby bonds can be listed on the local stock exchanges is rather unclear. The secondary bond markets also need to be supported by institutional infrastructure, that includes, among other things, efficient clearing and settlement arrangements. Clearing, settlement, custody and payment systems are either absent or not sufficiently developed. Consequently, traders (in bonds and other financial instruments) run many risks, particularly those that may result from the unreliability of counterparties, fraud, and multiple trades of some financial instruments.

The region needs creative financial institutions that can meet the changing financial requirements of ESCWA member countries, be it project finance, floating rate notes or any other form of fixed rate

financing. Investment banking services are also needed. These include financial analysis, the underwriting of bond issues; floating of bonds to the public, and, making markets for these bond issues.

Institutional investors hold the bulk of bonds outstanding in the region. This is particularly the case with government bonds. Being "buy-and-hold" investors, their main objective is usually to avoid or minimize mismatches in the maturities of their assets and liabilities; hence the minor incentives for trading in bonds in the secondary market. Other factors, such as the lack of market makers with access to liquidity support, also hamper the development of the bond market.

Bond dealers run highly-leveraged operations, and their inventories usually represent a certain multiple of their capital bases. Dealers can be market makers only if they obtain liquidity through the repurchase market or the central bank re-discount window. Credit facilities of this type are currently unavailable in most ESCWA member countries.

Currently, in a number of ESCWA member countries, new issues of private sector corporate bonds are subject to lengthy bureaucratic procedures. In addition, the issues often require assignment of collateral, or the availability of bank guarantees, either to cover the principal sum that has been borrowed, or the coupon payments. Such requirements are not peculiar to the financial markets of ESCWA member countries. In certain countries, such as Egypt and Kuwait, regulators view these requirements as prudential measures aimed at protecting investors. From the borrowers' point of view, bank guarantees add to the cost of issuing bonds between 1 and 1.5 per cent of the sum guaranteed. From the markets' point of view, by effectively transferring the credit risk to the banks, there is no differentiation of risk between issuers. This is reflected in nearly equal yields on debt issued by borrowers with very different risk profiles.

An important prerequisite for financial deepening in ESCWA member countries, is the development of appropriate legislative systems in these countries. Bahrain, for example, has drafted a completely new commercial law; and other ESCWA member countries appear committed to improving their existing legal and commercial structures. In view of globalization of markets, and the liberalization of rules regarding financial transactions, the legal regulatory framework is expected to be in line with the rest of the world; and standards of accounting and disclosure of companies in the region should be raised to international levels. This is an important issue, because financial markets and institutions in the region will have to compete more intensively with the more advanced international financial markets. The primary responsibility for regulating the bond markets in ESCWA member countries lies with the central banks. Shifting this responsibility to newly-created exchange and trade commissions, as in the case of Egypt and Jordan, would also contribute to the process of financial deepening in the region.

Accurate and timely information on the fundamental economic performance of ESCWA member countries is limited in most of the countries, hence the demand for more transparency in this domain. The ratings now being given by international rating agencies to certain ESCWA member countries, are expected to encourage the authorities of the countries in the region to provide more information and cooperate with these agencies. However, the region still needs to catch up with information technology worldwide. A higher degree of disclosure of public finances would affect favourably the views of the agencies and help both investors and creditors to properly assess the risks involved and make the right investment or lending decisions.

A key element in the development of bond markets in the region is to ensure that bonds are issued and traded at market rates and are not discriminated against by government policies or the legal system. To accomplish that, a number of steps need to be taken:

(a) Listing on the stock exchange all bonds issued to ensure transparency of the debt markets. The listing is often seen as a requirement for widening the investors base and enhancing the accessibility of bonds, particularly when institutional investors are prohibited from holding unlisted securities;

(b) Reconsidering bankruptcy laws that discourage creditors and make bonds costlier than equity. By assuring bond holders that they will get part of their funds if the company is declared bankrupt, the authorities can contribute to the deepening of the region's financial markets;

(c) Providing the effective legal framework for new local bond issues and derivatives markets, which will be needed to make the new bonds attractive to domestic and international investors. Strengthening the financial sector, including the banking and the local money markets, to allow the emergence of strong counterparties for swaps and other transactions, will also be needed;

(d) Abolishing regulations that put in place elaborate and long-drawn-out issuing procedures and a minimum maturity of (say) five years for bonds issued by corporates;

(e) Phasing out the bank guarantees currently required of bond issuers in certain ESCWA member countries and replacing them by the attainment of an acceptable level of credit rating;

(f) Allowing government finances to be scrutinized by the rating agencies and probing corporates to get their own credit ratings. In addition, banks should be encouraged to act as market makers, providing liquidity to the domestic bond markets.

X. AGENDA FOR DEVELOPMENT OF FINANCIAL MARKETS IN THE ESCWA REGION[16]

A. THE MACROECONOMIC BACKGROUND

An emerging market cannot succeed unless its economy succeeds. It is important, therefore, to send a clear message to the international financial markets that ESCWA member countries are following sound fiscal and monetary policies aimed at maintaining economic stability and creating a healthy business environment. Significant improvement has taken place in those countries that have embarked on economic structural adjustment programmes. However, more needs to be done to show the world that governments of ESCWA member countries are pursuing credible and sustainable economic policies. Disciplined and predictable policies can foster private sector confidence by reducing concerns about policy reversals.

The credibility of policies and the degree of macroeconomic instability and uncertainty are important influences on the forward braking decisions of private investors. If investors are concerned that a market environment is highly uncertain, they may delay investing until a more positive assessment can be reached. This may lock the economy into a low-investment, low-growth equilibrium if a substantial number of companies postpone their investment decisions. In contrast, policies perceived as consistent and unlikely to be reversed may turn expectations around and induce private investors to go ahead with their plans, thereby reducing the cost of adjustment.

The challenge is to adjust policies in line with the fundamentals before both domestic and foreign investors force a more costly resolution. ESCWA member countries undertaking privatization need to speed up the process of implementation of these programmes. They also need to speed up the process of implementation of policies leading to financial deepening and trade liberalization. Trade instead of aid should be the cornerstone of future strategies. ESCWA member countries need simple, low taxes, with modest revenue targets as a share of GDP. Easy and simple taxes are most essential in international trade, since successful growth will depend, more than anything else, on economic integration with the rest of the world. The region's largely self-imposed "exile" from world markets can end quickly by cutting tariffs and eliminating export taxes. Corporate tax rates should be cut significantly as is the case with the outward oriented East-Asian countries. As a rule of thumb, marginal tax rates of any kind higher than 20 per cent will surely be evaded, and will open up the doors to corruption. Simple tax schemes with low and uniform tax rates (of say 10 per cent) vastly simplify administration and are likely to raise government revenue in the process.

It appears that the traditional sources of growth in ESCWA member countries will not provide the needed basis for sustained economic growth. The outlook for the price of oil, still the region's most important export commodity, is uncertain; and without stronger, broad-based growth, ESCWA member countries will be unable to create enough jobs to absorb new entrants to the labour force, the former increasing at around 3 per cent annually.

Indeed, the already pressing need for job creation in ESCWA member countries is likely to intensify, since, in many of these countries more than half the population is under the age of 15. Without sustained economic growth, ESCWA member countries would not have sufficient resources to upgrade their economic infrastructure. They would not be able to address, for example, the problems of water scarcity, or to meet the health, educational, housing and other economic and social needs for their growing populations.

In addition to the region's economic difficulties, such as the absence of a regional market and the harmonization of economic and financial rules and regulations, a number of ESCWA member countries are considered to be confronted with political as well as social problems. These problems need to be addressed in order to give the economic structural adjustment process a better chance to succeed. Political stability is as important as economic opportunities, particularly for those countries striving to make the difficult

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[16] This chapter has benefitted substantially from the ideas suggested by Henry T. Azzam, in " The Emerging Arab Capital Markets", 1997, published by Kegan Paul International in association with the National Commercial Bank of Saudi Arabia.

transition towards a liberal economic system. Furthermore, specific social policies are needed to minimize the negative social impact of the economic structural adjustment programmes and to facilitate labour mobility between the public and private sectors.

B. AVAILABILITY OF INFORMATION

Accurate and timely information on fundamental economic performance as well as information on domestic companies and stock markets is limited in most ESCWA member countries. This lack of information is in part due to a profound desire for privacy, a characteristic trait in the region. The required information usually exists, but it is difficult to obtain. The region is expected to catch up with the information revolution worldwide, so that investors and creditors alike can assess properly the risks involved and make the right investment or lending decision.

The International Monetary Fund (IMF) has in the last few years been requesting developing countries (including those of ESCWA) to provide regular and timely macroeconomic data that would reflect sufficient transparency on their economic conditions and policies. The IMF recognizes that developing countries cannot be expected to produce statistics as timely, reliable and comprehensive as, for example, the developed countries. Therefore, two standards were set by that organization for publicly-published data: (a) a basic benchmark for all countries, covering topics such as GDP, inflation, trade, private sector borrowing, foreign exchange reserves, and both portfolio and foreign direct investment; and (b) the submission of comprehensive data concerning the size and maturity of their public sector's external debt.

C. THE LEGAL AND REGULATORY FRAMEWORK

Another factor seen as an obstacle to achieving a satisfactory level of portfolio and foreign direct investment in the region is the dearth of uniform investment laws and regulations that make accounting, tax treatment and a proper legal framework for settling disputes accessible. No strong regulatory body such as the Securities and Exchange Commission in the United States, exists. There is even an absence of professional self-regulatory bodies, sanctioned by law, that can promulgate rules and regulations covering financial disclosure by companies or even set basic professional codes of conduct and ensure that market manipulation and insider trading are kept to a minimum. Only two stock markets in the ESCWA region have formal independent regulators: Egypt and Jordan. These two markets have created sound precedents, with strong action being taken to enforce the regulators' decisions. ESCWA stock markets without a regulatory framework would, in time face problems caused, most probably, by possible action of investors who are maturing very quickly, acting in concert and manipulating the market.

In fact, all stock markets in the region need independent regulators who can reassure investors, and thus enhance the flow of foreign financial resources. Independent regulators are, indeed, a necessary institution for these stock markets, since such an institution would guarantee more transparency and give foreign investors the same protection as that offered by foreign markets. However, ESCWA member countries appear to be committed to setting up such an institution as a matter of urgency. So far, only Jordan has established a Security Exchange Commission to act as a watchdog on the Jordanian stock market (the Amman Bourse). No formal announcement from other stock exchanges has been made concerning similar legislation. The absence of an independent commission and the laws associated with it increases the level of investment risk as well as market risk and makes investment decisions precarious in most of the countries of the region.

To support the development of their financial markets, governments of ESCWA member countries need to design a legal system that guarantees property rights, including intellectual property rights, and conduct extensive in-depth and market-oriented analysis of laws, executive regulations and ministerial decrees to keep them continuously responsive to changes in the market. The governments should also apply the concept of a market-oriented legal and regulatory system as a filter for proposed regulations and reforms. They should accelerate reforms of the court systems to provide for the rapid repossession of assets pledged as security or collateral; furthermore, they should adopt accounting standards that are consistent with international practice, and establish a compliance programme.

High ethical and professional standards should be maintained by market participants, particularly by the key players (the investment houses and traders) involved with the market. While the legal framework may well address some of these issues, in many cases the standards can only be established and regulated by professional associations and self-disciplinary organizations. Not all breaches of ethical and professional standards may violate domestic legislation. Besides, swift imposition of sanctions on those who are deemed to have performed below the standards prevailing could turn out to be preferable to lengthy legal proceedings. Nonetheless, the courts can still be appealed to in the last resort.

D. SAVINGS RATES AND DOMESTIC BOND MARKETS

Another constraint to the development of domestic stock markets and capital accumulation in the region is the low level of savings. Domestic saving rates in ESCWA member countries vary widely; but most countries suffer from budget deficits, with excessive portions of private sector savings being used to finance current (i.e., consumption) expenditure rather than capital expenditure. The decline in public savings rates, even in the GCC countries, has reduced national rates to levels well below the 35 per cent of GNP, recommended by the World Bank. In fact, the savings rate in most ESCWA member countries has dropped to single digits during most of the past few years, with a high portion of national savings of such labour-exporting countries as Egypt, Jordan, Lebanon and the Syrian Republic being effectively held abroad. To build up their domestic pool of funds, the governments of these countries are expected to attract back these savings, encountering many of the same problems faced while attempting to attract foreign portfolio and direct investment. However, action necessary to boost national savings and encourage capital repatriation would begin by reducing the budget deficits and freeing up the interest rates.

Most companies in ESCWA member countries do not have access to medium- and long-term debt financing to leverage their balance sheets and develop. There is hardly a market for corporate bonds, certificates of deposit or floating rate notes in the region. Many financiers and entrepreneurs in those areas do not seem to have realized that the optimal corporate financing structure has nothing to do with the use of debt versus equity, but rather with the timing of the debt or equity financing under consideration and with how the funds will be used for growth, acquisition, restructuring or recapitalization. The viability of domestic borrowing through the issuance of public debt instruments such as development bonds and treasury bills and notes, has already been successfully tested in many ESCWA member countries, for example in Bahrain, Egypt, Jordan, Kuwait and Oman. Developing the markets for these instruments is expected to follow. It should be possible, therefore, to increase the volume of various government bonds and treasury bills and notes issued, fine-tune their flow into the primary and secondary markets and refine their prices. A government bond market would eventually give birth to interest futures markets and, when large enough, to an interest options market.

As the financial markets in the region gain depth, national and regional development finance institutions, as well as commercial banks and other corporations, could be encouraged to issue their own debt instruments, provided that a benchmark on pricing of these instruments is established by the governments of concerned member countries.

However, to encourage the development of financial markets in the region, the financial and managerial standing of corporates should be rated. This is because both private and institutional investors are usually reluctant to invest in papers of corporates whose financial and managerial conditions are not sufficiently known, i.e., rated.

E. OPENING UP TO REGIONAL AND INSTITUTIONAL INVESTORS

The small size of stock markets in ESCWA member countries should in fact be a helping factor in encouraging these countries to push for shares to be listed and traded across boundaries, forming in effect a regional financial market. A regional financial market would reflect a significant stage of economic cooperation, leading to economic integration among ESCWA member countries. It would help to avoid the problems encountered because of the small size of the domestic markets in each member country; pool resources; and provide financial institutions with a greater placing power. In short, it would help mobilize financial resources at the regional level.

Linkages between stock markets in ESCWA member countries would make it possible for investors from these countries to buy equities in each others' stock markets. Linkages between all stock markets in the region would form a single electronic trading system. They would also create opportunities for governments of ESCWA member countries to sell their bonds and treasury bills and notes not only within the boundaries of their own domestic markets but also throughout the region, leading to an increase in the amount that can be borrowed by these governments and further contributing to the development of domestic financial markets.

To give added depth to the financial markets in the region, boost demand for equities and encourage capitalization of financial resources, it is promotional for these markets to open up first to non-nationals residing in the region and then to international investors. Opening up to the latter would bring to the markets a new kind of investor who may be more inclined than domestic investors to require securities analysis, thereby increasing the level of sophistication in the markets.

F. SETTLEMENT SYSTEMS

One of the main problems facing financial markets in the region, notably those even only relatively open to foreigners, is that of the settlement systems, which are not as efficient as they could be and are not set up to allow the smooth flow of trade for foreigners. However, Egypt and Jordan introduced in 1997 a central depository system to facilitate easier settlement of trade in securities. Other countries in the region, notably Bahrain, Lebanon and Oman have recognized the need to adapt regulations to simplify settlements of trade in securities, since their current systems of settlements are seen as the main causes of bottleneck effects whenever foreign financial flows appear to increase substantially. In fact, the will to make the necessary changes exists in almost all ESCWA member countries; and it is anticipated that such changes will be effected whenever it is observed that they would encourage the flow of financial resources. Bahrain, Egypt, Jordan and Oman which are bracing themselves for considerable foreign engagement in their domestic financial markets, have started making these changes.

G. A BROADER ROLE FOR ESCWA BANKS AS FINANCIAL INTERMEDIARIES

Banks in the region have an important role in the development of the region's financial markets. They are expected to become the main intermediaries between the capital-starved business sector and the risk-taking public sector. Both business and investors need specialized institutions to help them plan the start-up of companies and assist them raise the required capital. The financial instruments of this intermediation are shares, bonds and all their related products such as futures, options and swaps.

What the region needs most to develop are investment banks that can provide strong financial analysis, the underwriting of share issues at their own risk, floatation of shares to the public at large and markets for these issues. Aside from the commission, income generated from buying and selling securities for clients, investment banks could establish their own trading portfolio utilizing the market intelligence gained through active trading for customers. They could also provide portfolio management services for those clients who do not have the time or the knowledge to manage their own investments in the stock market.

Corporate financial counselling is another function of the investment banking business, whereby corporates are advised of the appropriate mix of debt and equity and the right time to issue new securities. Investment banks can also participate in the venture capital business to help turn new ideas into productive concerns and provide equity capital to small enterprises. Investment banking takes an entrepreneurial dimension when encouraging the development and growth of new businesses.

Investment banking activities are expected to be introduced and developed either from within the existing commercial banking system or through the establishment of new institutions that would be able to provide brokerage services, portfolio and fund management, trading and underwriting of securities, etc.

Greater overlapping has been introduced during the past 10 to 15 years between commercial banks (credit risk) and investment banks (market risk) in the region. In fact, commercial banks began sometime

ago holding in their portfolios a large portion of their investments in securities. In addition, they have become directly involved in asset sales (auto receivables, credit cards and mortgages) by securitizing their assets. Commercial banks are, indeed, already in securities-related business. What they need is to strengthen and institutionalize these activities.

During the past few years, a number of banks in the region have established in-house expertise in the area of unit trust management, with clients being provided with a wide range of investment products denominated in major international currencies. The products include money market funds, equity funds as well as a combination of equity, bond and currency funds. The marketing and expertise acquired are expected to help the institutions to establish unit trusts for domestic capital instruments. Indeed, a number of banks in the region are now managing unit trusts and investing in others their domestic bonds and stocks. Encouragement of this development by the monetary authorities of ESCWA member countries is expected to create additional demand for stocks and bonds and open up new investment channels for domestic investors while keeping control of assets within the financial sectors of the countries.

To further develop and add depth to the financial markets in the region, banks in the region should list on the stock exchanges of their home countries as well as on the exchanges of other ESCWA member countries. Flotation of bank shares would enhance the finance position of these banks in the stock market and widen share ownership. Enforcement of the capital adequacy ratios of the Bank for International Settlements would prompt other banks in the region to raise new capital, and consequently issue and place shares, most probably, in the stock markets in which the banks are listed, thus adding more depth to these markets and strengthening the linkages among them.

However, if banks are to play, or are expected to play, a major role in vitalizing the stock markets in the region, it should be ensured that the returns to them are adequate enough to enable allocating the needed resources to share trading and underwriting activities. Serious consideration should also be given to the role of banks as market makers, allowing them to take positions, underwrite shares and make or create markets as buyers or sellers of shares. This would give added depth to the market and enhance the transparency of share trading in the region. Regulations could be strengthened to ensure that banks carry out these activities within permitted norms.

XI. CONCLUSIONS, RECOMMENDATIONS AND SUGGESTIONS FOR A PLAN OF ACTION

A. CONCLUSIONS AND RECOMMENDATIONS

Financial markets are looking over governments' shoulders, rewarding those who are implementing the right monetary and fiscal policies and punishing those who are not. In effect, the financial market has become the judge and jury of sound economic management. For countries which do not have the political will to open up and liberalize their economies, there is the very real danger that globalization will not mean increased investments, exports and growth, but, rather, marginalization and economic stagnation.

The ESCWA region, though abundantly endowed with natural, human and financial resources, has been more troubled by conflicts and instability than, probably, any other region in post-World War II history. The challenge facing the region today is to claim the future by integration into the world economy and to participate in the economic, financial and other developments that are taking place worldwide.

The route to these developments necessitates a number of fundamental changes: Governments of ESCWA member countries must proceed with regional integration, making economics rather than politics the driving force of their actions; these Governments should send a clear message to the market place that they are committed to pursuing reform policies aimed at economic liberalization; and, last but not least, financial markets in the region must attain added depth and versatility.

Globalization and regionalization of financial markets are not necessarily antagonistic but rather mutually reinforcing. A bolder policy to increase integration in the global market could at the same time favour more dynamic regional economic and financial integration efforts. ESCWA member countries need to develop their financial markets and integrate them with the rest of the world; and in so doing they are supposed to come together and create their own regional financial market and regional economic boom.

Financial market development is at the heart of economic development in the region. The state of financial sectors in ESCWA member countries varies from fairly basic public sector-dominated financial institutions to highly sophisticated private sector financial institutions. Overall, there is still a large amount of State-controlled lending at subsidized rates, keeping overall financial intermediation in the region below its economic potential. In a number of ESCWA member countries, subsidized credit expansion has given rise to inflationary pressures and encouraged the establishment of inefficient industries.

The region's financial markets, specifically the equity markets, are, in most cases, insufficiently developed; and as such they are not capable of offering companies, i.e., borrowers, good alternative financing possibilities or of channelling sufficient foreign portfolio capital into the private sector. In most ESCWA member countries, the number of listed companies on the stock exchanges is small and the stock exchanges have been mostly volatile.

Given the external financing environment facing developing countries (including those of ESCWA), the role of the financial markets in the process of mobilization and allocation of financial resources for development is expected to be even greater in the future. There is increased recognition in the region regarding the urgent need to develop financial markets and to intensify their process of internationalization. This comes at a time of increasingly reduced flows of aid and grants; increased international competition for private financial resources, and an uncertain environment for the region's terms of trade.

The historical experience of ESCWA member countries in development finance suggests that there is good potential for the development and internationalization of the countries' financial markets. This is a process that would be enhanced by—but would also contribute to—the beneficial medium-term economic impact of political and social stability in the region. Success in this process would depend on four major factors which are internal to the economies of the countries: first, success in improving their credit risk rating through sustained implementation of economic adjustment and reform programmes; second, progress in maintaining their external payment regimes; third, their ability to create specific investment opportunities in association with the economic structural adjustment and reform programmes; and, fourth, their success in

addressing institutional, organizational, administrative and legal issues, considered necessary for the development of their financial markets.

In, practically, all ESCWA member countries, banks are the major source of finance, making the financial markets of these countries susceptible to illiquidity and volatility; and the latter is further increased by relying disproportionately on foreign investors who may sell their equity holdings for reasons unrelated to the state of the local economy or companies in which they invest.

International financial markets have developed significantly during the past years. They now offer more efficient and comprehensive services than ever before. To have a chance to compete with these markets, the financial markets in ESCWA member countries must have more depth, versatility and transparency. There should be more public and private sector companies' stocks available for trading; and activities of the secondary markets should be further encouraged. Furthermore, governments of member countries should reduce their shareholdings in existing joint-stock companies; and expand their privatization programmes for public sector companies.

Financial market deepening requires a high degree of professionalism among market participants. It also requires the establishment of intermediary institutions that would act as underwriters, market makers, stock brokers and dealers, fund managers and financial and investment advisers. In addition, credit rating agencies should be established to make periodic analyses on local companies and thus provide investors with reliable business information. Moreover, accounting, auditing and reporting standards must be made in conformity with internationally accepted standards.

The development of bond and equity markets in the region remains subject to sustained economic structural adjustment and reform programmes. The financial sector reforms that have been undertaken by a number of ESCWA member countries during the past few years, still need to be complemented by reform of the financial infrastructure, including institution building and regulatory authorities.

Development of domestic financial markets in the region should be seen within the context of development of a regional financial market. Linkages among these markets and mutual opening-up are necessary steps in this regard. The establishment of market-making financial institutions for regional risk-taking adds a major dimension to this issue, since the role of these institutions would be to assume the risk of marketing securities issued by companies operating on a regional basis for the financing of regional economic development programmes.

B. SUGGESTIONS FOR A PLAN OF ACTION

Based on the conclusions drawn in section A above, the following may be suggested as a plan of action to be considered by the appropriate authorities of ESCWA member countries in their endeavour for development of their financial markets.

(a) To ensure that an adequate legal and regulatory framework for an effective financial market is established. The framework should address a number of issues, including that of the institutional, administrative, organizational and financial infrastructure;

(b) Conduct trust-building economic, monetary, fiscal and financial policies;

(c) Encourage the establishment of market-making financial intermediaries. This would help to establish a balance between the demand and supply of the types and maturities of available financial resources;

(d) Establish close and formal relations among the region's financial markets and undertake regionally harmonized action in the areas of financial, administrative and legal regulations. This would help to speed up the establishment of a regional financial market.

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