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ROLE OF FINANCIAL MARKETS IN PRIVATIZATION IN THE ESCWA REGION

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Preface

This study was prepared by the Economic and Social Commission for Western Asia in implementation of activity No. 05S433bD403, entitled "Role of financial markets[1] in privatization in the ESCWA region". It was carried out as part of the Commission's programme of work and priorities for the period 1996-1997.[2] The study was prepared by the ESCWA secretariat. The study also drew on various publications of the International Monetary Fund, the World Bank, the United Nations Conference on Trade and Development, and concerned organizations in ESCWA member countries.

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[1] Financial markets in this study refer to stock exchanges, except where otherwise indicated.

[2] The ESCWA region comprises the following: Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, the Syrian Arab Republic, the United Arab Emirates and Yemen, and the occupied territories.

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ABBREVIATIONS

LE	Egyptian pound
ACs	Affiliated companies
AFM	Amman Financial Market
BOT	Build-operate-transfer
CBE	Central Bank of Egypt
CIB	Commercial International Bank
ERSAP	Economic Reform and Structural Adjustment Programme
ESA	Employee Stockholder Association
ESM	Egypt's Securities Market
FOREX	Foreign Exchange
GCC	Gulf Cooperation Council
GDP	Gross domestic product
HCs	Holding companies
IMF	International Monetary Fund
IPO	Initial public offering
JD	Jordanian dinar
JVB	Joint-Venture Bank
MDE	More diversified economies
PEO	Public Enterprise Office
PSEs	Public sector enterprises
R&D	Research and Development
SDR	Special Drawing Right
Tbs	Treasury Bills
UNCTAD	United Nations Conference on Trade and Development

PART ONE
OVERVIEW

Introduction[3]

The existence of a developed financial market increases the options for Governments to divest themselves of public sector enterprises (PSEs). Specifically, it makes the public offering of shares or subscriptions in the domestic stock exchange a real option. Public offering is one method of privatization. Privatization can also take the form of a private sale or tender offer, where a pre-identified buyer or group of buyers acquire public sector enterprises through direct acquisition or private placement. A developed financial market also implies greater access to the general investing public.

Offering acquisition of State assets to the private sector is usually a politically sensitive issue. It faces resistance from many quarters, particularly management and the labour force. It is therefore expected for privatization to be a slow process and for Governments to be cautious in pursuing it. Concern for transparency, for securing a fair deal, and for avoiding concentration of wealth or creation of a private monopoly that may replace the old public monopoly are all issues that can potentially slow down the privatization process.

Mobilizing political support is therefore a key element to speedy and successful privatization. One way to ensure this support is to widen the share ownership of PSEs that are subject to privatization. This can be achieved by using the financial market as a vehicle. The financial market helps to implement the privatization process while at the same time overcoming the political resistance of the public. Widening share ownership can help to create a critical mass of property owners who are willing to support the difficult transition process to a market economy.

The presence of a developed financial market allows Governments to carry out divestment of PSEs simply by selling shares to the public. Listing a PSE on the stock exchange helps to attract the support of the investing public. However, if a PSE is not listed, a public offering would require that it be listed after complying with certain legal, financial and disclosure standards, governed by the applicable laws of the financial market.

Listing a specific company for privatization on the stock exchange usually requires that the company be restructured. This in turn results in a transparent process that makes the privatization issue politically acceptable. Wider distribution of shares makes it difficult to "re-nationalize" the privatized assets.

The existence of a developed financial market makes investment in shares of the privatized PSEs liquid and may in itself encourage investors to place their funds in these shares. This is because the liquidity of an asset and the ease with which it can be disposed of are key features in making it attractive for investment. This is true for domestic investors, but more so for foreign investors and "flight capital".

Listing a PSE on the stock exchange is also beneficial from an economic welfare point of view, in that the PSE, like any other private company, has to face the discipline of the financial market and operate more efficiently than it typically does. For example, listing a PSE on the stock exchange will subject it to the scrutiny of bankers and investors. If its performance deteriorates, there is a potential risk of a decline in the number of its shareholders as well as shareholders' equity, leading to a possible takeover.

There is a two-way relationship between financial market development and privatization. The existence of a developed financial market makes divestment decisions of Governments much easier, given

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[3] Based on Ahmed Abisourour, "The emerging Arab capital markets: status, role and development prospects", in *Financial Policies and Capital Markets in Arab Countries,* Said El-Naggar, ed. (Washington, D.C., International Monetary Fund, 1994).

the supply and demand of information. On the demand side, information concerning market capitalization of the stock exchange is an invaluable indicator of the size of the market, its degree of liquidity and its absorptive capacity—all key factors in deciding when to list a candidate for privatization so as not to crowd out the market. On the supply side, the existence of a developed stock market infrastructure means that a share distribution mechanism is present, allowing for widespread ownership to take place with relative ease.

Although the ESCWA region contains some of the world's largest institutional investors in the international financial markets, its financial markets are relatively small, fragmented and dominated mainly by commercial banks. For example, the total capitalization of the ESCWA member countries' formal financial markets, or, stock exchanges, is estimated at only around $65 billion, compared with foreign assets held by the private sector in the ESCWA region, estimated at over 255 billion.

While there are considerable differences across ESCWA member countries in the importance of financial markets, with Egypt, Jordan and Kuwait having thriving equity markets, the supply of corporate securities remains generally limited, both in absolute terms and relative to the size of the GDP of the economies of these countries. This situation reflects a number of factors constraining the supply and demand of equities, including the closed, family-owned enterprises in the region.

It is increasingly recognized that, given the competition for foreign financial resources and the limited availability of domestic financial resources in a number of ESCWA member countries relative to their development finance needs, financial markets can play an important role in providing financing to productive sectors and in facilitating the process of privatization.

Notwithstanding the relatively limited development of financial markets in the ESCWA region, policy makers in ESCWA member countries are increasingly aware of the beneficial role of equity markets in enhancing the process of privatization, and consequently the mobilization and allocation of financial resources for development. Considering the experience of emerging markets in other developing regions, particularly in Latin America and South-East Asia, two conditions can be viewed as prerequisites for the development of financial markets in the ESCWA region if they are to play a beneficial role in the privatization process. The first prerequisite is a macroeconomic environment conducive to the development and growth of private sector enterprises; and the second, a strong equity market structure. The latter can be achieved through appropriate policies relating to information and accounting mechanisms, market regulations and supervision, property rights, pricing efficiency, and taxation regimes.

To this end, efforts have been made by a number of ESCWA member countries to implement reforms in the fiscal and monetary sectors by reducing, among other things, inflationary pressures and the ratio of budget deficit to GDP, and by strengthening external sector performance. Moreover, a number of these countries have experienced significant private capital inflows (Egypt and Lebanon) and a reverse currency substitution (Egypt, Jordan and Lebanon).

The impact of financial reforms in the ESCWA region has primarily been on addressing structural inadequacies in the legal and regulatory frameworks. This, however, differes among ESCWA member countries, as a result of two sets of factors:

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

    (a) Improvement in the 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 reform, particularly in the following areas:

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

(b) Privatization of PSEs, especially in the industrial, telecommunication and financial sectors;

(c) Reform of the domestic investment regime, including the dismantling of Government monopolistic as well as oligopolistic structures in the market.

From a macroeconomic perspective, the key factors determining the future development of financial markets in the ESCWA region and their success in implementing the role envisaged for them in the privatization process are the state of domestic macroeconomic policy and the status of external financial relations.

These factors will remain the key issues in influencing investors' perceptions of credit and transfer risk. To this end, appropriate aggregate demand management policies must be accompanied by greater emphasis on structural reforms so as to enhance the supply responsiveness of ESCWA economies, thereby reducing their vulnerability to unanticipated exogenous shocks and improving their social sector performance.

It is also evident that ESCWA member countries need a set of policies aimed specifically at enhancing the supply and demand equities. The financial markets could receive a boost from a privatization process whose *raison d'être* lies in the need to address public sector inefficiencies and to proceed to level the playing field for public and private sector activities. To enable the financial markets to play their anticipated role in privatization efficiently, the policies must be directed at establishing certain conditions, including clear property rights, effective settlement and custody systems, transparent trading and pricing conditions among the various financial instruments, and an appropriate arrangement for capital and dividends repatriations.

This study deals with the role of financial markets in privatization in the ESCWA region, within the anticipated framework of economic and financial structural adjustment programmes for member countries. The focus of the study, however, will be on Egypt and Jordan. These two countries were selected because they have been successfully implementing economic and financial structural adjustment programmes, including privatization and financial sector reform.

Chapters I and II in part one of the study explain the relationship between economic and financial sector reform and privatization in the ESCWA region, examining whether reform would facilitate privatization. Part one introduces the reader to the world of financial markets; to economic and financial sector reform; and to the relationship of these elements to privatization. In addistion, some questions are raised concerning the substance of financial markets and their imperatives as they relate to privatization.

Part two is a case-study of Egypt. Chapter III presents a background analysis of the features and characteristics of the Egyptian economy and its need for economic reform. Chapter IV provides an analysis of Egypt's financial market, including the securities and banking markets. Chapter IV also reviews the state of both markets; their characteristics, activities and objectives; and the various obstacles they face in achieving them. Privatization in Egypt has gained the attention of many quarters during the last few years, mainly because of its clear guidelines, programming, methods of execution and timetable of implementation. These and other related issues are the subject of chapter V.

Part three is a case-study of Jordan. Privatization in Jordan is still in the embryonic stage. No privatization programme has been put together yet. This has led to conflicting views regarding the privatization methods that should be applied and the PSEs that should be privatized. This is partly because the Government has begun work in this area only recently (1994 and 1995). Chapter VI presents a background analysis on features and characteristics of the Jordanian economy and Jordan's need for economic reform. This is followed in chapter VII by an analysis of financial sector reform. In this regard, significant measures have been undertaken during the last few years. Chief among them have been liberalizing access of foreigners to the Amman Financial Market (Stock Exchange), liberalizing interest rates and eliminating foreign exchange regulations. Chapter VIII presents a descriptive analysis of Jordan's Financial Market. The chapter also addresses a number of questions raised concerning the deregulation of the market, the monetary and financing policy framework, the market's boundaries for competition, and other related issues. Privatization has become the subject of a significant public debate during the last few years. The country's economic and financial structural adjustment programme foresees that the Government will implement effective measures in this area. The Government has recognized that only through privatization will PSEs become efficient, foreign investments be encouraged, and the financial burden on the Government's budget caused by PSEs be reduced. These and other related issues are the subject of chapter IX.

Cooperation and harmonization among the ESCWA region's financial markets are considered major issues that can enhance privatization in the ESCWA region. In part four, some of the impediments to privatization will be identified and suggestions offered as to how they should be dealt with. These are the focus of attention in chapter X. Chapter XI presents conclusions and recommendations as well as some ideas for a plan of action.

I. ECONOMIC AND FINANCIAL SECTOR REFORM IN THE ESCWA REGION[4]

Not all ESCWA member countries face the same economic challenges. As they differ in terms of their economic structures, availability of resources and levels of development, so do they differ in their main challenges and the resulting pressures for economic reform.

For the Gulf Cooperation Council (GCC) countries, the main challenge is in maintaining cautious macroeconomic management strategies in light of the uncertainties prevailing in the world oil markets.[5] The principal benefits of "ongoing" financial sector reform and the continued development of financial markets for this group of ESCWA member countries can therefore be expected to be in the form of enhanced flexibility in the use of monetary and fiscal policies to deal with unexpected macro-economic shocks.

For ESCWA member countries with more diversified economies (MDEs), the main challenge is in attaining sustained economic growth to support a growing population.[6] For these countries, the benefits of financial sector reform are expected to be in the form of a more efficient use of resources. The focus, however, is on reinforcing the nature of the financial sector as well as other structural reforms. For most of these MDEs, the central problem appears to be in the predominance of the public sector in economic activity, owing in part to past policies aimed at securing control over strategic natural resources or establishing essential industries. In many cases, this stance has not only led to large fiscal deficits and a burgeoning public debt, but also to a tendency for many PSEs to become inefficient and financially weak. This is a result of government control of pricing and investment decisions in most of the PSEs and the lack of pressure to meet the test of a competitive market for their products. Therefore, the need for restructuring or even privatizing has arisen.

Since privatization is considered by most ESCWA member countries to be the preferred long-term solution, a supportive financial market is essential to provide a vehicle for asset sale to the private sector and to facilitate proper valuation of these assets. The financial market has also been considered for another role in this regard, namely, to attract foreign financial resources, provided investment policy restrictions and exchange control measures are liberalized. For ESCWA member countries where the pay-off is considered to be primarily in terms of effective and flexible macroeconomic control, the principal task would be to refine the tools of indirect monetary policy and develop the financial market infrastructure.

An important and ongoing challenge is seen in the development of liquid interbank and short-term money markets that can be used by the central banks for open market operations. Along these lines, Egypt and a number of other ESCWA member countries have already introduced treasury bill auctions at market-determined interest rates that have quickly become the key determinant of domestic monetary conditions. Other ESCWA member countries have taken steps to increase their reliance on reserve requirements (Jordan

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[4] This section is based on the following: Manuel Guitián, "The role of financial sector reform in macroeconomic and structural adjustment, in *Financial policies and Capital Markets in Arab Counctries;* André Hovaguimian, "The role of financial institutions in facilitating investment and capital flows", in *Financial Policies and Capital Markets in Arab Countries ;* and Ahmed Abisourour, "The emerging Arab capital markets: status, role and development prospects, in *Financial Policies and Capital Markets in Arab Countries,* Said El-Naggar, ed. (Washington, D.C., International Monetary Fund, 1994).

[5] The GCC countries are: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

[6] ESCWA member countries and areas with more diversified economies are: Egypt, Iraq, Jordan, Lebanon, Syrian Arab Republic. Republic of Yemen, and the occupied territories.

and Yemen) and to develop the interbank market (GCC countries, Jordan, Egypt and Lebanon). Still, further benefits are expected to come from sustained efforts to deepen the financial markets through such measures as promoting competition among actors in the financial sector and progressively widening access to the markets.

Another distinguishing feature of the economic challenges faced by ESCWA member countries is the extent to which some of them are faced by a severe external debt problem and debt servicing difficulties, while others are to a certain extent capital surplus countries, numbering among the world's largest investors and donor countries. Considering the great potential for intra-ESCWA capital movements, financial sector reform would assist in fostering the freer movement of capital among ESCWA member countries.

The recent developments in the international financial markets, as indicated by globalization, deregulation and securitization, have left their mark on ESCWA member countries. Countries with "open" economies have become less insulated and have been subjected to disturbances and shocks that are not a result of domestic factors. For indebted member countries, capital flight has become a serious problem and speculative capital movements have at times caused abrupt disruptions in the normal functioning of their financial markets.

However, financial markets in many ESCWA member countries have developed into increasingly important channels for the mobilization and allocation of financial resources. They have contributed toward financing private and public sector investments in productive assets. Frequently, this has taken the form of loan rather than equity finance, thereby resulting in a less secure pattern of corporate finance and a less efficient allocation of financial resources.

As a consequence, excessive corporate indebtedness has risen with public sector deficits, even in the GCC countries, which only a few years ago were generating surplus funds significantly beyond the absorptive capacity of their economies. This indebtedness is considered to have constrained economic activity and increased the need to consolidate the financial structure of public sector enterprises in most ESCWA member countries. It has also promoted an awareness of structural imbalances within domestic financial intermediation mechanisms.

During the last few years, most ESCWA member countries have acted to develop their domestic financial markets. There have been policies aimed at improving the business environment, correcting the legal and regulatory framework of the securities markets, and producing comprehensive securities laws. These laws are based on a unified set of objectives that are similar to those of market-oriented economies:

1. To mobilize savings through equity and long-term debt investment opportunities in both public and private sector;

2. To facilitate access to capital funds by new businesses and spread risks of long-term investments;

3. To broaden the ownership base of enterprises through wide distribution of equity shares.

Historically, both the business environment and the size of the securities markets in ESCWA member countries have been shaped by the Government and the institutional structure of financial intermediation.

The public sector has been prominent in determining the level of economic activity in virtually all ESCWA member countries. This situation has been dictated by either the requirements of transition after

independence or the level of government control of economic resources and activities, and the abrupt accumulation of significant financial resources by the Government. The need to implement ambitious economic development plans has further strengthened the role of the public sector. This has resulted in two major sets of opposing implications for savings, investment and resources allocation and, hence, capital accumulation and economic development structures.

Public sector involvement in economic activity has helped to develop infrastructure which otherwise could not have been developed to its present level. This involvement has also paved the way for more growth in the private sector. At the same time, the public sector monopoly of economic activity is seen as having adversely affected the aggregate volume of national savings. Increased public expenditures for government services, which are mostly underpriced or subsidized, have raised aggregate demand and, thus, consumption of these services, which in turn has led to a lower rate of savings. Consequently, certain distortions in the price system have emerged, making allocation of resources less optimal, rekindling inflationary pressures and adversely affecting the level of aggregate savings.

As to the institutional structure of financial intermediation, the financial markets in almost all ESCWA member countries are dominated by commercial banks, which traditionally have confined their lending mainly to short-term trade financing. However, the issuance of securities instead of bank loans as a principal financial investment has become urgent in recent years. The change in attitude is caused by the drive for privatization which is gaining momentum in most ESCWA member countries.

Although the business environment for finance is considered to have improved in ESCWA member countries in recent years, the inadequate regulatory and institutional structures of the financial markets in most of these countries have not been helpful in improving the environment to its fullest extent possible. Consequently, financial markets in the ESCWA region frequently remain informal, lacking transparency and suffering from the undesirable consequences of unchecked speculation.

The lack of inadequate regulatory and institutional structures has in fact impaired the emergence of some ESCWA's financial markets, and has caused some others to develop in an undesirable manner, requiring costly corrective measures.

Tne laws and regulations governing the financial markets in the ESCWA region differ in approach, but they all, despite their shortcomings, aim at mobilizing savings, providing corporate finance for both the public and private sectors, and safeguarding the interests of both the shareholders and the traders. The problem areas in these markets relate mainly to the enforcement of accounting standards, the quality of information disclosure and the protection of small investors from insider trading and other malpractices.

II. PRIVATIZATION IN THE ESCWA REGION

In broad terms, privatization is linked to the notion of reduced state involvement in the economy in general and a reduced level of subsidies in particular. Privatization in the ESCWA region is generally taken to encompass three aspects:

1. Sale of publicly-owned assets;
2. Contracting out of a number of government services;
3. Deregulation of statutory monopolies to allow competition.

During the last few years, privatization in the ESCWA region has gained prominence, owing to the following factors:

(a) The recognition that a significant number of PSEs have become a burden on the state, financially as well as administratively;

(b) Increasing pressure to privatize the PSEs;

(c) A favorable public discussion about privatization.

Most ESCWA member countries are characterized by significant State (i.e., public sector) involvement in the economy. The pressure to reduce this involvement by privatizing PSEs has been of two kinds: first, external pressure, particularly from the International Monetary Fund, which has applied this pressure in structural adjustment programmes tailored for a number of ESCWA member countries; and second, internal pressures which originate from two sources:

1. The fiscal situation exemplified by the fiscal deficits of varying sizes that almost all ESCWA member countries face. A perception has developed that privatization would reduce these deficits, especially since a significant portion originates with PSE subsidies and the prices of a number of government services.

2. The ideology with respect to the role of the State in the economy.

The public debate concerning privatization has become favorable in most ESCWA member countries during the last few years, with the discussion centering on the necessity to deregulate prices and remove subsidies, and to increase private sector involvement in the economy. The stated objectives of privatization by almost all ESCWA member countries can be summarized as follows :

(a) To reduce the absorption of State investments and expenditures;

(b) To improve management and efficiency in economic activities by trimming bureaucracy and reducing Government interference;

(c) To deregulate the labor market;

(d) To increase productivity.

However, reducing State involvement in the economy is a policy that can be viewed from three dimensions:

1. Political: political freedom is a function of private ownership;

2. Administrative: the large scale bureaucracy associated with State involvement drains skilled manpower, causes undesirably high levels of centralization and creates a bureaucratic constituency;

3. Economic: government intervention blunts and distorts the market signals. It is also contrary to financial efficiency which is often measured in terms of widespread distribution of share ownership (i.e., shareholder democracy).[7]

In this context, the assumption is that wider share ownership would redistribute wealth and expand the domestic financial market. However, income distribution, particularly in ESCWA member countries with more diversified economies, is such that it is unlikely that privatization would benefit the small investor, as most shares would most likely be bought by wealthy individuals.

The implication is that, far from redistribution of wealth, privatization may simply reinforce the existing concentration of wealth or economic power, replacing public sector monopoly by private sector monopoly. A possible mechanism to avoid such an outcome would be to privatize by giving preference to workers and employees—the cooperative route. However, this may raise a number of problems, especially when privatization candidates are capital-intensive, making it unaffordable for the worker or employee to make purchases, unless the sale price for them is made for them below the market price.

The smallness of domestic financial markets in most ESCWA member countries may also be considered an obstacle for large-scale privatization, especially of capital-intensive PSEs. However, by taking the ESCWA region as a whole, it could be argued that the available surplus liquidity of the region would surpass this problem. The issue that needs further clarification in this regard is whether governments of ESCWA member countries would allow non-national capital to participate in the privatization process, regardless of the privatization method. The smallness of domestic financial markets gives rise to two main issues:

1. Volatility, where the financial markets would experience significant fluctuation in the prices of shares as a result of deliberate manipulation owing to the small number of traded shares and market fragmentation.

2. Short-termism, where exigencies of the market may force companies to make decisions or not undertake activities (investments) which in the long-run would be beneficial.

With regard to the fiscal objectives of privatization in the ESCWA region, it is assumed that privatization would increase government revenues, though on a one-time basis only, and reduce government expenditures.

In regard to revenues, it is objectively difficult to accept the assumption that privatization would lead to a rise in revenues. On the one hand, the change in ownership of PSEs actually results in a one-time increase of government revenues, whereby the increase is equal to a balancing reduction in private savings. On the other hand, the market value of an asset is equal to the present value of its expected stream of future income. Therefore, if assets of PSEs are sold at market value, the government is simply exchanging a future

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[7] Paul Stevens, *Privatization in the Middle East* (University of Surrey [United Kingdom], Department of Economics, 1989).

stream of revenues for a lump sum today. Consequently, the effect of privatization on government revenues would be neutral.[8]

In regard to expenditures, the gain is also debatable. It is true that PSEs are frequently a drain on the government budget of most ESCWA member countries, with the annual net transfer from the government budget to non-financial PSEs accounting for an average of around 4 per cent of GDP of these countries. Removing this transfer would certainly provide fiscal relief. To achieve this would mean either closing down the PSEs or privatizing them. The former option is not relevant to the privatization issue. The latter option, however, raises the question of who would take on the loss makers, or whether they can be privatized in the first place. To sell loss-making PSEs involves more than giving them away. It means that they would be sold with a lump sum equal to the anticipated negative future cash flow, thus increasing rather than decreasing government expenditures.

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[8] Christian Schiller and Peter S. Heller, "The fiscal impact of privatization, with some examples from Arab countries", in *Privatization and Structural Adjustment in the Arab Countries,* Said El-Naggar, ed. (Washington, D.C., International Monetary Fund, (1989).

PART TWO
CASE-STUDY OF EGYPT*

* This part of the study is an ESCWA-revised version of the contribution of Mona El-Baradei and Mahmoud Mohieldin, who served as consultants to the Economic and Social Commission for Western Asia.

Note: References in this part of the study have been reproduced as submitted by the consultants.

III. FEATURES AND CHARACTERISTICS OF THE EGYPTIAN ECONOMY AND NEED FOR ECONOMIC REFORM

During the 1980s, economic and financial developments in Egypt were considered less favourable than those of the 1970s. This was because the fall in oil prices and the subsequent drop in financial flows to Egypt brought to the surface economic and financial problems that had easily been contained during the 1970s and early 1980s. Chief among those problems was the increasing burden of external debt. This was in addition to the rising budget and balance of payments deficits.

To lighten this burden, a critical review of economic and fiscal policies took place within what generally has become known as an economic structural adjustment programme. A major issue in the review was the role of the public sector in economic development in Egypt. During the second half of the 1980s, a considerable degree of rising uneasiness built up with regard to the assumption by the public sector of the majority shares and controls of economic activities which otherwise would have been the business of the private sector.

Prior to the so-called open-door policy, or *Al-Infitah* (Arabic), which was introduced in 1973 and was primarily intended to stimulate domestic and foreign private investments, public sector share in economic activities in Egypt was considered high. In the period between 1960 and 1973, it constituted around 18 per cent of GDP and 74 per cent of gross fixed capital formation. In 1980/1981, it accounted for around 40 per cent of Egypt's labor force; 54 per cent of value added in the economy; 60 per cent of total budget expenditures; and 70 per cent of capital expenditures.

The public sector gained prominence during the early years of the Egyptian revolution of 1952, which placed high expectations on it to stimulate economic growth, promote industrialization, improve the welfare of the citizens, and reduce foreign influence on the Egyptian economy. Seen in a historical perspective, there was some justification for these expectations. Owing to its mercantile mentality, the private sector was considered as lacking social awareness and a farsighted vision for ambitious economic development plans.

The economic recession which started in 1982 in Egypt and lasted until 1990 negatively affected the financial position of Egypt. Its foreign exchange reserves were barely enough for financing one-month imports, or two months less than the internationally accepted standard.

The recession also highlighted the financial burden resulting from the Government's budgetary support of the public sector. Indeed, the share of the Government's capital transfer and lending to and equity investment in the public sector in relation to total Government expenditures was estimated at around 27 per cent during the 1980s. The level of investment of public sector enterprises was closely related to the level of their deficits. This forced the Government to finance the deficits either by capital infusion or by buying additional equities (equity investments) or by domestic and foreign borrowing, with the latter contributing largely above mentioned economic recession of the 1980s.

This period, however, was also characterized by a number of negative developments in international and regional economic performance which affected Egypt badly: GDP growth rate slowed down to an average of 2.7 per cent during the period 1986-1990; the budget deficit/GDP ratio, excluding debt amortization, amounted to around 23 per cent in 1986; the external debt/GDP ratio was 119 per cent in 1987, with the debt service ratio amounting to 40 per cent; and inflation increased from an average of around 17 per cent during the first half of the 1980s to around 25 per cent during the second half.

For a number of reasons, PSE's efficiency continued to decline during this period. The reasons included government interference in managerial decisions; administering prices; overstaffing; lack of competition; and lack of accountability of senior management. In the mid-1980s, the overall deficit of non-financial PSEs accounted for around 8 per cent of GDP. The slow- down in economic growth and the increase in foreign debt service payments signified the worsening position of the PSEs and consequently of the state of the Egyptian economy.

Multilateral lending organizations, foreign Governments, banks and institutions, when asked for their assistance in solving these problems, encouraged efforts aimed at reducing the dominance of the public sector in the economy. To achieve this, a decentralized market based on an outward-oriented economy would have to be created, and private sector activity would have to be encouraged by a competitive and stable environment, free from government intervention. Efforts aimed at developing a financial market capable of playing a central role in Egypt's privatization efforts were also encouraged by these organizations.

At the core of Egypt's economic and financial structural adjustment programme, and in particular the privatization process, has been the development of Egypt's financial market during the last few years. The financial market has been shown to be highly capable of distributing economic resources efectively, upgrading allocative as well as productive efficiency, and raising medium and long-term funds necessary for investment. It has become the main medium that allows investors to form their own views on the value of assets of PSEs which are considered for privatization. It has been helpful in enabling investors to form a reasonably correct evaluation of the current financial status of the PSEs and the prospect of their profitability.

The amendments of Capital Market Law No. 95/1992 as well as other supplementary administrative measures have been major steps in the reform efforts of Egypt's financial market. They have increased significantly the financial market's effectiveness in tapping domestic financial resources and attracting foreign investments to Egypt.

IV. FINANCIAL MARKET

Egypt's formal financial market includes the insurance market, the securities market, the banking market and the non-bank financial institutions.[9] In this section, the focus will be on the development of the securities and banking markets. Both markets have been the major targets of Egypt's economic structural adjustment programme, and the main actors in its financial market and privatization programme.

A. THE SECURITIES MARKET

Egypt's Securities Market (ESM) was established in 1883.[10] It has been continually subjected to Government intervention. As a result, its operations and effectiveness in the country's financial development have been restrained. Since early 1970s, efforts have been made to revive the ESM, but its performance has remained modest. Its role in mobilizing savings and raising private capital has remained weak, governed mainly by supply and demand issues. Moreover, over the years a series of developments have dampened the credibility of the Egyptian securities market, including the consecutive measures of Egyptianization during the 1950s, and nationalization and expropriation during the 1960s. This situation was further exacerbated by a number of factors, including the losses of the remaining joint-stock companies during the 1970s and 1980s; hit-and-run activities which flourished during the early years of the open-door policy; and the sudden rise and demise of "Islamic investment companies".

It is interesting to note that the low profile of the ESM was not the result of a lack of investors or a shortage of capital. Indeed, the remarkable growth of the money market and the increasing use of bedding instruments against inflation, especially real estate and some forms of informal finance during the last two decades, show that there was potentially a significant demand for securities, and that the problems were primarily on the supply side. Among these problems, one may include the prevalence of PSEs; the relatively low costs of bank funding for projects; the over-listing of close (unquoted) companies; the limited number of instruments; the unfavourable tax treatment; the inadequate information disclosure; the absence of a uniform standard of accounting; and finally, the lack of anti-fraud measures in the country. As a result, the ESM represented less than 5 per cent of the new funding for both the public and private sectors during the period 1989-1991. The size of the market, i.e., the ratio of its capitalization to GDP, which averaged around 14.5 per cent in 1994/1995, was relatively low by the emerging market standards. In fact, the ESM was capable of mobilizing only 3 per cent of the LE 39 billion national savings during the period 1989-1991. This ratio was in deep contrast to the market performance during the period 1958-1961, when it provided between 25 to 50 per cent of the new capital raised by the private sector alone.[11]

The dawn of the 1980's and the beginning of the 1990's witnessed tangible efforts by the Egyptian Government to revive the ESM's is role and activities. Investment Law No. 230 of 1989, the economic

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[9] The insurance market comprises nine insurance companies, including one reinsurer, four insurance pools, and the government insurance fund, in addition to 350 private insurance funds. Of the nine insurance companies, four are State-owned. The market is dominated by three State-owned companies, managing 85 per cent of the general insurance business and 94 per cent of the life insurance. The setting of entry barriers is left to the discretion of the Insurance Authority. Foreign ownership is allowed in the free zones only. However, under the the General Agreement on Trade in Services (GATS), foreign presence in the insurance marekt in the form of joint ventures, under the 49 per cent rule, is expected to be allowed during the next few years.

[10] The ESM was first established in Alexandria in 1883, then in Cairo in 1890.

[11] Central Bank of Egypt, *Economic Review*, various issues.

structural adjustment programme which started in 1991, and Capital Market Law 95 of 1992 all helped the the ESM regain its importance in mobilizing, managing and allocating financial resources.

Capital Market Law 95 of 1992 was essential in introducing the rules and regulations that would be necessary to enable an emerging stock market to achieve the ultimate objective of free interaction among the various market forces. The Law regulated a significant number of issues, including company listing on the ESM; requirements for the completion of quotation; and matters concerning public offerings. It empowered the Capital Market Authority to interfere in setting closing prices when necessary. The regulations, though considered by some as obstructive to the development of the ESM as a free market, were nevertheless necessary for the gradual development of the market, which for a long time was characterized by speculative practices.

There are indications that the ESM in Egypt has been showing promise. The value of traded securities increased by almost ninefold during the period 1991-1995, from LE 424 million in 1991 to LE 3.8 billion in 1995; the number of traded securities increased from 23 million to 71 million; the number of annual transactions rose from around 11 000 to around 470 000; the issued capital of listed companies increased from LE 3.5 billion to LE 7.7 billion; and, the market volume of shares and bonds issued, increased from around LE 2 billion to around LE 8.7 billion. During the first seven months of 1996, the ESM continued its upward trend with significant increases in all key indicators. At the end of August 1996, the value of trading amounted to LE 4.2 billion, compared with LE 1.8 billion during the same period of the previous year; the volume of trading reached 68.8 million, compared with 15.5 million; and the number of transactions of quoted companies totaled 302 000, against 153 000, an increase of nearly 100 per cent.[12] Share prices also increased during the period. This was the result of the improved performance of companies, and a rise in the price earning (P/E) ratio.[13] The inclusion of the ESM in the 1996 index of the International Finance Corporation, the private sector arm of the World Bank, is another step towards considering the ESM as an emerging market. It will lead to more capital flow from the international financial markets to Egypt, thus further enhancing the role of the ESM.

B. THE BANKING SECTOR

Liberalization measures, undertaken during the 1970s encouraged the establishment of foreign, private and joint-venture banks. These measures led to an increase in the number of banks registered with the Central Bank of Egypt (CBE), from 7 in 1974 to 81 in 1995. As at end 1995, the banking sector in Egypt was composed of 28 commercial banks, four of which were public;[14] 32 investment and business banks, 21 of which were branches of foreign banks; and, 21 specialized banks.[15] As a result of the increase in the number of banks, bank branches increased to 2 241 in 1995. Despite this development, however, banking activities remained concentrated roughly in three urban centres: Cairo, Alexandria and the Suez Canal governerates.

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[12] Capital Market Authority, *The Capital Market in Egypt*, August 1996.

[13] The P/E ratio is broadly defined as the ratio of estimated earnings from a company's share to the price paid for it.

[14] These are: the National Bank of Eypt, Banque Misr, Bank of Alexandria and Banque du Caire.

[15] These comprise one industrial bank, two real estate banks and 18 agricultural banks based in the governerates, including the Principal Bank for Development and Agricultural Credit.

The four public sector banks dominate the banking sector. This dominance is emphasized even more by their significant portfolios in joint-venture banks. In terms of bank assets, public sector banks accounted for around 68 per cent of total bank assets in 1995, compared with 62 per cent in 1991.

Both the structure of the banking sector and the geographic concentration of bank branching indicate a highly segmented market and lack of competition. With their large branch networks, public sector banks dominate the process of mobilization of savings. But, with most of their services still being conducted in a traditional way, there is some question as to whether they mobilize and allocate financial resources efficiently. This is particularly so because the public sector banks are protected by an array of regulations and preferential treatments. For example, they enjoy government preference in branching and depositing public pension funds. This preferential treatment, coupled with a lack of market competition, has created a situation in which government-owned financial intermediaries are characterized by inefficient mobilization of financial resources, low profitability, operating inefficiency and bureaucracy in loan processing, reduced autonomy, and overstaffing and poor management.[16]

In addition, because public sector banks are more prone to government interference in credit and planning decisions than private sector banks, they tend to be burdened with a significant amount of non-performing and doubtful loans, most of them nominally government-guaranteed.

The banking policy of the Egyptian Government does not allow banks to collapse. Inefficient banks are permitted to stay in business, with the help of the CBE and the banking sector at large. The public fear that the collapse of one bank could lead to a chain reaction in the banking sector implies that the banking sector has adopted a form of collective rescue responsibility. This is to say that, regardless of their condition, banks are kept in business. Consequently, inefficient banks are not restructured, merged with others liquidated, but are allowed to continue violating credit standards and getting involved in high-risk lending and bidding for deposits.

Within the framework of Egypt's economic structural adjustment programme, a number of financial sector reform measures concerning bank supervision and control were introduced during the last few years. Most important among the measures is Law No. 37 of 1992, which strengthened the authority of the CBE through a new set of rules and regulations governing on-site as well as off-site supervisory responsibilities. Bank supervision in Egypt, however, still suffers from several impediments such as limited autonomy of the CBE, lack of adequately qualified supervisory personnel that could handle the significant number of banks, political pressure that compromises effective supervision, and lending on the basis of name rather than balance sheet.

Licensed banks in Egypt are required to hold government securities as one component of their compulsory liquidity ratio. This ratio, introduced in 1958 and set at 30 per cent of bank domestic and foreign currency deposits, remained unchanged until 1991, when it was reduced to 20 per cent. This was the result of the measures introduced as part of Egypt's economic structural adjustment programme. During the period 1958-1991, however, the actual spread changed considerably, averaging 48.7 per cent. This indicated a rate of 18.7 per cent in excess liquidity and reflected inefficiency in the bank intermediation process. The inclusion of government securities in bank portfolios was considered a major reason behind the creation of the excess liquidity in the banking sector. The increasing use of treasury bills (Tbs) by the Government to finance budget deficits enhanced the share of Tbs in bank portfolios, especially because Tbs were risk-free and enjoyed tax-free interest rates. Moreover, the excess liquidity seems to have reflected a concern of the monetary authorities regarding the low capitalization (capital adequacy ratios) and insolvency of some banks.

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[16] World Bank, *Egypt, Financial Sector Report - Banking Sector,* draft, February 1992.

V. PRIVATIZATION

Privatization is considered a major constituent of Egypt's economic structural adjustment programme. The public sector has dominated Egypt's economic activities since the early 1960s. It has been argued that this was the main reason behind the misallocation of resources, budget deficits and low GDP growth rates recorded during the 1980s.

A. PUBLIC SECTOR PERFORMANCE AND EFFICIENCY PRIOR TO THE PRIVATIZATION PROCESS

The public sector has played a major role in Egypt's productive and utilities sectors. However, since the beginning of the liberalization process in 1973, a number of efficiency indicators point at a weak performance of the PSEs (table 1). This weak performance, recorded mainly in the industrial, transport and power-generating sectors, was a major factor behind Egypt's escalating budget deficit. During the 1970s and 1980s the public sector suffered from a large and growing deficit, mounting external debt, low rates of savings and declining financial rates of return. The ratio of the deficit of non-financial PSEs to GDP increased from around 1 per cent during the 1970s to over 6 per cent in the early 1980s. Therefore, this ratio fluctuated between 5 and 6 per cent, and accounted for around 20 to 25 per cent of the overall budget deficit of the Central Government.

The decline in the financial rates of return on invested capital which was brought about by price control contributed significantly to the increase in the overall deficit of PSEs throughout the 1970s and the 1980s. Table 1 shows that the net rate of return (I) dropped from 7.78 per cent in 1975 to 6.87 per cent in 1980/81; the net rate of return (II), from 15.6 per cent to 14.31 per cent; and the net rate of return (III), from 6.6 per cent to 4.3 per cent. This development continued throughout the 1980s, with rate of return (I) dropping to 3.62 per cent and rate of return (II) to 7.24 per cent in 1989/90. Rate of return (III) was at only 1.7 per cent by 1983/84; full data were not available at the time of writing.

In contrast to the development of financial ratios during the 1970s, productivity ratios recorded significant increases. The incremental capital output ratio increased to 6.7 per cent during the period 1973-1979; the marginal productivity of capital increased to 15 per cent; and the total factor productivity to 6.5 per cent. During the period 1979-1983/84, however, only the first ratio continued the upward trend, increasing to 19 per cent. The other two ratios dropped significantly: the second ratio dropped to 5 per cent, and the third became negative 4.4 per cent, indicating the worsened overall economic efficiency of non-financial PSEs, particularly the efficiency, or profitability, of their investments.

To address these problems, during the early 1990s Egypt, in cooperation with the International Monetary Fund and the World Bank, initiated a PSE privatization programme.

B. THE PRIVATIZATION PROGRAMME

Law No. 203 of 1991 (Public Enterprise Law), issued within the context of the economic reform and structural adjustment programme (ERSAP), marked the beginning of the public sector reform and privatization programme. The Law aimed at eliminating the different treatment of public and private sector enterprises and at ensuring free and fair competition for all businesses. To achieve these aims, two approaches were adopted by the Government. The first separated management of PSEs from their respective ministries and treated both PSEs and private-sector enterprises on equal footing. For this purpose, a law was issued in July 1996 stipulating that PSEs be regrouped under purpose-built holding

companies and given autonomy in **management, pricing and funding.** Employment and suspension decisions, however, remained subject to Government regulations. The second introduced a privatization programme, under which most PSEs were offered for sale in the medium term.[17]

TABLE 1. EGYPT: PERFORMANCE INDICATORS OF NON-FINANCIAL PSEs [a/]
(percentage)

	1975	1977	1980/81	1983/84	1986/87	1987/88	1988/89	1989/90
Financial rates of return (371 PSEs)								
Net rate of return (I) [b/] (total net assets)	7.78	7.88	6.87	4.23	2.87	3.43	4.03	3.62
Net rate of return (II) [c/] (Book value of capital employed)	15.60	16.43	14.31	8.25	5.52	6.67	7.93	7.24
Net rate of return (III) [d/] (revalued capital)	6.60	5.00	4.30	1.70	n.a.	n.a.	n.a.	n.a.
Labor productivity (1986/87 = 100)								
Output/worker [e/]	97.90	104.0	123.30	94.70	100.0	108.8	112.4	114.9

	1973-1979	1979-1983/84
Aggregate productivity ratios		
Incremental capital output ratio	6.7	19.0
Marginal productivity of capital	15.0	5.0
Total factor productivity growth	6.5	-4.4

Source: World Bank, Arab Republic of Egypt, *Public Sector Investment Review, Main Report, 1993.*

a/ Net rate for 1975-1983/84 includes economic authorities
b/ Net profit (after tax) divided by net assets
c/ Net profit (after tax) divided by capital employed
d/ Ratio of current surplus (net of depreciation) to gross capital employed less accumulated depreciation.
e/ Gross output per employee in constant prices of 1986/1987.

n.a.: Not available.

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[17] As indicated in the World Bank (1993) Appendix IV, the first step in privatization in Egypt was undertaken in 1990/1991 by selling 2,000 small local government-owned enterprises, and starting to sell large hotels. The second step was programmed for implementation in 1991/1992 and included the following:

- Continuation of the sale of local government-owned enterprises;
- Sale of the public sector share in Law 230 companies;
- Sale of the public sector share in Law 97 companies;
- Lease of under-utilized production capacities and sale of unnecessary assets;
- Sale of small, profitable public sector companies.

The third step was to continue to reinforce the privatization programme in 1992/1993.

1. Objectives

The objectives of privatization in Egypt are by and large the same as in other developing countries which have undertaken privatization programmes: to improve productive and allocative efficiency and to correct fiscal imbalances in order to enhance economic growth and development.[18]

In Egypt, the establishment of an independent advisory body, the Public Enterprise Office (PEO),[19] marked the beginning of the privatization programme on a large scale. The total of 314 PSEs were regrouped in affiliated companies (ACs) under 17 holding companies (HCs). This act released the PSEs from the direct control of the ministries concerned. Another law, Law 203 of 1991, was introduced to realize this aim. This was in addition to the elimination of the preferential treatment given to the public sector by the Government, at the expense of the private sector. Law 203 established new rules for the economic activities of PSEs, such as profit maximization; assigned the gradual elimination of their subsidies; and gave them autonomy in decisions pertaining to their operations.[20]

In 1993, the PEO published an action plan entitled "General Procedures and Guidelines for the Government's Programs of Privatization, Restructuring and Reward System". The plan, which was subsequently revised, is considered to be the only formal document reflecting the Government's commitments and objectives concerning privatization. The document indicates the following main principles of the programme:

(a) Public offering of shares;
(b) Transparency of the privatization process;
(c) Widening share ownership.

2. Criteria for selection of privatization companies

In contrast to many other developing countries engaged in privatization, where the public authorities themselves choose which direction of privatization to pursue, Egypt has indicated that only profit-making PSEs will be privatized. This criteria applies when a company making a modest profit can be restructured towards better selling conditions in the future. Therefore, candidates for restructuring are companies which can generate competitive rates of return to attract investors.

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[18] It is not difficult for a Government to advance reasons for adopting a privatization programme. It can put forward one, or all, of the reasons listed in the literature. Vickers and Yarrow (J. Vickers, and G. Yarrow, *Privatization, an Economic Analysis,* [London MIT Press, 1988]) summarize what appear to be the main objectives of privatization as follows: improving efficiency; reducing public sector borrowing requirements; reducing government involvement in enterprise decision-making; easing problems of public sector pay determiniation; widening share ownership; encouraging employee share ownership and gaining political leverage. Table 2 summarizes the potential impact of privatization on productive and allocative efficiency as well as on revenue receipts through different methods or instruments of privatization.

[19] The PEO, established in 1992, is a technical office responsible for setting up plans and monitoring the restructuring and privatization programme. It ensures a smooth regulatory environment away from bureaucratic obstacles.

[20] M. Mohieldin, and S. Nasr, "On Privatization in Egypt with reference to the cases of the Czech Republic and Mexico", paper presented at the conference organized by the Centre for Political Research, Alexandria, 1995.

TABLE 2. EGYPT: IMPACT OF PRIVATIZATION

	Instruments/methods	Objectives		
		Allocative efficiency	Productive efficiency	Revenue receipts
1.1	Asset sales (of monopolies)	No	Yes	Yes
1.2	Asset sales (of companies in competitive product markets)	Yes	Yes	Yes
2.1	Deregulation (with asset sales)	Yes a/	Yes	Yes
2.2	Deregulation (without asset sales)	Yes a/	Yes	No
3.1	Franchising (normal)	Yes b/	Yes	No
3.2	Franchising (monopoly rent auction)	No	Yes	Yes

Source: M. Bishop, J. Kay and C. Mayer: *Privatization and Economic Performance* (Oxford University Press, 1994).

a/ Under competition and contestability.
b/ With competitive bidding.

Another criterion for selection has been the issue of whether a PSE is considered strategic for the country. While the word "strategic" has rather a broad meaning, it has been associated in Egypt's privatization programme with the following types of companies:

(a) Monopolistic companies, the prices of whose products/services would become subject to arbitrary private sector control if privatized;

(b) Companies producing essential public products/services;

(c) Companies located in areas of high unemployment rates;

(d) Companies related to national security issues.

Consequently, certain establishments have been excluded from the privatization programme. This includes the oil sector, the Suez Canal, the telecommunications network, the railway organization, the military industries, Egypt Air, the insurance companies, and the public sector banks.[21] Since the total assets of these establishments constitute around 85 per cent of total assets of the public sector, only 15 per cent of the assets of the sector are in fact being considered for privatization.

3. *Methods of privatization*

The methods the PEO applied in privatizing more or less encompassed all the known privatization methods in most developing countries.

[21] At the time of this writing, the Egyptian Government announced that public sector banks might become subject of privatization during the next few years.

These methods included:

(a) Sale of shares through public auction or tender, including sale to anchor (strategic) investors;

(b) Public offering;

(c) Employee and/or management buy-out;

(d) Lease or management contract;

(e) A mix of the four methods.

The public sale method was considered during the first stage of privatization but was abandoned later on in favour of the tender sale method, through which three companies were sold. Recently, however, the Government has begun to consider the partial sale method, through public offering. The method implies the release of a portion of a PSE equity to test its market competitiveness and its absorptive capacity as well as its ability to determine the share price. However, this method results in a lengthy privatization process because the sale implies the offering of only a portion of equity. Moreover, owing to the limited number of shares offered, the method is not helpful in widening the share ownership base. Following is a brief description of some of these methods:

(a) Sale to anchor investor

This method involves the sale of the PSE's equity or most of it to an anchor investor, willing to be committed to bring in know-how, improve the efficiency and productivity of the PSE and provide new investment during a specific time period. Three companies were sold through this method.[22] Owing to pressure caused by public fear that sale to anchor investors would lead to foreign dominance of the economy, this method was abandoned and replaced by the method of public offering.

(b) Public offering

This method implies the sale of 10 to 20 per cent of the shares of privatization companies to the public through subscription. Around 10 per cent of the shares of 15 companies, worth LE 711 million, were sold through this method, with other shares worth LE 154.2 million being sold to the companies' employees through proxies, namely the Employee Stockholder Association (ESA). The ESM legislation allows the formation of such associations to widen share ownership, aimed at increasing employees' personal interest in the privatization programme and consequently providing an incentive for higher productivity. It is noteworthy, however, that, owing to the low ratio of employees ownership in the equity of privatized companies, exercising ownership rights in management by the ESAs has proved to be limited. In 1995, the Government moved to majority sale to the public; that is, the sale of the remaining 80 to 90 per cent of the equity of privatization companies through public offering to the ESM, by subscription.

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[22] These were: El Nasr Bottling Company (Coca Cola), the Egyptian Bottling Company (Pepsi Cola), and El Nasr Steam Boilers Manufacturing Company.

(c) Sale of shares in joint-venture companies

This is the third sale method applied within the framework of implementation of Egypt's privatization programme. Up to the end of 1995, the value of conducted sale of ACs shares in joint-venture companies amounted to LE 125 million. During the 1980s, the privatization programme was considered to be timid, lacking significance, credibility and adequate compensatory measures. Furthermore, during the early 1990s, the programme was frequently criticized as being slow and performing far below targets. Up to the end of 1994, only 8 per cent of the total assets of PSEs assigned for privatization were sold. To complete the programme by the year 2000 as envisaged, the Government plans to sell one company every week, excluding public sector finance companies.

A new development in 1996 marked the threshold of the implementation of an ambitions privatization programme. Three initial public offerings (IPOs) took place through the ESM, with two being majority-privatized,that is, over 50 per cent of the equity of privatization companies. In addition, two secondary flotations were made and a third company offered 27.5 per cent of its equity to an anchor investor. This development was well received by both the local and international financial markets, as reflected both in the extent to which the offerings were oversubscribed and in the number of foreign investors expressing interest in the subscriptions.[23] In 1996, foreign investment funds were allowed to subscribe for the first time in the IPO of a privatization company (a real estate company), with 41 funds from six countries participating in the deal.

As at end July 1996, 28 companies were majority privatized (including 10 companies under liquidation), with a book value representing 5.2 per cent of the total book value of Law No. 203 companies (public sector companies). Another 17 companies were minority privatized, constituting 9.6 per cent of total book value. The Government also sold part or all of its stake in a large number of joint-venture companies, established under Law No. 43.[24] It launched a plan aimed at privatizing the 23 joint-venture banks (JVBs), with the objective of promoting competition in the banking sector, thus reducing the excessive interdependence among banks and minimizing the systemic banking risk. Following the successful privatization of the Commercial International Bank (CIB) and the improved ESM conditions, the privatization process of JVBs started taking shape, with the Government announcing that all JVBs with public sector ownership of 49 per cent or less would be privatized. At the time of writing, 15 JVBs, including the CIB, were already privatized.

4. *Sale proceeds of privatized comapnies*

Recognizing that privatization is a necessary tool to address the financial problems as well as the restructuring of divested companies, and to ensure the most efficient use of technology to improve productivity, the Egyptian Government announced that sale proceeds of privatization would be used to settle the companies' debts and to compensate labour first. The remaining funds would be channeled to the Treasury to help repay the public debt. Table No. 3 shows sale proceeds as at end August 1996. It shows that until the beginning of 1996, the actual utilization of the sale proceeds was carried out as follows: around 30 per cent of the proceeds of Law No. 203 companies were deposited at banks and 22 per cent, which reflect the proceeds from initial public offerings, were used for capital increase by the Metallurgical

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[23] In one case, the issue was approximately 50 times oversubscribed.

[24] Ministry of Economic and International Cooperation, *Egypt: Economic Profile (1996).*

Holding Company and the Mining Holding Company.[25] **Other utilization** included 18 per cent in the form of loans to ACs and 12 per cent for use by the HCs, at their discretion. It is worth noting that the collected sale proceeds represented less than 53 per cent of the total, with over 47 per cent yet to be collected.

TABLE 3. EGYPT: SALE PROCEEDS FROM PRIVATIZATION, AS AT END AUGUST 1996

Number of companies	Description	LE million
n.a.	Law No. 203 companies	3376
28	Initial public offerings	2232
4	Anchor investors	665
21	Employee Stockholder Association (minority)	304
-	Workers	175
-	Law No 230 (Joint-ventures)	128
10	Employee Stockholder Association (majority)	248
-	Sale of assets (land and utilized assets)	3032
Total		10160

Source: Public Enterprise Office and Ministry of Economy and International Cooperation (1996).

C. PERFORMANCE OF THE PUBLIC SECTOR DURING PRIVATIZATION

The implementation of Law No. 203 of 1991 aimed at removing the dualism that existed between public and private sector businesses. This Law determined that PSEs operate under the same set of conditions and rules that govern the operations of the private sector. This was expected to enhance competition in the market because a number of constraints which restricted the operations of PSEs were removed, including the administered prices of their products and services as well as the policy of excessive employment.

The financial performance of PSEs during the period 1990/1991 - 1994/1995, however, was not as good as expected.[26] Net surplus after taxes fell from LE 1 197 million in 1990/91 to only LE 42 million in 1992/93, (table 4). Although their performance picked up in 1994/95 to LE 1 195 million, it remained below the level of 1990/1991. In 1994/1995 the carried-over deficit (LE 9 764 million) was more than four times its level in 1990/1991 (LE 2 365 million). The increase in the number of loss-making companies, from 60 in 1990/91 to 88 in 1994/95, explains only one cause behind this performance. Others included the decline in the number of profit-making companies, the rise in the average wage of workers, the gradual increase in the current deficit and the drop in government subsidies to PSEs.

Table 5 shows an impressive increase in both the return/equity ratio and the labor productivity ratio of PSEs of public sector enterprises. The former increased from 43.8 per cent in 1990/91 to 86.1 per cent in 1994/95 and the latter from 113.5 per cent to 157.5 per cent. This increase, nevertheless, could not conceal the fact that the performance was still based to a great extent on "borrowed money". The rise in the debt/investment ratio, from 65.5 per cent in 1990/91, to 68.7 per cent in 1994/95, is the evidence. Had the rise in labor productivity (table 5: net value added/worker) continued, it would have—in the final

[25] The bank deposits were made at the discretion of the respective holding companies.

[26] No data for 1995/1996 were available at the time of this writing.

analysis—resulted in a rise in the **profitability of the enterprises, thus** reducing the dependence of their investment finance on borrowing, and consequently their debt/investment ratio.

TABLE 4. ECONOMIC INFORMATION ON PUBLIC SECTOR ENTERPRISES, 1990/91-1994/95
(Millions of Egyptian pounds)

Item	1990/91	1991/92	1992/93	1993/94	1994/95
Operation revenues	44 077	48 897	50 385	52 385	55 455
Subsidies	274	251	137	180	129
Financial revenues	134	143	165	232	227
Current transfer revenues	5 836	6 759	6 651	7 108	7 484
Total revenues	50 321	56 050	57 338	59 905	63 295
Wages	4 468	4 752	5 465	5 497	5 793
Number of workers	1 063 440	1 060 805	1 045 294	1 008 363	964 446
Average wage (Number)	4 201	4 480	4 941	5 451	6 007
Total number of companies (Number)	314	314	312	313	292
Profit-making companies (Number)	254	224	204	214	202
Loss making companies (Number)	60	90	108	99	88
Distributable surplus (Including taxes)	2 479	2 946	3 473	4 224	4 986
Distributable surplus (Excluding taxes)	1 783	2 124	2 513	3 120	3 689
Current deficit	586	1 622	2 471	2 387	2 494
Net surplus after taxes	1 197	502	42	733	1 195
Net transfers to government	2 153	2 603	n.a.	n.a.	n.a.
Carried over deficit	2 365	3 909	6 170	7 891	9 764
Gross value added	10 180	10 856	11 105	12 036	12 977
Net value added	8 656	9 025	9 091	9 911	10 855

Source: Public Enterprise Office, unpublished data, 1996.
n.a.: Not available.

TABLE 5. EGYPT: PERFORMANCE INDICATORS OF NON-FINANCIAL PSEs DURING PRIVATIZATION, 1990/91 - 1994/95
(Percentage)

	1990/91	1991/92	1992/93	1993/94	1994/95
Return on assets ratio	6.4	7.7	8.3	8.5	8.8
Return on assets ratio excluding projects	7.1	8.3	8.9	9.2	9.4
Return on equity ratio	43.8	57.9	74.6	80.7	86.1
Debt/investment ratio	65.5	66.5	68.2	68.4	68.7
Net value added/worker 1989/1990=100)	113.5	123.7	121.7	137.5	157.5
Gross value added/LE of wage	2.28	2.36	2.15	2.19	2.24

Source: Egypt, Cabinet, Information Centre for the Public Sector, *Achievements of the Public Enterprise Sector, 1990/91- 1994/95*, Vol. I (1995).

D. IMPEDIMENTS TO PRIVATIZATION

There were several impediments to the privatization process in Egypt. To begin with, there was a widespread fear that privatization would increase the already high rate of unemployment in the economy, which amounted to around 17.5 per cent in 1996. The methods chosen for privatization and evaluation of the privatization candidates also appear to have been problematic. This is mainly because there was not a well-developed securities market, which usually constitutes the backbone for a successful privatization programme. Thus, although several years have passed since the implementation of the privatization programme, it does not seem to have resulted in a significant change in the share of the public sector in GDP, nor in an increase in that of the private sector. Below is a summary of the main impediments to this development in the privatization process in Egypt.

1. Financial restructuring

One of the objectives of privatization is to raise funds to improve the financial position of loss-making and low-profitability companies. This is usually done by reducing their debt burden. Most of these types of companies suffer from unbalanced financial structures which affect their productivity and performance. Reduction of debt of viable companies should make them profitable, in turn rendering them attractive for privatization. It is therefore worth noting that the estimated debt of the 314 PSEs which were regrouped under 17 holding companies was around LE 37 billion in 1995 and constituted around 50 per cent of the total assets of the holding companies in that year.[27] Servicing the debt was beyond the capability of the PSEs.

Debt restructuring (rescheduling) or relief has become necessary for successful privatization. The private sector has shown unwillingness to invest in debt-ridden companies which cannot meet their debt obligations. Although many of the PSEs are profitable on an operational basis, their debt problems make them loss-making. Solving their debt problems would remove a major impediment to the privatization process. Any attempt to solve these problems should begin with determining the magnitude of the debt, followed by selection of a debt management method.[28]

2. Role of the financial market

Over the past few years, the Government was for a while considering whether to develop the financial market by introducing new financial instruments *per se* to create market supply, or to privatize, thus creating market demand through privatization shares. In the former, the financial market would develop on its own independent of privatization, although privatization would play a significant role in it. In the latter, privatization would contribute to the development of the financial market.

[27] The volume of non-performing and doubtful loans of public sector banks is considered to be close to this estimate.

[28] The method could be either debt-equity swap or issuance of government or holding company bonds to be applied on a case-by-case basis, taking into consideration the impact on pace and viability of privatization.

During the period 1993-1994, the trading value of listed as well as unlisted shares was on the rise, with market capitalization increasing significantly.[29] In 1995, however, the share prices experienced a decline, leading to a slowdown in the privatization process.

The revival of the financial market in 1996 was due to the change in the Government's privatization policy from the tender method[30] to the public offering method. In the former, investors would be asked to tender for companies, with only a small portion of the available shares, if any, being reserved for the public; in the latter, however, shares of privatization companies would be offered to the public for subscription.

3. *Concern with unemployment*

Concern with unemployment has so far been a major reason behind the slow pace of privatization in Egypt. In 1996, public sector enterprises in Egypt employed 1.3 million employees representing around 8 per cent of the total labor force in the country.[31] With an unemployment rate of around 17.5 per cent in 1996, public sector employees cling to their jobs, which are considered secure compared to jobs in the private sector. The decline in the number of public sector employees by around 2.2 per cent (29 000) during the period 1989/90-1992/93, lends credibility to the public fear that privatization will increase unemployment. This decline represented a small per cent of the total, but it should be seen against a backdrop in which the labor force is increasing by 2 per cent annually and the private sector assuming a relatively low profile in employment generation.

4. *Inadequacy of the legal framework*

Law No. 203 of 1991 does not provide mandatory provisions to force or even encourage the Government to implement the privatization programme or speed up its process. For example, the Law neither provides clear guidelines concerning the valuation of assets nor indicates provisions for the protection of the small shareholder. The above-mentioned "General Procedures" are used to a great extent to establish the legal framework, but they are neither binding nor sufficient.

5. *Power of holding companies*

The general assemblies and the boards of directors of the holding companies have the upper hand in initiating and deciding the sale of affiliated companies. They are considered to bear part of the responsibility for the slow implementation of privatization. It is understandable that, since the directors owe their positions and privileges to the very existence of the affiliated (PSEs) companies, they may not show enthusiasm in taking decisions aimed at their privatization. They would prefer instead to continue with the status quo, fearing that they may have less secure prospects if the privatization process goes ahead.

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[29] The number of listed shares traded amounted to around 13.7 million in 1993. It more than doubled in 1994. The number of transactions in these shares rose from 11 000 to 52 000. It rose from 1 400 to 135 000 in unlisted shares, which numbered 4 million in 1993 and increased to 30 million in 1994.

[30] Sale to highest bidder with no role of the financial market.

[31] Excluding Government employees.

E. PROSPECTS OF PRIVATIZATION

On the basis of the review presented above, it is not clear whether privatization in Egypt is the result of a vision or the outcome of a pragmatic process. It is difficult to identify a well-defined correlation between the privatization programme and an existing national economic development strategy. It is difficult to understand the rationale behind the allocation of the sale proceeds to the Public Enterprise Office and the holding companies; and it is also difficult to decide whether such allocation is compatible with achieving specific economic targets and challenges. For example, it is maintained that when applying the criteria for the selection of privatization candidates, the overall objective of the privatization programme, increasing efficiency in managing PSE resources, was observed. But this is only one criterion for successful management. There are a number of other criteria, including productivity, export promotion, competitiveness and new technologies. It is important to take all of these criteria seriously in order to increase the merits of public sector reform. These concerns do not seem to have weighed heavily in the minds of economic policy makers in Egypt. Hence, the logic of the new economic strategy of Egypt takes a long-term perspective that is not influenced by short-term gains. Within this strategy, which values the comparative advantage of private and public economic agents, privatization is only one of the components necessary to secure sustainable development. Other components include such important elements as, research and development (R&D), inward investment and a regionally - oriented economic policy.

The privatization experience during the last two years shows that there is a two-way relationship between financial sector development and privatization. Development of the financial market facilitated the privatization process by mobilizing domestic and foreign funds. Privatization, in turn, attracted portfolio investments that revived the activities of the financial market. Moreover, banks in Egypt played a vital role in the valuation of PSEs offered for sale, introducing sub-custodial service and financing leveraged and management buyouts. A number of banks, operating under the universal banking concept, established investment funds which have become highly active in dealing with shares of privatized companies. These funds penetrated the field of venture capital, brokerage and portfolio management.[32] At the end of May 1996, they numbered 10 with a total capital of LE 1.5 billion.

With regard to the future of the privatization programme, the Government has recently announced that by the end of 1996 nine companies will be privatized through the ESM and four others will be offered to anchor investors. This is in addition to the preparation of eight companies for the point of sale. Furthermore, the Government planned the transfer of ownership of 40 companies from Law No. 203 of 1991 to Law No. 159 of 1981, either through public offering or selling to anchor investor, or a combination of both.

The Government, however, expects that the sale value of PSEs planned for privatization in 1997 will match the combined sale values of PSEs privatized in the preceding two years. Privatization in infrastructure has opened a new horizon for private investment. Private participation through Build-Operate-Transfer (BOT) has already been approved in power generation and highways.

[32] National Bank of Egypt, *Economic Bulletin,* various issues.

PART THREE
CASE-STUDY OF JORDAN

VI. FEATURES AND CHARACTERISTICS OF THE JORDANIAN ECONOMY AND NEED FOR ECONOMIC REFORM

The Jordanian economy is by and large a market-based economy, despite the fact that the public sector controls around 68 per cent of GDP. It employs over 43 per cent of the total labor force, excluding security, military and related services, and holds about half of the equity shares in 20 per cent of the public shareholding companies and around 10 per cent in more than 56 per cent of them. However, most of Jordan's productive assets, except those in the Government's services sectors, are in the hands of the private sector.[33]

The Jordanian private sector could be described as a "receiving rather than giving" sector, as its activities significantly depend on the operations of the public sector. Indeed, the private sector has not so far been able to develop a critical mass that could effectively parallel the activities of the public sector. Its financial resources tend to be a by-product of Government expenditures. The ratio of Government expenditures to GDP in Jordan is considered to be one of the highest in the region, amounting to around 40 per cent, compared with around 29 per cent in the Syrian Arab Republic and 35 per cent in Saudi Arabia.

The relatively small size of the economy and its limited natural resources have forced Jordan to develop strong external economic and financial relations to cover its economic development needs. The level of economic activities in Jordan tends to be greatly affected by these relations. Important indications of this relationship are foreign trade with neighbouring Arab markets, foreign financial assistance (aid and grants), and remittances from Jordanian expatriates, particularly from the GCC countries. The anomaly of this dependence on external relations has been vulnerability of the economy to exogenous factors beyond the control of the country itself. In addition to this peculiar set-up, the economy itself is characterized by the following:

- Structural problems, indicated by the low degree of complementarity among the various sectors, and extensive dependence on foreign markets for imports and exports;

- Chronic imbalance between budget revenues and expenditures, and the existence of a long-standing budget deficit. Recently, however, domestic revenues have managed to cover current expenditures;

- Serious discrepancies between investment and national savings, leading to a significant dependence on external sources, mainly aid, grants and debt for financing investment.

- Imbalance between population density and employment, resulting in structural distortion in the employment market.

The Jordanian Government, in order to solve these problems, indicated an economic development course in the country as early as the beginning of the 1950s. Its development programme aimed to encourage private sector activities, create a suitable environment for investment, develop human resources and make full use of available natural resources.

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[33] Taher Kanaan, "The State and the private sector in Jordan" (in Arabic), summary of a paper presented to a seminar on privatization in Jordan, held at the Royal Cultural Centre in Amman on 18 December 1995.

The development process, however, has suffered from several impediments. These include: (a) Economic legislation with conflicting objectives; (b) unclear objectives regarding the role of the private sector versus the public sector; (c) pressure on available natural resources; (d) lack of realism in planning objectives; (e) lack of information; and (f) lack of total commitment to planning objectives.

The significant issue confronting development planning in Jordan throughout the last four decades has been the unexpected increase in population. This increase has resulted from successive waves of immigration from Palestine (1948-1950), the West Bank and Gaza (1967) and the GCC countries (1990-1991), the latter in the wake of the Gulf crisis. These human waves have slowed down the process of implementing development plans, increased unemployment and created excessive pressure on the country's infrastructure and Government services.

Almost all of the development plans in Jordan have adopted the following targets: increasing GDP growth rates; building basic infrastructure; improving government social services; enhancing mobilization of domestic resources; establishing basic industries; and creating employment opportunities. For an economy such as that of Jordan, which is small as measured by its GDP size, it is considered unusual that these targets were adopted by almost all of the development plans regardless of changing circumstances and availability of financial resources.

Considering the scarcity of development finance, the vulnerability of the economy to exogenous factors becomes even more acute, particularly since domestic production activities account for around 69 per cent of the GDP. Both the drop in the oil prices during the second half of the 1980s and the Gulf crisis in 1990/1991 are examples of these exogenous factors.

To lessen unfavorable development in the Jordanian economy, the Government undertook a number of measures during the second half of the 1980s. They included:

(a) Widening the margin of fluctuation of the Jordanian dinar (JD) against the Special Drawing Rights (SDRs) as a first step towards a complete flotation of the JD;

(b) Restricting demand for foreign exchange by, for example, reducing imports of luxury goods;

(c) Containing speculation on the JD by restricting transfer of foreign exchange to a limited number of activities;

(d) Rationalizing budget expenditures and increasing revenues; the latter through such measures as raising custom tariffs on a number of imported goods, levying new taxes and increasing rates of existing ones.

These measures, however, proved to be insufficient to create the required conditions and the economic vitality needed. The economy's performance continued to deteriorate, leading to a depreciation of the JD against the dollar by around 50 per cent during a very short period of time in 1988. To redress the deteriorating situation, Jordan, in cooperation with the IMF, adopted a stringent economic and financial structural adjustment programme for the period 1989-1992.

During 1989 and throughout the months preceding the eruption of the Gulf crisis in August 1990, Jordan made significant steps in containing most of the negative developments of the previous years. Indeed, rising inflation was contained; budget and balance of payments deficits reduced; a reasonably stable exchange rate for the dinar established; the foreign reserve position improved and servicing of the external debt resumed.

The Gulf crisis, however, interrupted these positive developments. Its impact on Jordan was significant, as reflected in the loss of Jordan's main export markets (Iraq and the GCC countries); the pressure on infrastructure and government services by the arrival of over 300 000 returnees from the GCC countries; and the loss of revenues from tourism and Iraqi transit. Jordan worked out a second economic structural adjustment programme with the IMF for the period 1993-1998. This programme aimed to re-establish confidence in the economy; create the "right" environment for savings and investment; and eliminate distortions in the economy. The programme was to contain inflation; reduce both budget and balance of payments deficits; and restrain the rise in public external and domestic debt. The economic and financial policy measures which were introduced to achieve these results included:

(a) Reducing monetary expansion to an average annual rate of around 9 per cent. This was to be achieved through reducing credit to the public sector in favor of the private sector by fixing a credit ceiling in relation to the volume of assets;

(b) Establishing a stable exchange rate for the JD;

(c) Maintaining a market-oriented interest rate;

(d) Raising domestic revenues and reducing current expenditures, so that revenues would contribute to the financing of capital expenditures, thus reducing dependence on external sources;

(e) Promoting exports to reduce the trade balance;

(f) Encouraging foreign investment by liberalizing foreign investment rules and regulations and offering additional investment incentives;

(g) Reducing the burden of external debt by rescheduling and restructuring of the debt, increasing the use of the IMF and World Bank facilities, and making use of debt-equity swap and debt-export swap.

VII. FINANCIAL SECTOR REFORM IN JORDAN

The two economic reform programmes, which were introduced in Jordan and discussed earlier, included some specific measures for the reform of the financial sector. These measures included:

- Deregulation of the financial sector; decontrolling of the interest rate; freedom for banks to determine fees and commission rates on their financial services; and elimination of bank-specific administrative norms;

- Improvement of the monetary policy framework, including development of indirect monetary policy instruments; out-scaling preferential credits in priority areas; and lifting direct credit controls;

- Promotion of competition in the financial sector, encompassing the easing of entry and exit barriers, enlarging the scope of business boundaries of financial institutions, improving the ownership structure of financial companies, and restructuring state-run or state majority-owned financial institutions;

- Liberalization of trade in financial services, including lifting controls on outbound and inbound direct investments, allowing private holding of foreign exchange (FOREX) and other financial assets, moving toward a market-determined exchange rate system and providing market access to foreign financial institutions on a non-discriminatory basis;

- Fortification of prudential regulations and the supervision framework, including the recapitalization of banks; enhanced transparency and improved protection for depositors (investors).

These reform measures were to achieve microeconomic efficiency and macroeconomic stabilization. Policy makers in Jordan realized that wide-ranging economic structural reform policies—fiscal reform, price reform, exchange rate and trade system reform—implied application of fundamental policies for an efficient reallocation of financial resources and redirection of new savings and investment flows to productive projects. The authorities also recognized that reform of the financial sector, including increasing access to foreign financial resources, would help to ensure sound and economically viable enterprises that have access to the credit flows that are necessary for restructuring.

The underlying argument here is that a well-functioning credit market is necessary to provide lenders with the required information to assess risk and creditworthiness of borrowers, and to allocate and value credit according to the risk involved, thus facilitating the separation of efficient from inefficient enterprises. There is also increasing recognition that financial sector reform that implied promotion of an outward orientation of the economy would significantly enhance the pivotal role of the financial market in the privatization of PSEs. It would facilitate proper equity valuation and offer a channel for widespread distribution and trading of claims.

The authorities have realized that a reformed financial market would play a significant role in the privatization and restructuring of PSEs, particularly regarding the elimination of preferential access to credit and subsidized exchange rates. However, the reform of the financial sector in Jordan has not been without obstacles and problems. For example:

1. The reform of the financial sector has been followed by a period in which the growth of domestic credit exceeds the growth of the bank deposits. This was caused by the removal of the credit

controls which previously constrained the supply and demand of credit. The removal of restrictions resulted in banks lending for previously restricted activities, such as financing pent-up consumption (e.g. durable or luxury goods), or speculative activities (e.g. real estate and stock market). It resulted also in the creation of opportunities for some large Jordanian enterprises to consolidate their monopolistic position through acquisition of related enterprises. The increased demand for credit, however, was partly supported by an enhanced ability of the banking sector to mobilize domestic savings. The reform of the financial sector led to a rise in the competition for funds by offering competitive interest rates and services.

2. The reform of the financial sector, though encompassing capital account liberalization, has not been very helpful in achieving a significant increase in the inflow of foreign financial resources. Free access by banks and other non-bank (financial) institutions to international financial markets remains by and large restricted by administrative and foreign exchange regulations of the Central Bank of Jordan.[34]

3. The reform of the financial sector initially jeopardized the safety and the soundness of the banking sector. It enhanced competition in the market and created unprecedented pressure on weak (undercapitalized) financial institutions which were already involved in excessive risk-taking activities. In the initial stage of the reform of the financial sector, the safety of the banking sector was also challenged by rapid and uneven credit growth. Banks were not well prepared to assess and price differential credit risk appropriately, especially when interest and exchange rates were fluctuating widely.

To deal with these problems, monetary authorities introduced regulations and policies which could be described as prudent. They included:

(a) Licensing policies to ensure adequate capitalization and sound management;

(b) Classification and provisioning to avoid potential losses or problem assets;

(c) Minimum auditing standards, sufficient for proper disclosure and acceptable reporting requirements;

(d) Exposure limits on lending to prevent concentration of risk in a single borrower, a group of related borrowers or a particular industry; for example, the economic sector;

(e) Bank restructuring, to allow supervisors to plan effectively for recapitalization and transfer of ownership, or to dispose of insolvent banks speedily.

To develop and strengthen the financial market, the banks, which dominate the market, were given greater freedom to respond to market signals by choosing their own customers and setting interest rate levels.

[34] While this study was in press, the Central Bank of Jordan liberalized restrictions and administrative regualtions on foreign exchange transfer and holding.

VIII. FINANCIAL MARKET

Jordan has a relatively well-developed financial market, the Amman Financial Market (AFM). The AFM plays an increasingly important role in the economic life of the country. The financial instruments traded in the market include private company stocks and bonds and government bonds. The bull market during the first half of the 1980s was associated, *inter alia*, with an influx of remittances from Jordanian expatriates. However, following the fall in oil prices during the second half of the 1980s, the volume of remittances declined and a significant portion of the funds invested in the market were also withdrawn. A second surge, nevertheless, was recorded in 1992. This was in line with the marked improvement in the economic and financial performance of the country. The market activity during this period was well above the previously recorded levels. The daily volume of trade averaged around $5 million on several occasions.

The AFM is dominated by banks, mainly commercial ones. It is relatively small in terms of capitalization as well as volume of trade. Until 1995, the AFM was characterized by strict controls over rates of return and administrative allocation of financial resources through the banking sector and specialized public sector financial institutions

Prior to the reform of the financial sector in 1994 and 1995, the financial market was strictly regulated by the Government-controlled Market Issuance Committee. The committee not only undertook thorough research of applicants and their companies' prospectuses, but also set the issue date and the premium to be allowed in the primary market. The formula used by the Committee to weigh book value against market value was considered as an instrument of underpricing shares; therefore, it worked as an obstacle to companies in raising additional funds and making higher profits in the secondary market.

The relatively low ratio of shares traded to shares outstanding, estimated at around 15 per cent in 1995, was attributed, on the one hand, to the substantial government's share portfolio, a significant portion of which was not traded and, on the other hand, to the AFM regulations which forbade company owners to take up more than 10 per cent of the new shares offered by their companies, thus discouraging many of them, reluctant to dilute their shareholdings, from issuing new shares.

Development in the AFM, nevertheless, has been encouraging during the last few years. The level of activities and standards of dealing have improved and the interest of foreign investors in the market has increased. Foreign ownership represents between 15 and 20 per cent of the total equities of quoted companies. Currently, the Government is planning to continue with the reform of rules and regulations of the AFM in order to attract additional foreign investments. The planned privatization of a number of PSEs is expected to be carried out within the context of this reform.

It is worth noting that recently the Government has begun to undertake financial liberalization efforts. These measures are being carried out in anticipation that some of the above-mentioned conditions could have a possible adverse impact on the overall process of intermediation of the financial market, which plays a vital role in the mobilization and allocation of domestic financial resources as well as in the competition for foreign savings. The process includes greater price flexibility of traded instruments, reduction of preferential credit facilities and a move towards indirect monetary control instruments.

The AFM is still confronted with a number of problems, particularly regulatory and constitutional ones. Indications of these problems include inefficiency in offering financial services, a vague definition of property rights, and the shortcomings in liability clearing procedures. However, the AFM still can play a significant role in the planned privatization of PSEs. This role can be in the form of: evaluating stocks of PSEs offered for sale; providing funds necessary for investors in stocks; providing hire-purchase funding

for the small investor; and transforming part of the debt of PSEs into equity shareholding. This will rectify their financial structures and enable the promotion of their shares when they are offered for sale, as well as assisting in the establishment of investment funds to place investors' funds in stock and widening ownership of shares.

In promoting the privatization process, the commercial banks, by virtue of their dominance in the AFM, can buy ailing PSEs and resell them after readjusting their financial and administrative structures. This is expected to accelerate the privatization process, especially for PSEs which cannot be offered for sale through public subscription. The banks can also raise funds for PSEs, through implementing reform programmes for their affiliated companies, as a first step towards privatization. Moreover, the banks, as a means of supporting the privatization process, can expand the margin of their finance mechanisms by developing investment trustee services regarding buying and trading shares.

IX. PRIVATIZATION

Although privatization in Jordan was already considered in the country's first economic structural adjustment programme (1989-1992), it was only in 1994 and 1995, that the Government started undertaking steps aimed at privatizing a number of PSEs. The main reason for this delay was the absence of a social safety net (i.e., a social fund) capable of absorbing the social impact of privatization, particularly on employment.

Except for the sale of parts of Government shareholdings in the Jordan Hotels and Tourism Company, the Government's privatization efforts have been confined to changing the legal form of a number of PSEs into Government-owned companies whose shares, or part of the shares, are to be offered for sale in due time following the restructuring. Prominent among these PSEs have been the Jordan Telecommunications Corporation, the Water Authority, the Public Transportation Company and the Petroleum Authority. In late 1996, the Government established a privatization office at the Prime Minister's Office and appointed a foreign investment bank as the financial advisor responsible for the financial and marketing aspects of the privatization process. The Government also began to look for qualified personnel for the task.

The Government has, nevertheless, completed the commercialization of the Alia Gateway Hotel and Duty Free Shops at Queen Alia International Airport. When the preliminary steps were being undertaken to clear the way for privatizing both the Jordan Telecommunications Corporation and the Public Transportation Company, the Government authorized the private sector to provide complementary services for both PSEs.

The Government has also recognized that the fiscal burden caused by subsidizing PSEs and specific Government services would be a drain on financial resources needed to sustain the impressive economic performance experienced during the last few years. This is particularly true since part of these resources were planned to be in the form of external borrowing, leading to a rise in the external debt of the already heavily-indebted country. In addition, the Government has concluded that, in light of the limited government funding sources for investment in infrastructure, it is necessary to mobilize private financial resources. Privatization, therefore, is considered to be an important vehicle for attracting private sector investment, particularly in infrastructure. In using privatization as a vehicle to accelerate mobilization of resources for investment in infrastructure, the Government has used the following two methods: first, sale of privatization candidates in the utilities sector to strategic, or anchor, investors to bring in immediate revenues for investments in infrastructure; and second, linkage of the sale to mandatory investment requirements, where strategic investors must commit themselves to provide new investments during a specific period of time in order to expand and improve services.

In addition to the economic structural adjustment programme, there are other equally important factors behind the Government's drive for privatization:

- Privatization is expected to reduce the financial burden on the Government budget caused by regular subsidies to PSEs. By releasing scarce financial resources, the Government will be able to increase investment allocations to sectors that directly benefit the poor, such as education, nutrition and health.

- Privatization will improve the efficiency of PSEs, which have not only been performing poorly, but have also been highly resistant to change despite almost continuous reform efforts;

- Privatization will bring in the investment resources needed for the modernization of the public sector.

Considering the government's commitment to restrict public spending and reduce the budget deficit and external debt, privatization is seen as an instrument for consolidating Jordan's public finance. To achieve this result, however, requires that the privatization proceeds be used for retiring the external debt, in order to reduce the debt burden and improve the credit rating of the country. Only in this manner can foreign financial resources be used for investment. The success of privatization efforts will also depend on the proceeds being used for infrastructure investments to reduce fiscal pressures. Converting loss-making PSEs into profit-making PSEs would reduce fiscal drain. In addition, the expected improvement in the performance of privatized PSEs, reflected in a rise in sales and profits, would result in increasing government tax revenues.

The Government, however, has indicated that privatization in Jordan will not necessarily be limited to the sale of assets of PSEs to the private sector, i.e., changing ownership of PSEs, but other methods are also under consideration. For example, the privatization of the Alia Gateway Hotel and the Duty Free Shops at Queen Alia International Airport was carried out through commercialization of the former and corporatization, of the latter.

Finally, privatization in Jordan, as elsewhere, could have symbolic and catalytic benefits. A well-structured privatization effort could send a powerful signal regarding the government's commitment to the private investors and the financial market. It would also allow the government to concentrate its limited financial and managerial resources in areas in which the private sector may be reluctant to invest and in areas in which the social benefits may be high.

Despite all the positive points that have just been discussed, up to now the privatization process has not been smooth. There are, as a recent World Bank report argues, some key issues that still need to be addressed. Below are these issues and the policy action expected: [35]

1. Lack of broad public participation in privatization. To establish such participation, the Government intends to combine sale of shares to a strategic investor with a public share offering;

2. Involvement of foreign investors. There is a concern that privatized PSEs may fall into the hands of foreign investors. This, it is argued, will give control over the PSEs to foreigners, reduce the economic sovereignty of the country and make its economic activities even more vulnerable. To avoid such a development, the Government is expected to require foreign buyers to have local partners. The Government itself also intends also to introduce the so-called "golden shares rule" in order to acquire a voice in the decision-making process of the privatized PSEs.

3. Limited absorptive capacity of the AFM. This, however, is not considered to be a real concern. Subscription in shares of privatization candidates usually takes place at the financial institutions which issue the privatization equities on behalf of the privatization candidates. The only concern in this regard is whether the regulations of the AFM are adequate for adjusting the listing requirements for the concerned candidates.

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[35] World Bank, *Jordan Privatization Note* (December 1995).

4. Labour issues. Although the Government has repeatedly indicated that it would guarantee job security in the privatized PSEs, there is still real public concern about the Government's ability to meet such a guarantee, partly because of the relatively high unemployment rate in Jordan, and partly because it is not certain if buyers would be willing to continue having the privatized PSEs remain substantially overstaffed as before.[36]

To lessen the impact of job security issues on privatization, the government is considering the following options:

(a) Include in selling contracts a "specific" degree of job security for a period of time;

(b) Support employees financially to set up small businesses to provide services to the privatized PSEs on contractual basis;

(c) Establish an "employee share ownership plan" to facilitate employee ownership of the privatized PSEs. This would give the employees incentives to assist in the restructuring efforts of the PSEs.

5. Rise in consumer prices. This is an area where a real concern exists. Since most prices of utilities and services of PSEs are subsidized, the privatization of PSEs may result in raising these prices, at least during the first few years following the privatization. In order to lessen the effect, the Government is considering establishing a regulatory agency that safeguards the interests of the consumers.

6. Non-transparent procedures. This issue, in conjunction with the issues of unemployment, consumer prices and foreign ownership of privatized PSEs, forms the main basis for public resistance to privatization. To make privatization procedures transparent, the Government is considering applying transparency measures applied by other countries in their privatization programmes. These measures include: pre-defined and publicized criteria for pre-qualification; a clearly defined bidding process; hiring of reputable and experienced financial advisors to evaluate and market the privatization candidates and execute the transaction; and execution of a public information campaign to inform the general public of the Government's privatization efforts.

[36] This was estimated at between 20 and 25 per cent in 1996.

PART FOUR
REGIONAL ISSUES, CONCLUSIONS, RECOMMENDATIONS AND ELEMENTS FOR A PLAN OF ACTION

X. REGIONAL ISSUES: IMPACT OF COOPERATION AND HARMONIZATION AMONG THE ESCWA REGION'S FINANCIAL MARKETS ON THE PRIVATIZATION PROCESS[37]

The current lack of integration among ESCWA financial markets is a direct reflection of the unequal development of their legal and administrative regulations, absence of proper regional brokerage intermediation and limited access of non-national investors to a reliable, sufficient and regular flow of information.

Financial intermediation among ESCWA member countries continues to be carried out mainly through international financial markets. Financial intermediation (for example, in foreign exchange) among financial institutions even in the same country, as in the case of Jordan, is carried out through such international financial markets as foreign banks. The major factor limiting intra-regional financial intermediation is the prevailing imbalance between the supply and demand of capital at varying maturity levels.

Demand for capital in ESCWA member countries with more diversified economies is mostly for long-term investment, which produces low rates of return in the early stages of development. In contrast, the supply of capital in the GCC countries is attracted by liquidity and higher rates of return on short-term financial instruments provided by the international financial markets. Financial markets in the ESCWA region, therefore, are not considered capable of bridging this maturity gap.

Another factor constraining financial flows among ESCWA member countries lies in the lack of economic integration and coordination of financial policies among the countries themselves. While some progress has been made in this regard, especially among GCC countries, more is still needed to encourage brokerage intermediation across borders and coordinate overall financial policies.

The protectionist attitudes in most ESCWA member countries tend to be dictated by two main factors: (a) a concern that non-nationals may gain control over the domestic economy or a significant segment of economic activities; (b) a concern that foreign portfolio investments may bring in "hot money" that for whatever reason may suddenly be withdrawn, creating disruption in the domestic financial market.

Among ESCWA member countries which have undertaken economic and financial reforms, Egypt and Jordan seem to have overcome these concerns. This has been acomplished by requiring that boards of directors of privatized companies be composed entirely of nationals and by setting a ceiling on the number of votes by any individual shareholder, as well as by limiting foreign portfolio investments to closed-end or partially closed-end investment trusts, such as country funds.[38] Since these funds cannot be liquidated, foreign investors wishing to withdraw will have to sell their holdings to others on the secondary market.

Foreign direct investment (excluding oil) and portfolio investment flows to ESCWA member countries are among the lowest in the world. Both types of external finance remain constrained by the

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[37] Based on Ahmed Abisourour, "The emerging Arab capital markets: status, role and development prospects, *Financial Policies and Capital Markets, in Arab Countries,* Said El-Naggar, ed, (Washington D.C. International Monetary Fund, 1994).

[38] Country funds are funds that provide opportunities to invest in a diversified portfolio of securities across industries, thereby avoiding the risk associated with direct investments in specific companies. They provide insitutional investors with the opportunities to enter newly emerging markets, where poor corporate disclosure practices and domestic laws make it difficult or costly to invest in alternatives.

prevailing restrictive investment regimes and the absence of well-developed institutional arrangements, including intermediaries, instruments and markets, in most ESCWA member countries. To attract foreign investment, ESCWA member countries will have to make more effort in financial liberalization, economic policy reforms and in institution-building. These are necessary to introduce proper financial intermediation vehicles and new financial instruments.

The main reason why both portfolio equity investment and direct investments remained negligible in ESCWA member countries during the last decades is that equity markets are not sufficiently developed and foreign investments are subject to extensive restrictions. Only during the last few years have a number of ESCWA member countries, notably Egypt and Jordan, begun to open up their markets for portfolio equity investments through country funds because this type of investment is usually tied to economic return and not to ownership objectives.

Cooperation and harmonization among financial markets in the ESCWA region would improve the efficiency of the markets by lowering intermediation costs through economies of scale. They would also open the markets to new sources of funds and increase their ability to hedge against financial risks associated with the exchange and interest rate and with price volatility, provided that the currencies of the respective ESCWA member countries are used as currencies of denomination for traded financial instruments.

However, cooperation and harmonization should be preceded by opening up the financial markets to non-nationals and by establishing a trust-building investment environment. Creation of these conditions, in turn, requires a feasible, liberal and harmonized legal, administrative and institutional framework of financial market rules and regulations. It also requires the presence of efficient financial intermediaries and attractive financial instruments. The latter is particularly important, when country funds exist and the investors can shift from one financial instrument to another, especially stocks of privatized companies.

The current state of cooperation and harmonization among financial markets of ESCWA member countries leaves a lot to be desired. This situation is not the result of a low level of national savings in the member countries, nor is it caused by a low level of demand for financial resources in the region as a whole. It is attributed to the imbalance between demand and supply with respect to types and maturity of available financial resources. With ESCWA financial markets being thin by virtue of their recent creation, and by the fact that investors in the region traditionally prefer liquid or short-term assets to mid-and long-term funding for investment projects, the establishment of close relations among ESCWA financial markets requires development of financial institutions and intermediaries to create a balance between the different investors' preferences. In other words, for cooperation and harmonization among ESCWA financial markets to enhance the privatization process, it is necessary to have the type of financial institutions that are capable of attracting various investors' preferences.

The unsatisfactory state of cooperation and harmonization among ESCWA financial markets, and consequently its discouraging impact on the privatization process, cannot be isolated from the overall state of economic affairs, nor from the political, administrative and judicial rules and regulations in the countries concerned. It is, therefore, useful to note that while some ESCWA member countries with more diversified economies have enacted investment promotion laws, entailing investment incentives, they have simultaneously introduced administrative regulations and legal procedures that effectively obstruct these laws and incentives, consequently hindering the inflow of capital necessary to conclude privatization deals. Moreover, the refusal of most GCC countries to list privatization candidates from other ESCWA countries on their stock markets does not help the privatization process in the ESCWA region. The imposition of restrictions comes at a time when these countries are pursuing a policy of free transfer of capital. The restrictions do not help to further harmonization and cooperation among ESCWA financial market or promote intra-regional capital flows and enhance privatization.

By lifting the restrictions, the savings of citizens in GCC as well as other ESCWA member countries could be directed towards productive investments, especially in member countries undertaking privatization, provided that their investment environment is competitive in every aspect. However, in order to facilitate harmonization and cooperation among ESCWA financial markets, a number of obstacles need to be addressed. These are:

1. Lack of a developed legal and organizational infrastructure. In contrast to the organizational constitution of the primary market, which has developed relatively satisfactorily, the development of the legal constitution still lags behind. The frequent changes in the legal infrastructure and the subsequent amendments introduced are evidence of this. As for the secondary market, this market is either partially or barely organized. Administrative, rather than legal, regulations and procedures determine the processing of the business in this market, thus leaving it legally unprotected. This is a discouraging case, particularly for the non-national investor, who may find himself in such a situation when selling stocks of privatized companies in the secondary market. A market with a satisfactorily developed legal infrastructure would protect such an investor, increase capital flows among ESCWA financial markets, and enhance the privatization process.

2. Narrowness and lack of depth of ESCWA financial markets. The number of financial instruments traded in most ESCWA financial markets is very limited. The major instruments are shares or stocks of public shareholding companies. Another indication of the lack of depth of these markets is that any change in the extent of market business, regardless of volume, usually causes a fluctuation in market prices. An increase in the number of financial instruments, accompanied by the creation of country or trust funds, would encourage non-national investors in countries undertaking privatization to restructure their investment portfolios in favor of buying stocks of privatized companies. Given the issue concerning legal protection in the secondary market, cooperation among ESCWA financial markets would help to expand the process of restructuring investment portfolios and enhance the privatization process.

3. Lack of developed market intermediaries and techniques. In most ESCWA financial markets, financial institutions have not met the expectations set upon them concerning their role as intermediaries between investors and borrowers. Aside from the intermediation and management of new issues during the mid 1970s and early 1980s, most of the new issues made during the last few years could not be satisfactorily placed. This was mainly the result of inefficient methods of offering subscription and marketing the issues. In the secondary market, market-makers are either newcomers with insufficient experience, or do not exist at all. Another factor is the lack of skilled traders and dealers. In almost all the ESCWA region's financial markets, the job of the latter seems to be limited to bringing together buyers and sellers, although it should include offering financial and investment advisory services to potential investors.

There are still other obstacles in addition to the ones mentioned above; for example, the different attitudes of ESCWA member countries towards banking and financial business flows; the unsatisfactory discloure of imformation; unsatisfactorily developed computer-based telecommunication systems; and finally, the rigid demarcation of spheres of activities for financial market institutions and participants. Only by removing these obstacles can cooperation and harmonization among ESCWA financial markets become a serious possibility.

It should be borne in mind that cooperation and harmonization among financial markets usually enhance the privatization process in a gradual manner. However, the fact that financial activities and institutions in ESCWA financial markets are not as sophisticated as those in the international financial markets, should not hinder the drive for cooperation and harmonization. On the contrary, this situation should be an added reason for introducing them, as they will be essential to improve the efficiency of ESCWA financial markets on a regional basis.

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

A. CONCLUSIONS

1. A number of ESCWA member countries have recently embarked on economic reform programmes aimed at enhancing the efficient utilization of economic resources and correcting structural imbalances. These programmes are characterized by increased reliance on market mechanisms, strengthening of the private sector and reducing control of the public sector on economic activity.

2. The economic reform programmes implemented by ESCWA member countries are closely linked to enhancing the role of the private sector in economic activity while minimizing public sector domination in a bid to promote more efficient and rational use of economic resources. However, it is obvious that one of the major constraints on the drive to liberalize economies of most ESCWA member countries lies in the absence of well-developed financial markets. The role of these markets would be to broaden the base of property ownership and accelerate the transfer of this ownership to the private sector, while privatization, in turn, would boost the development of these markets.

3. It should be recognized that both the structural deficiencies of financial intermediaries in ESCWA financial markets—where the role of the intermediaries would be to underwrite and promote share issues of privatization companies—and the absence of market-making institutions, make it necessary for the banking sector to assume major responsibility for ensuring the success of economic reform, sustaining the privatization process and developing financial markets. The role of the banking sector, therefore, should not be limited to one country, but should cover the entire ESCWA region. This would bring ESCWA economies closer together and establish links between individual ESCWA financial markets, with the ultimate objective of creating a single ESCWA financial market within the framework of a viable and competitive economic bloc, in line with the global trend towards economic integration.

4. The privatization process in the ESCWA region is an endeavour new to most member countries. It has been largely prompted by the poor performance of the public sector. It has gained acceptance as a necessary corrective measure following the serious deterioration of the economic environment in the region in the mid-1980s. Developing countries, including ESCWA member countries, were confronted with a number of economic problems, including falling export prices, declining terms of trade, rising international nominal as well as real interest rates, contracting financial flows, mounting external debt burden and increasing protectionism, particularly by the developed countries. These problems, in combination, led to major domestic and external imbalances and to a slowdown of economic growth.

5. With the banking sector dominating the activities in the financial markets of ESCWA member countries, its role in the privatization process, and the role of the financial markets themselves, could be summarized as follows:

(a) To take part in feasibility studies, valuation and promotion of PSEs scheduled for privatization;

(b) To participate effectively in redressing financial imbalances and restructuring of PSEs to rehabilitate them for privatization;

(c) To act as financial advisors to investors willing to buy assets or shares of PSEs offered for public subscription;

(d) To create windows of opportunity for financing to provide credit to small investors wishing to become shareholders in privatized PSEs;

(e) To act as a catalyst in attracting foreign investors to buy in privatized PSEs, for example through bank acquisition of shares offered for public subscription.

6. ESCWA financial markets are not yet sufficiently developed to play the above-mentioned role effectively, intermediating reasonably between the supply and demand of financial resources; in other words, establishing a financial balance at different levels of maturity. ESCWA markets have had their own experiences in their drive to achieve the objectives for which they were established. In implementing their duties, however, they appear to have a number of characteristics in common. These include: a modest volume of trade; a lack of specialization; a lack of efficient intermediation; a limited number of financial instruments; the inability to attract government funds; and finally, an unsatisfactory legal, administrative and institutional framework and infrastructure.

7. If financial markets in ESCWA member countries are expected to play a significant role in the ongoing privatization process, particularly on a regional level, efficient financial institutions and intermediaries capable of creating a balance between investors' preferences and borrowers' needs are required. In other words, to increase capital flows among ESCWA financial markets and enhance regional participation in the privatization process, the financial markets must be made capable of changing available financial resources in the region into long-term financial resources based on the competitive terms of the market. Moreover, stock markets and company laws need to be clarified and overhauled; share transfer procedures need to be simplified; distortions arising from differentiated tax treatment of financial instruments need to be reduced. There is also need for a comprehensive review of factors affecting access of non-nationals to individual financial markets.

8. The conclusions of the two case-studies on the role of the financial markets in privatization in Egypt and Jordan have shown that this role is not totally different from their role elsewhere in the developing countries. Being still in their early stages of development and having a number of weaknesses, financial markets in both countries are not expected, at least in the short-term, to be fully capable of playing the role envisaged for them in privatization, such as facilitating proper equity valuation and offering a channel for widespread distribution and subsequent trading of claims. Until then, Governments of both countries may, in some cases, overlook these weaknesses in spite of eventual public resistance, although public offering would be more viable.

9. Privatization in both Egypt and Jordan is basically a public policy pursued by the Governments for their own purposes and not through an initiative of the private sector itself. If the private sector is benefiting from privatization, it is not because of its own merits but mainly because the Governments of both countries have become convinced that, in light of their chronic fiscal deficits, they no longer can continue their economic welfare policies.

B. RECOMMENDATIONS AND ELEMENTS FOR A PLAN OF ACTION

The following measures are proposed:

1. Implement economic and financial sector reforms directed at establishing conditions favourable for the development of financial markets and the growth and development of private sector enterprises. This is because there is increasing recognition of the beneficial role of the financial markets in privatization. The creation of these favourable conditions would entail improving the business environment

and establishing adequate legal, administrative and institutional structures for rules and regulations, similar to those of market-oriented economies.

2. Enhance the responsiveness of market participants, particularly the investors, to the role of financial markets in privatization. To enhance supply and demand of equities in the financial market, specific policy measures should be undertaken, aimed at setting prices of shares at a level affordable to the small investor, creating conditions of clear property rights, and implementing transparent trading and pricing mechanisms.

3. Lower barriers to capital movements and harmonize financial and commercial regulations and standards. The small size and fragmentation of ESCWA financial markets make it difficult for any one country in the ESCWA region to develop a diversified financial market of reasonable depth. Cooperation among ESCWA financial markets, therefore, should be enhanced, with a view towards the integration which would bring benefits in terms of greater scale, sophistication, expertise and links to wider markets.

4. Enhance cooperation among ESCWA financial markets through the establishment of regional intermediaries and market-making financial institutions. The former would intermediate between investors and borrowers in establishing a balance between the supply and demand of capital at varying maturities. They would also assist in the listing and public offering of shares of privatized companies. The latter would assume the regional risk of marketing the shares and other securities issued by these and other companies. Both organizations would facilitate the role of financial markets in privatization.

5. Encourage the role of investment banks in developing financial markets, consequently enhancing privatization. Investment banks are an important constituent of financial markets. They are intermediaries in locating and collecting investment funds. They are also major players in the development of financial markets, bringing new securities to the market, arranging private placements, providing fund management and performing corporate advisory services, particularly for privatization candidates.

6. Lift those existing regulations and restrictions which impede the entry of foreign investors into the region's financial markets. Demand for shares of privatization companies could be raised by encouraging foreign portfolio investment. The concern that foreign portfolio investments reflect volatile flows of money and increased foreign control of the economy could be met by such means as closed-end country funds, whose shares can be traded but not redeemed.

7. Introduce regulatory frameworks to provide for accurate and adequate disclosure of information on privatized companies, set procedures for listing and public offering, and curtail improper activities such as insider trading. These regulations would increase investors' confidence in shares and securities of privatization companies in ESCWA member countries.

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