Bolstering Financial Stability and Development in Arab Transition Countries

October 1, 2014
Blog originally published in Arabic on the Economic Window

Financial systems in the Arab Countries in Transition (ACTs)—Egypt, Jordan, Libya, Morocco, Tunisia, and Yemen—could gain significantly from reforms that foster financial stability and development.

Like in many other countries across the Middle East and North Africa (MENA), banks in the ACTs dominate the financial system. Competition among banks is limited while state ownership of banks is significant in many cases. Bank credit is highly concentrated in a few large and well-connected borrowers. In some countries, nonperforming loans (NPLs) are at elevated levels. In addition, the non-bank financial sector remains underdeveloped and access to finance for most people and firms remains very limited.

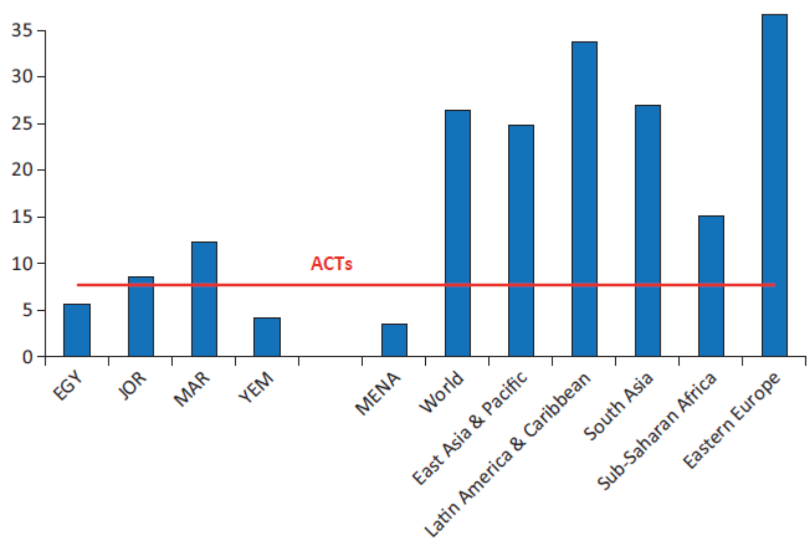
The IMF's paper titled **"Toward New Horizons—Arab Economic Transformation amid Political Transitions,"** lays out key elements of economic policy reforms for the ACTs. This post highlights policy reforms needed to lay the foundations for financial stability and development.

Structural impediments…

The ACTs compare well with other regions in the world in the size of financial intermediation, as measured by credit to the private sector over GDP, except for Libya and Yemen.

Nonetheless, **lack of access to finance** is a major constraint for firms and households. Only 7 percent of firms use banks to finance investment, by far the lowest share among the world's regions (Figure 1). More than 30 percent of firms identify access to finance as a major constraint, a higher percentage than in all other regions except sub-Saharan Africa. In some ACTs, only a small share of adults has bank accounts.

Few Firms Use Bank Credit to Finance Investments
(Percent of firms using banks to finance investments, latest year available)



Source: World Bank Enterprise Surveys.

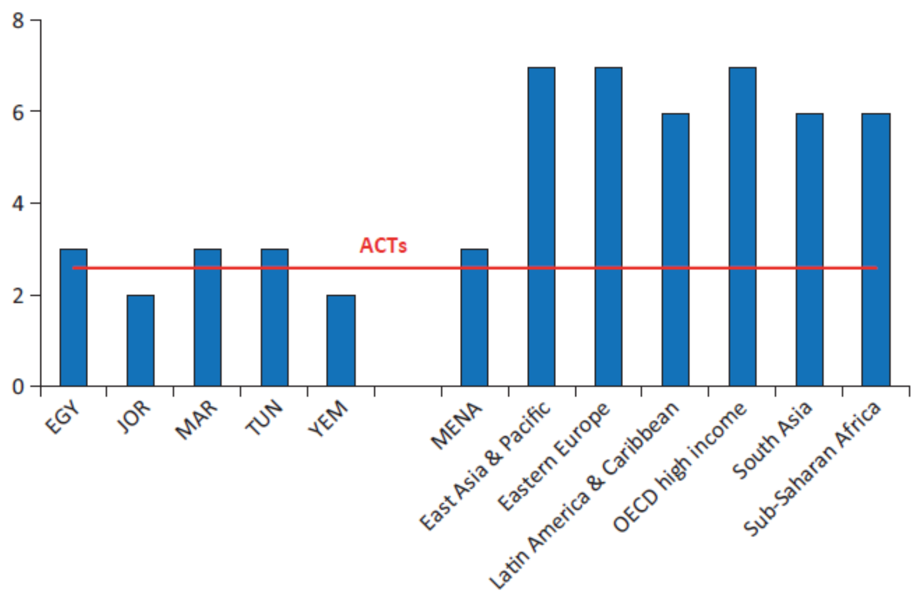
This low access to finance has been the result of a variety of factors, including poor financial infrastructure, weak banking competition, connected lending, and underdevelopment of the non-bank financial sector.

In addition, many banking systems in the ACTs suffer from **elevated non-performing loans** (NPLs). High NPLs can hamper the ability of banks to extend new loans and can thus be a drag on economic growth. Poor risk management in banks, combined with weak financial infrastructures, have resulted in a higher ratio of NPLs compared to other regions. In some countries, it is also the result of a history of connected lending between state-owned banks and state-owned enterprises. The economic downturn in the context of political transitions also played a role.

Furthermore, the **financial infrastructure** in the ACTs is weak. The ACTs still depend on traditional public credit registries, and even the countries that have introduced private credit bureaus are lagging behind other regions in coverage and quality of information. Credit bureaus can help banks in reducing credit losses and increase access to credit.

Besides, the ACTs have severe **weaknesses in protecting creditors' rights**: the region ranks last in the area of credit rights as measured by the legal rights index of the World Bank's Doing Business indicators (Figure 2). Insolvency regimes suffer from the lack of efficient exit mechanisms and protection for secured creditors. Improvements in this area can reduce creditor risks and unblocks lending to SMEs and consumers.

ACTs Rank Last in Legal Rights
(Strength of legal rights, latest year available; 0–10)



Source: World Bank, Doing Business.

Also, **bank competition is lower** than in most emerging market regions. The ACTs have the largest bank concentration in the world (as measured by the share in total assets of the three largest banks in each country), stifling competition.

Non-bank financial sectors remain underdeveloped in most ACTs. The non-bank financial sector consists mainly of government bond markets and equities, with little presence of corporate bond issuance. Stock markets in some ACTs are large but have limited trading volume. Encouraging firms to use capital markets for their financing needs would free up lending capacity in banks and could lead them to focus more on lending to SMEs.

…call for bold reforms

In light of these trends and structural impediments, the ACTs need a bold agenda for financial development and stability. Starting points and reform needs vary across countries, but there are a number of common areas for reform.

- There is a clear need to expand **access to finance**, particularly for SMEs, to enable entrepreneurial activity and spur job-creating growth. Important steps include strengthening the financial infrastructure, such as improving credit information systems and collateral regimes, and reforming insolvency regimes. Strengthening competition among banks will also be important, to create better incentives for them to expand their lending. Introducing new technologies such as mobile banking, improving the financial literacy especially among SMEs, and ensuring consumer protection will also boost financial inclusion.

- Countries also need to develop **alternatives to bank finance**. This will further their economic development and, in countries where bank financing for the public sector limits the availability of private sector credit, can help address a key bottleneck. To that end, ACTs should develop strategies for (i) deepening local bond markets and catalyzing private issuance; (ii) expanding the institutional investor base, including the pension and insurance industries; (iii) developing alternative instruments to bank financing, such as leasing and factoring, venture capital and private equity; and (iv) promoting microfinance.

- Fostering **Islamic finance** will contribute to the inclusion of wider segments of the population in the financial system, and thus help to build a more inclusive economic model. In some countries, Islamic banks are evolving rapidly in the variety, distribution, and operational complexity of their products, to meet the challenges of Shari'a compliance and competition. To support sound market growth and guard against potential financial stability risks, policymakers are advised to develop comprehensive regulatory and supervisory frameworks for Islamic finance products. It will also be important to guard against market fragmentation with too many instruments, given generally thin instrument liquidity and a narrow investor base in most ACTs.

- Finally, continued improvements to systems that safeguard **financial stability** are needed to ensure stable economic conditions for growth and job creation. There are four main areas in which the ACTs can enact improvements: macroprudential regulation and supervision, financial safety nets and crisis management systems, microprudential regulation and supervision, and bank corporate governance rules.

The rewards of successful reform can be significant. Empirical estimates show that raising access to finance can increase per capita GDP growth. Financial development and stability can also significantly reduce income inequality and poverty, and potential gains in these areas are much larger in the ACTs than in other regions in the world.