MENA-OECD
INVESTMENT
PROGRAMME

CHALLENGES FOR REFORM OF FINANCIAL MARKETS IN MENA COUNTRIES

- Working Group 4 -

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TABLE OF CONTENTS

INTRODUCTION 3

I. BACKGROUND 4

II. FINANCIAL MODERNISATION IN NON-OECD COUNTRIES AND THE OECD OUTREACH EFFORT 7

III. CHALLENGES OF FINANCIAL REFORM IN THE MENA REGION 9

- Description of the Financial System 9
- Situation in the Capital Markets 10

IV. PROPOSED OECD MENA PROGRAMME FOR 2006-2007 18

- Fixed Income Markets 18
- Equity Markets Programme 19
- Integration of Capital Markets in MENA 20
- Equity Financing for Enterprise Creation and Enterprise Modernization 20

ANNEX: RESTRICTIONS ON PURCHASE OF DOMESTIC SHARES BY NON-RESIDENTS IN MENA COUNTRIES 24

REFERENCES 28

INTRODUCTION

1. At the Meeting of Working Party 4 of the MENA-OECD Investment Programme in Jeddah in February 2005, it was decided that preparation for the Ministerial Meeting in Jordan should focus on developing a work programme covering the period 2006-2007. It was also decided to establish a Task Force to take stock of the current situation and develop proposals for action to be submitted to the Ministerial meeting. Moreover, concerning Output 2 (The Development of the Financial System), it was decided that future work would concentrate on capital markets. Within this broad heading, four areas were designated as having the highest priority:

- fixed income markets;
- reform of the overall institutional, legal and regulatory framework for capital markets;
- the development of integrated regional markets, including regional platforms for equity trading, and
- finance for smaller dynamic and entrepreneurial firms.
- It was also decided to establish a Task Force to take stock of the current situation and develop proposals for action to be submitted to the Ministerial meeting in autumn 2005.

2. In ensuing months, the OECD Secretariat has consulted with MENA countries and other international organisations in order to formulate a programme that meets the needs of MENA countries and in order to avoid duplication with other ongoing work. Thus, a brief meeting of some members of the task force was held in Abu Dhabi in May 2005 where options for future work were considered.

3. This report outlines a substantive proposal for the content of the work programme which has been considered at the Meeting of Working Group 4 in September 2005. It is intended to serve as a basis for a first set of proposed recommendations that will be submitted at the MENA Ministerial Meeting in February 2006. The specific proposals are elaborated in section IV of this report. As a background to those proposals, this document addresses the following questions:

(i) What have been the salient characteristics of the transformation of global financial systems that have occurred in the past two decades and how has the OECD participated in the process of transformation?

(ii) How has the OECD interacted with non-Member countries concerning financial reform?

(iii) What has been the record of the MENA countries with respect to financial reform and what are the priorities for reform at this time?

I. BACKGROUND: REFORM OF THE FINANCIAL SECTOR IN THE 1980S AND 1990S AND THE ROLE OF THE OECD

4. In the past two decades, economic analysts and policy makers have increasingly recognised that the financial system can make a significant contribution to economic growth, productivity and employment creation. Well functioning financial markets promote efficiency in allocating investment and enhance productivity by a) identifying promising projects and firms, b) fostering good corporate governance, c) facilitating the mobilisation of domestic savings, and e) protecting against possible systemic shocks. Observing the changes that have taken place in the past 25 years, a consensus has emerged that a deregulated financial sector operating in a competitive, open environment with market-based supervision grounded in international norms, is optimal contribution for economic development.

5. The new market-based paradigm for the design of financial systems contrasts with earlier thinking about the proper role for official intervention in the financial system. In the past, financial institutions, particularly banks, were considered "special" entities in which it was appropriate for governments to intervene regularly in pursuit of a wide range of economic and social objectives. Among these objectives were support of industrial policy, maintenance of employment, development of local communities, and assistance to the government in financing its debts.

6. In earlier times, the financial sector tended to be strongly differentiated among countries and to be heavily influenced by national legislation. Institutional arrangements varied widely with some countries, such as the United States and Japan enforcing strict institutional separation between banking and securities business, while other countries such as Germany followed a model of universal banking. Many countries discriminated against foreign institutions seeking to become established in their markets and imposed restrictions on cross border operations.

7. Heavy official intervention to favour certain groups or activities often operated to the detriment of less favoured market participants. The saving/investing public was obliged to accept lesser returns on assets, and had a relatively narrow range of investment choices. Sectors that did not gain the explicit backing of the authorities often lacked access to finance. In addition, this pattern did not encourage financial institutions to develop strong risk management systems or to observe strict prudential norms. Arguably, the limitation of risk by official prohibition and detailed regulation often contributed to destabilisation of the financial system, especially if countries subsequently decided to liberalise.

8. Over the past two decades, the world financial system has seen a fundamental restructuring as well as a change in the accepted doctrine regarding the role of the state in the financial sector. To some degree this reflects the broader trend of deregulation and regulatory reform sweeping the OECD countries, but it also reflects some sector-specific concerns. The financial system has moved from being a component of the economy that was most constrained by national laws and regulatory restrictions to one that is global and market-driven. Some of the defining trends characterising the transformation of financial system are described in the following paragraphs.

9. **Deregulation.** In all OECD countries, financial institutions have been given increased freedom to develop products, to set their own prices, to solicit business and to assume risk. Most of the old regulations that sharply segmented the markets into banking, securities and insurance sectors have been lifted and financial institutions are now free to offer the combination of financial services that best satisfies client demands. Financial institutions now devise products and services with those that are in direct

competition with those offered by other kinds of financial institutions. As a very simple example, money market mutual funds have displaced bank deposits as a means of holding liquid assets in many countries.

10. **Financial innovation.** New financial products have been developed that have enabled savers and investors to enhance returns and acquire assets that meet their risk/return objectives. Investors increasingly utilize products that were previously prohibited or only available to sophisticated institutions. Some of the financial innovations that have emerged and/or gained prominence in the past two decades are off balance sheet facilities, derivatives, asset-backed and mortgage-backed securities, hedge funds and private equity.

11. **Advances in Technology.** The application of information and communication technology, including the use of the Internet, has played a pivotal role in the transformation of finance. Virtually every aspect of finance - beginning with the way savers and consumers interact with financial intermediaries - has undergone changes. Inside each intermediary, back office work has been automated, enabling firms to increase the number of transactions handled exponentially, while cutting costs drastically. Consumers routinely use telephone and internet banking. Technology has transformed securities trading, leading to the elimination of most trading floors and making it possible for alternative trading systems to challenge traditional exchanges.

12. **Securitization/Disintermediation.** Increasingly, financial intermediation is taking place through the capital markets, rather than through on-balance sheet lending by banks. Even traditional commercial banks have been de-emphasising lending and increasing their capital markets operations. This is true both in hitherto bank-based systems such as Germany and capital market-based systems such as the United States.

13. **Privatisation.** In countries where significant shares of banks were owned by public sector entities, ownership has been transferred to private hands.

14. **Institutionalisation of Asset Holding.** To an ever greater degree, the public has been holding assets in the form of institutional saving, rather than bank deposits. Institutional savings include pension funds, collective investment schemes (i.e., mutual funds, unit trust etc.) and insurance. Consequently, a large share of financial assets is managed by money managers with a high degree of professionalism who compete to achieve the best possible investment results using the latest available techniques of portfolio management.

15. **Liberalisation.** Restrictions on the establishment and operations of foreign financial institutions have been removed, as have restrictions on international capital movements.

16. **Internationalisation.** Finance is now a global business with major institutions operating in several markets. Securities trading moves among centres around the globe. Cross border and multicurrency business is commonplace. International competition is promoting a convergence of products and institutional structures across countries.

17. Overall, assessment of this financial system is highly positive. It is broadly agreed among OECD countries that the reformed system of finance that relies on market mechanisms is better able than its predecessors to meet the challenges such as technological advance, employment creation, the financing of innovation and provision of retirement income. Thus, the OECD Jobs Strategy, a major template for promoting competitiveness in domestic economies and in generating employment, typically recommends reforms in the financial system to enable economies to meet the challenge of employment creation. Following this trend, a proposed recommendation to MENA countries' regulators of financial markets could be:

18. One consequence of the open market-based financial system has been a heightened level of systemic strain. During the period of financial modernisation, a series of crises in banking systems and capital markets has occurred that has obliged those responsible for financial institutions and financial market supervisors to improve their techniques for market supervision. This is especially important since government rescues of banking systems have been costly and financial crises have resulted in high costs that must be borne by the general population in terms of government expenditure such as losses of income, employment and savings. In response to these challenges, national supervisors have been working to improve techniques for market supervision. Meanwhile, efforts to agree on global standards, share best practices and to improve international communication and coordination among supervisors have advanced considerably.

19. It should be emphasized that the fact that financial modernisation has been accompanied by increased systemic instability does not mean that systemic risk can be reduced by avoiding liberalisation or deregulation. Countries that have failed to modernise have proven to be at least as prone to systemic instability as those who have reformed. Nevertheless, the heightened risk in the modern global financial system highlights the need for balanced reforms and for proper sequencing of reform.

20. With liberalisation and more reliance on market forces in recent years, a change has taken place in the paradigm under which financial institutions operate. This, in turn, implies a new relationship between the financial officials and the institutions for which they were responsible. In place of the older systems under which financial institutions were subjected to a very detailed regulation and were expected to meet a wide rage of economic and social goals, financial institutions today are basically expected to be held accountable for meeting a smaller number of objectives, especially 1) to earn adequate rates of return 2) to observe high prudential standards and 3) to act in the interests of parties to whom they owe fiduciary duties, especially depositors. In order to earn a competitive rate of return, the institution is expected to develop products to meet customer needs, while observing high standards of risk management.

21. Previously, the authorities controlled the risks that financial institutions assumed and often sought to limit risk by prohibiting certain products or techniques. Under the new paradigm, the process of oversight of financial institutions consists of four elements: 1) risk management procedures and governance systems within the institution, 2) industry and SRO codes, standards and best practices, 3) prudential oversight by the supervisory authorities inside an established legal framework, and 4) surveillance by the market. As a result, each institution has an increased need to **strengthen in-house governance systems** in order to focus the institution, mitigate conflicts of interest and control risk. The in-house governance regime includes robust risk management systems, transparent disclosure practices, strong internal compliance functions to assure that standards are observed and effective oversight by boards and auditors. There is significant evidence that this change in financial supervision and in the internal governance of banks has resulted in more robust financial intermediaries, able to manage risk more effectively than in the past.

22. The OECD has been at the epicentre of this process of momentous change over the past two decades. OECD committees and working parties form part of a global network through which officials from the major national financial markets, offshore centres and international organisations communicate regularly. OECD has also coordinated its work with other international organisations such as the IMF, the World Bank, the Basle Committee and IOSCO. In addition, the OECD participates in the Financial Stability Forum (FSF), which brings together experts from central banks, financial supervisors and international organizations with the task of identifying possible vulnerabilities in the financial system and recommending reforms and deciding on the allocation of tasks. The OECD has taken an active role in disseminating best practices by its analytic work, which is often of a comparative nature.

23. The OECD has been a strong advocate of liberalisation. Through its Codes of Liberalisation and other instruments, the OECD has actively promoted the removal of exchange restrictions and the opening of domestic markets of its Members to competition and strongly advocates national treatment for foreign financial institutions.

II. FINANCIAL MODERNISATION IN NON-OECD COUNTRIES AND THE OECD OUTREACH EFFORT

24. To a considerable degree, non-OECD countries have followed the pattern of financial modernisation as described above, but the transformation has been slower and less complete. In addition to the pattern of pervasive official intervention in financial markets prevalent in the OECD countries, many emerging markets pursued policies that further reduced the scope for market forces. Financial intermediation tended to be dominated by banks, and a large share of banks was government owned and/or controlled. In addition, many private financial institutions were "captured" by governments or allied with industrial groups, which and used them either to advance objectives of national industrial policy or the particular interests of owners of industrial/ financial groups. In many countries, extensive intervention and distortion of relative prices led to "financial repression" that rendered the financial system incapable of allocating resources according to market criteria.

25. On balance, consensus on the need to liberalise has been slower to come about in emerging markets. Nevertheless, modernisation has advanced significantly. Policy makers in emerging markets gradually began to conclude that excessive state intervention, protected markets and distorted prices generally were hindrances to development. Efforts to accelerate development of financial systems through deregulation, liberalisation of controls and opening of markets to foreign competition remain key ingredients of reform.

26. Increasingly, the OECD has seen it as part of its mission to communicate its ideas about the proper framework for policy with non-Members and to enable non-Members to benefit from the collective experience of OECD countries. Since the late 1980s, the OECD devoted appreciable efforts to Outreach programmes, aimed at engaging in policy dialogue with non-Members and providing assistance regarding issues of common concern. Outreach efforts have encompassed the financial sector as well as other sectors. These relationships have evolved considerably, with some Outreach partners eventually becoming Members of the OECD or permanent observers in OECD committees. Some significant developments in Outreach programmes related to the financial sector are summarised in the following paragraphs.

27. Contact with non-Members initially involved the dynamic Asian economies, sometimes known as the "Tiger" economies. In view of the impressive performance of these economies in world production, trade and finance, the need to engage in dialogue was urgent. In these countries, financial modernisation tended to lag behind the impressive progress in their production and trade. Many policy makers clung to their older model of growth which involved a heavy dose of state intervention, mainly to channel resources to export industries. Additionally, many of these countries had rather protectionist views about market access for foreign financial institutions. Accordingly, they had initially expressed scepticism about the market based approach to economic reform advocated by the OECD. However, in the late 1990s, several Asian economies pursued unsustainably high growth programmes, ran large current account deficits and borrowed excessively abroad—especially on short term, with the result being the Asian financial crisis of

1997. Other countries, such as China, escaped the direct consequences of the crisis but were impressed alarmed by the vulnerabilities of a fragile financial system that the crisis had exposed.

28. One of the lessons that Asian countries have drawn from the crisis is that domestic financial systems should be reformed on the basis of internationally accepted norms and best practices. Improved supervision based on global standards and principles as well as a diversification of domestic financial systems away from reliance on banks and towards capital markets have been made part of reform programmes in all Asian economies. The OECD Outreach Programme has expanded to include all major economies in Asia, including China, Indonesia and India.

29. Following the onset of the systemic transition in Central and Eastern Europe, OECD contact with non-members proliferated and the OECD accelerated its efforts to facilitate the transformation of financial systems. In general, the most rapidly progressing transition economies immediately saw the need to support the systemic transition by introducing institutional, legal, and regulatory structures modelled on those existing in most advanced countries as adapted to local conditions. Policy dialogue and technical assistance spanned a wide range of issues, including bank privatization, rehabilitation strategies for disposal of non-performing loans and development of capital markets. Significant work was also done on related sectors such as pensions and insurance as well as reform of legal regimes, privatisation and corporate governance. It is fair to say OECD policy dialogue with transition economies made a valuable contribution to the systemic transformation in Central and Eastern Europe. Significant work has also been done with Latin American countries. Under the MENA-OECD Investment Programme, the OECD's outreach programme which has been thriving since the late 1980s has been expanded to include the countries of the MENA region.

30. There are persuasive reasons to believe that the experience of OECD countries will prove relevant to MENA countries as it has to other non-Members. Many MENA countries have large and growing populations, scarcity of domestic savings and an urgent need to generate employment. The general set of policy prescription concerning reform of the financial sector, which have proven useful to other emerging markets should also be highly relevant to those MENA countries facing basic development challenges. Other MENA countries have special characteristics such as small populations, high oil revenue, limited domestic diversification and foreign exchange revenues in excess of current needs. Two specific observations can be made about these countries:

1) As with other MENA countries and indeed all emerging markets, a market-based system incorporating international best practices can advance this objective. Given the range of experience of OECD countries and its framework for multilateral policy dialogue, it can make a unique contribution to financial reform. This multilateral network for dialogue will operate alongside many of the existing financial reform programmes operating under the auspices of other international organisations.
2) The OECD has a reserve of experience that address the particular needs of countries that experience windfall gains from favourable global trends, that aspire to be international financial centres and that seek to achieve economic diversification.

Recommendation 1: Modernise the financial system to meet the challenge of employment creation and technological advance. Broaden the range of financial services and products that are available. Align supervisory practices with global standards. In keeping with the worldwide trend of deregulation and liberalisation, allow individual institutions to innovate and take risk as their capabilities increase. Encourage competition on regional and global levels. Provide national treatment to foreign participants in domestic markets.

III. CHALLENGES OF FINANCIAL REFORM IN THE MENA REGION

Description of the Financial System

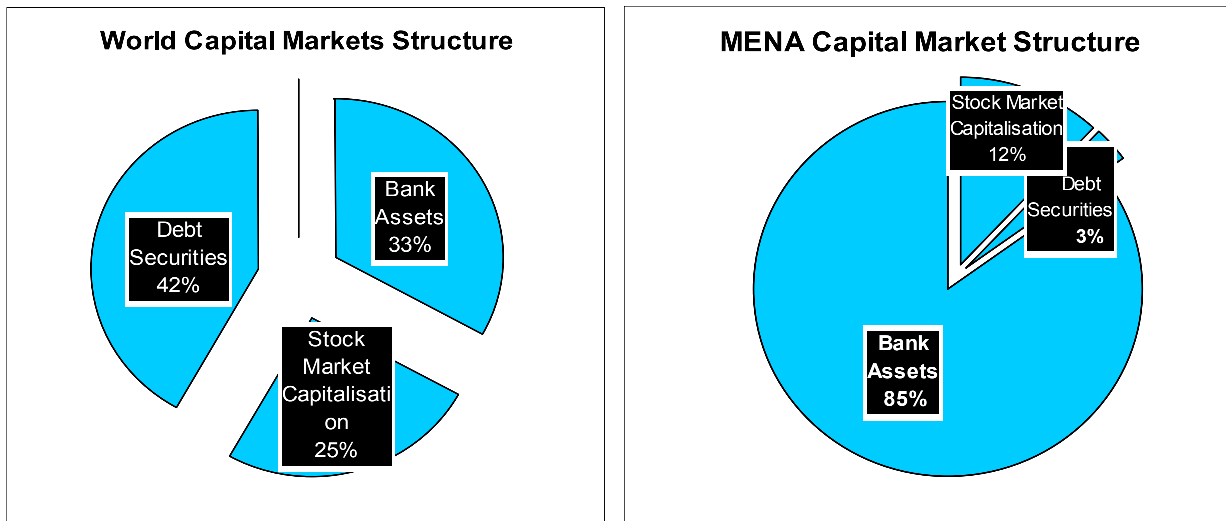
31. Despite considerable diversity among MENA countries, some broad generalisations can be made. In the first place, there is a striking imbalance between the large amounts of savings that have accumulated in certain MENA countries and the rather early stage of development of the financial markets. Numerous studies have concluded that the MENA region lags behind other major regions in terms of financial development, which in turn has made it more difficult to attain the objectives of economic diversification and employment creation. Moreover, while the level of development of financial markets in the MENA region was comparable to that of other emerging areas in the early 1980s, the gap has widened in ensuing years. A recent study by the IMF using various measures of financial development found that all other regions of the world except sub Saharan Africa, had achieved higher rates of financial development in the past two decades than the MENA region.

32. Although Gulf oil exporters accumulated very large amount of assets at various times in past decades, limited domestic opportunities for investment in markets and the lack of financial systems capable of deploying those funds within the region, have meant that oil-related surpluses have often been placed with financial intermediaries based in OECD countries and invested offshore. One measure of mobilisation of financial assets is that bank assets and stock market capitalization account for relatively low shares of GDP. (There are exceptions. Some of the Gulf States that aspire to become international financial centres have high ratios of financial assets to GDP and Jordan also has a rather high degree of financial intermediation.)

33. Some of the symptoms of lagging development are the tendency to export capital for investment to other areas of the world while pressing economic needs within the region are unmet. Similarly, the small and medium enterprise (SME) sector has in many countries have not been able to realise its potential, particularly its potential to generate employment, partly due to the lack of appropriate financing. The IMF report calls for reduced government intervention in credit allocation, strengthened institutional and regulatory quality, enhancement of financial skills and reduced public ownership of financial institutions. Similarly, a report by analysts at the World Bank notes that financial intermediation has been transformed by technology, innovation and liberalisation and that MENA countries face serious challenges in adapting to the new highly competitive environment. Another recent research study by IMF staff identified four main factors that underlie lagging financial performance in MENA countries a) excessively large government sectors, b) weak institutions, c) underdeveloped financial sectors, and d) inefficient investment.

34. Beyond the low aggregate rates of financial intermediation, the concentration of financial intermediation in the banking sector is an additional challenge. It is widely seen as desirable to have balance among the three possible sources of financing a) bank credits, 2) bonds, and 3) equity. However, the financial systems of MENA countries are more heavily bank oriented than in any other world region. In the Global Financial Stability Report of 2004, the IMF estimates that bank credit amounted to 33% of worldwide financial assets. Bank assets accounted for 85% of financial assets in the MENA countries, compared to 48% in emerging Asian countries, 41% in Emerging Europe and 35% in Latin America.

Figure 1 - Capital Markets Structure: World/MENA



Source: IMF Global Financial Stability Report, September 2004.

35. In most MENA countries government ownership of banks is pervasive. Moreover, the private sector receives a lower share of bank credit than in other emerging areas, and bank credit is skewed toward shorter term lending, with more than half of all credits having maturities of less than one year. Partly owing to the prevalence of government ownership and reliance on guarantees for loans, many banks have not developed a sophisticated credit approach, and thus may have concealed problems of non-performing assets. In essence, privatization of banks, modernisation of the legal and regulatory environment and fuller integration into the global financial system represent long term solutions.

Recommendation 2: Modernise the legal and regulatory financial environment and promote fuller integration into the global financial system. Upgrade bank governance practices through increased transparency and accountability while fostering privatisation of banks. Diversify financial systems away from excess dependence upon banks.

Situation in the Capital Markets

36. As noted previously, the Working Group 4 has decided to focus its efforts on the capital markets. This decision partly reflects the need to enhance the ability of capital markets in MENA countries to engage in intermediation and in order to diminish the present excessive dependence on bank lending. In addition, large amounts of assets are accumulating in MENA countries and a large share of those assets is likely to be invested in the MENA region than in the past. Yet, since the region has one of the least advanced capital markets in the world, it is not well equipped to deploy these inflows efficiently.

37. Most analysts see the fixed income market as the cornerstone of the capital market. By offering a risk-free highly liquid “benchmark”, this market provides a basis for pricing other assets with a higher risk of non- payment as less liquidity. In MENA, the share of fixed income assets in GDP is the lowest in any world region. Fixed income assets accounted for 4% of GDP in MENA, against 6% in Asia, 12% in

emerging Europe and 16% in Latin America. Bond financing is heavily tilted toward government debt, with sovereign issues accounting for 82% of all issues, which is higher than any other region in the world. Conversely, financial institutions and non-financial corporations account for less of the total issuance than in any other world region. There are also serious shortcomings in the government debt market, such as incomplete yield curves, lack of hedging instruments and a broad investor base. Due to scarcity of fixed income assets and lack of active traders, most bond issues are quickly bought by long term investors, with little secondary trading. With booming oil revenues, government bond issuance is likely to diminish, causing a contraction in the supply of government debt. Thus, the pool of investible assets may well contract in the face of rising revenue.

Table 1 - Non-banks Capital Markets: Fixed Income- Size and Distribution

International Bonds Outstanding (End 2003)

	Sovereign (in $ bln)	**Corporate** (in $ bln)	**Financial** (in $ bln)	**Total** (in $ bln)	**Share** (in %)	**% of GDP** (in %)
MENA	**23.8**	**1.2**	**4**	**29.0**	**4.8**	**3.9**
Africa	8.5	3.5	4.1	16.1	2.7	7.4
Emerging Europe	80	10.4	16	106.4	17.6	11.7
Asia	34.1	55.6	77.8	167.5	27.7	5.9
Latin America	185	43.3	57.8	286.1	47.3	16.0
Total	331.4	114	159.7	605.1	100	10.0

Source: BIS.

Table 2 - Non-banks Capital Markets: Fixed Income- Size and Distribution

International Bonds Outstanding by Sector (in percent) (End 2003)

	Sovereign	**Corporate**	**Financial**	**Total**
MENA	**82**	**4**	**14**	**100**
Africa	53	22	35	100
Emerging Europe	75	10	15	100
Asia	20	33	46	100
Latin America	65	15	20	100

Source: BIS.

38. In the MENA region, most private firms rely upon bank credit, but there is a strong consensus that expansion of the corporate debt market would be beneficial to the corporate sector and would reduce the financial system's vulnerability to crisis. However, structural weaknesses have discouraged the deepening of non-government debt markets.

Recommendation 3: Deepen markets and broaden the investor base for fixed income securities. Utilise available techniques to issue government debt on market terms and to encourage secondary trading. Build market infrastructure, including specialised intermediaries to deal in government paper, repurchase agreements and hedging instruments. Adapt government debt management technique to reflect the specific properties of countries with no net borrowing needs. Accelerate development of the market in other fixed income assets.

39. As of 2002, the equity markets of most MENA countries represented lower shares of GDP than in emerging markets in Latin America and Asia. However, in the GCC countries as well as Jordan market capitalisation/GDP ratios were comparable to those in other emerging markets. With the rise in revenue associated with the surge in oil prices of recent years, equity prices have been booming, especially in oil exporting countries. In the three years ending in June 2005, Dubai's Stock market rose 768% while Qatar's rose 600%, and that of Kuwait and Saudi Arabia 225% and 290%, respectively. Meanwhile, Initial Public Offerings (IPOs) are at record levels. As a result, the ratio of market capitalisation to GDP of the GCC countries has risen further and is now approaching that of many developed markets. However, with a lack of free float in most listed equities issued there is a dearth of liquidity. The ratio of traded equity to GDP remains lower than in other emerging markets. Partly as a result, MENA markets have a low weighting in most global emerging market indices.

40. In most MENA markets, there is a small number of listed companies. Many listed companies have substantial government ownership. Most of the listed private companies are family owned with limited transparency. Interlocking directorships, cross share holdings and shareholder agreements are common means of perpetuating insider control.

Table 3 - Concentration Measures

Average Company Size (in $ millions)	
MENA	**80**
Africa	232
Emerging Europe	123
Latin America	294
Emerging Asia	118

10 Largest (% of MC)	
MENA	**54.4**
Africa	44.3
Emerging Europe	63.9
Latin America	41.1
Emerging Asia	38.6

Source: Standard & Poor

41. Institutional savings are very small. Some countries, such as Saudi Arabia, Egypt and Jordan have fairly large funded pension schemes. However, even in those cases, investment in domestic capital markets is rather small. In all countries other forms of institutional savings such as insurance and collective investment schemes (CIS) represent low shares of national income. The scarcity of institutional savings results in the absence of natural purchasers for many categories of securities. A more vibrant institutional investor community should be aimed at including a significant presence of foreign asset mangers to stimulate professionalism in the investment management sector, deepening competition and the introduction of global practices.

Recommendation 4: Foster a more vibrant institutional investor community. Improve the protection of property rights. Encourage transparency and disclosure in the corporate sector. Enhance investor protection. Utilise international standards for accounting and audit. Narrow discrepancies between listed and non-listed companies. Review the tax system and the bankruptcy regime in order to create an environment that is conducive to investment.

42. Countries of the MENA regions have been making significant attempts to strengthen their regulatory and institutional infrastructure for capital markets. Originally, many countries did not have institutions dedicated to capital market supervision. However, in the past few years, such institutions have been formed and efforts have been launched to enact the necessary laws and regulations and to build human resources in the supervisory agencies. Some countries, such as Jordan, Egypt, and Tunisia launched their reforms relatively early. Some countries in the Gulf that aspired to be international financial centres began significant reforms in the 1980s and several others are striving to develop world class infrastructure, including high quality supervision, in order to enhance their standing as international financial centres.

43. Other countries, realising the need to enhance capability to invest domestically as well as to minimize the risk that business would migrate to offshore centres, launched their own reforms more recently. In Saudi Arabia for example, the capital market lacked some of the basic features of more advanced markets such as a designated supervisory authority and a stock exchange with well defined functions. There was no specialised securities regulator and the Saudi Arabian Monetary Authority (SAMA) regulated the capital market.[1]

44. A key reform was the enactment of the Capital Markets Law in 2003 designed to promote a stronger, more efficient and transparent capital market based on international practices. The Law establishes the Saudi Arabian Capital Markets Authority, composed of five commissioners as the primary regulatory body for the Saudi Arabian capital market and the Saudi Arabian Stock Exchange. This body will execute the normal functions of securities market oversight.

45. Previously, equities were traded among a limited number of banks in an automated over the counter system. The Capital Market Law provided for the formation of a stock exchange, which is to be structured like major exchanges in countries with moderately advanced capital markets. [2]

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[1] The functions of the SAMA include: Regulating investments and securities in Saudi Arabia; register and regulate the Saudi Arabian Securities Exchange (including the national securities depository); Registering securities to be offered for subscription or sale to the public; organize training programmers and promote high ethical standards; Registering and regulate non-bank financial intermediaries, including members and employees of the Stock Exchange, and others involved in the organization and operation of the capital market, including custodians of securities and credit-rating agencies; Protecting the integrity of the securities market against abuses arising from the practice of insider trading; Reviewing, approving and regulating mergers, acquisitions and all forms of business combinations; Providing investor education and promote investor awareness; Preventing fraudulent and unfair trade practices relating to the securities industry; Performing such other functions and exercise such other powers not inconsistent with the law as necessary or expedient for giving full effect to the provisions of the law.

[2] The functions of the SASE are to: Ensure the fairness and transparency of markets operated by the Exchange; Admit members (both brokering and clearing); List and explain the requirements and conditions for the listing of securities; Promote high ethical standards among members, their employees and market participants; Promote high standards of corporate governance, and Ensure timely and accurate dissemination of market information; Perform such other functions and exercise such other powers not inconsistent with the law as necessary or expedient for giving full effect to the provisions of the law.

Figure 2 - Regulation of Stock Exchanges

The Framework for Securities Market Regulation and the Regulation of Stock Exchanges[3]

Best Practice 1

The development of securities markets requires appropriate laws and regulations governing: the raising of funds on capital markets; the operation and integrity of intermediaries, the exchanges themselves, the after- trade service systems (including securities settlement systems); the operation and integrity of corporations; the protection of investors; and the fair treatment of outside contributors of capital including the prohibition of self-dealing and safeguarding shareholders'.

Best Practice 2

The allocation of the power to regulate should be clearly specified.

Best Practice 3

A stock exchange should be established with sufficient capacity to undertake the responsibilities for building and maintaining the integrity of a fair market.

Best Practice 4

A stock exchange has a front-line obligation to develop standards of proper business behaviour (including compliance and disclosure) for: *a)* its own members or shareholders; *b)* listed companies; and *c)* the issuing process. These standards are subject to review and/or approval by the regulator. An exchange also has the responsibility to co-operate with the regulator and other SROs to maintain the integrity, fairness and soundness of the market.

46. One of the reasons that MENA equity markets continue to diverge from global norms is that foreign participation is limited. Most countries have limitations on foreign investment in domestic equities and, with the exception of countries that are seeking to become international financial centres, there is limited participation by foreign intermediaries and investors in the domestic markets. In addition to the restrictions on foreign participation on which ANNEX 1 provides and overview, foreign investment is further impeded by lack of confidence in the fairness and transparency of MENA markets and lack of confidence in investor protection systems. However, most sizable financial markets have significant foreign presence. Foreign participation introduces global practise into the domestic market and encourages firms to strive to attain global standards of transparency and investor protection.

47. With greater liberalisation foreign forms are likely to participate both as intermediaries and as foreign investors. By participating as intermediaries (i.e. investment banks or securities dealers), foreign firms are likely to facilitate the introduction of the best available techniques to achieve transparency and investor protection from the global marketplace. This will spur reform on the part of domestic intermediaries and improve overall confidence in the market.

48. There is a serious problem at this time that markets are already under pressure due to the small amount of available equity and the surge in oil related revenues. Valuations have already been stretched seriously. It can therefore be argued that the addition of foreign demand would thus push valuation even higher, contributing to further speculative pressures in thin equity markets. Indeed, if markets are opened to foreign investment without other reforms, the danger of speculative excess is significant. Indeed, speculative pressures are already intense. Liberalisation must therefore be accompanied by a sharp increase in the supply of equity, which can be achieved by improving the overall environment to encourage

[3] Taken from Best Practices for the Development of Stock Exchanges in Transition Economies, FEAS, Working Group on Capital Markets Development of the Federation of Euro-Asian Stock Exchanges.

companies that are now closely held to list increased portions of their equity. Simultaneously, portfolio diversification can be enhanced by making it easier for major foreign companies to list on local exchanges.

Recommendation 5: Encourage foreign participation in financial markets by introducing global practices to the domestic market and upgrading market infrastructure. Encourage foreign investment in local markets and open local markets to listing of foreign securities.

49. In addition to encouraging opening their financial markets to all countries, there is considerable scope to deepen regional cooperation among MENA countries. Some countries have small populations and are major oil exporters, and typically import unskilled labour, whereas others have large populations and the generation of employment is a critical task. Some countries are net exporters of skilled labour. Others are capital importers, while still others export capital. Moreover, many countries with high savings, which had traditionally invested their surpluses in the major global financial centres, are now seeking to place an increased share of assets within the region. Given these potential complementarities in economic structure, there are undoubtedly numerous possibilities for expanded intra-regional cooperation. Integration would enable investors throughout the region to achieve more portfolio diversification, while users of capital could improve borrowing terms. At the same time, deeper markets would enable more companies to move from bank to equity finance. One obvious possibility is for more cross-national listing and trading of investment instruments.

Recommendation 6: Expand intra-regional cooperation amongst capital markets. Increase cross national listing and trading of investment instruments. Explore possibilities to launch regional trading platforms. Accompany regional integration with liberalisation for participants from outside the MENA region.

50. Fostering the development of Small and Medium Sized Enterprises (SMEs) is seen as a major objective in OECD countries and non-members alike. Policy makers have concluded that a high rate of company formation is essential to achieving full employment. Traditional, larger and well-established companies have tended to generate limited and in many cases no net employment, even though many such companies had reasonably good records of profitability. Therefore, the ability to generate employment to a large extent depends upon the prospects for smaller companies.

51. Within the general category of SMEs there is a clear perception among policy makers (i) that potential high growth companies, particularly those utilising new technology are of critical economic importance and (ii) that the lack of finance in appropriate forms may be a serious barrier to expansion of this sector. High growth SMEs, which are often found in technology intensive sectors, act as innovators and employ new technology, and have play a crucial role in raising productivity and maintaining competitiveness.

52. In many countries, small and medium-sized enterprises (SMEs) have generally not shown dynamic growth and rates of enterprise formation tend to be low. In other countries, the SME sector may account for a large share of output and employment, but activities remained concentrated in smaller family-owned companies embodying relatively low technology and with limited growth potential and relatively low investment per worker. By contrast, in a few countries, such as the United States and Korea, the SME sector had proven to be a source of employment growth and of technological innovation.

53. One salient characteristic of high growth SMEs is that they are ill-suited for traditional means of finance, such as bank lending, government guaranteed loans and listing on traditional stock exchanges. Their characteristics have traditionally included high growth potential, but with negative cash flows, untried business models and uncertain prospects for success. Such firms rarely generate sufficient cash

flow to service debt and their risk is too high to be suitable candidates for debt finance. Instead they will usually progress through several stages of equity finance. Those providing funds often use the prospect of future injections of equity as a monitoring tool.

54. The OECD is a recognised centre of expertise in finance for high growth SMEs. In particular, it has been observed that a small number of OECD countries have been successful in developing successful venture capital industries and in financing dynamic SMEs. OECD bodies are seeking to identify the elements to make for successful equity markets suited to high growth SMEs, and there is a commitment to sharing this body of expertise with non-members.

55. The risk capital industry is becoming more global in scope, with India and China becoming major players. Despite their relatively low levels of per capita income, both of these countries had significant parts of their economies linked to the global process of research, technical innovation and diffusion. Furthermore, both have large communities of highly trained scientific technicians, many of whom have acquired experience in foreign centres of research and marketing and who maintain close links to those centres. China is also engaging in massive R&D spending.

56. Private equity, rather than venture capital strictly defined, is becoming a major force in transforming many emerging markets, such as Asia, Latin America. In all of these markets, there are large numbers of companies that are family-owned and controlled with limited transparency and which generally do not operate under international norms of transparency, corporate governance and investor protection. Such companies often operate on the margins of the formal financial system, maintaining opaque accounts and utilising funds from informal sources. Frequently, such behaviour results from high nominal rates of taxation and bureaucratic rigidity. While some companies may be profitable and may employ large numbers of workers, they are often ill-equipped to address issues such as expansion of capital, strategic repositioning or succession. Additionally, the owners of such companies may find it difficult to realise value from their investments. The private equity market is often effective in acting as a bridge from traditional proprietary companies and modern listed companies. MENA countries appear to fit into this general pattern.

57. Since institutional savings, which are abundant in the major OECD countries, are absent in non-OECD markets, as is the skill in private equity, most of the venture capital and private equity firms active in outside of the OECD region are foreign affiliated. The MENA countries, where there are many high net worth individuals as well as many charitable foundations and endowments, may have the potential to develop an indigenous risk capital market based primarily on domestic savings although substantial reliance on foreign skills in venture capital will probably be needed in the early phases of development of they industry.

58. Islamic finance is one of the fastest growing components of the international financial market. Islamic finance, which prohibits lending for interest, may be well suited to risk sharing equity finance which is a vital part of the financing for fast growing SMEs.

Recommendation 7: Assess the entire framework for financial support of SMEs. Improve the potential of the financial system to provide finance to innovative and/ or high growth companies. Assess the need to enact or modify laws that impact the competitiveness of financial intermediaries specialised in providing for equity finance to new companies and/or companies in need of restructuring. Facilitate the operations of foreign private equity and venture capital firms. Identify the potential of Islamic finance to support SMEs, especially high growth SMEs.

59. Dealing with these structural challenges, which have long troubled the MENA countries, is especially urgent at present. Oil-related revenues have recently been rising sharply, and these revenues will have to be invested efficiently. Moreover, wealth holders in MENA countries are choosing to invest larger shares of assets in the region, as opposed to major offshore markets. Without adequately developed structured financial markets, the region will be exposed to severe imbalances reflected in boom/ bust cycles in asset markets. With a rapidly growing labour force and high initial unemployment, the need to deploy financial resources effectively in order to generate employment is a serious problem, even in the high income Gulf oil exporters. In brief, the present time offers both great opportunity and significant risks to development of sophisticated financial markets in the region.

IV. PROPOSED OECD MENA PROGRAMME FOR 2006-2007

60. Based upon the analyses and preliminary recommendations in the preceding sections as well as on consultations with MENA countries and other international organisations, the OECD Secretariat has developed a proposed work plan for financial markets to cover the period 2006-2007. In its Outreach activities, the OECD usually organises multilateral policy dialogue meetings. These meetings typically include representatives of the official sector (i.e. from OECD Member countries, non-Member countries, and international organisations,) as well as representatives of the private sector and of independent researchers from universities and research institutes. This format will constitute the core of the programme, although there may be some scope to adapt the programme to meet special needs.

Fixed Income Markets

61. One of the main sectors where a need for reform has been identified is in the fixed income sector of the capital markets. The OECD is especially well placed to respond to this need since a well established Outreach programme for the development of fixed income markets already exists.

62. The OECD's Government Debt Management Working Party (WPDM), which has been in operation for more than 20 years, brings together senior officials responsible for the management of debt of OECD countries (which constitutes the overwhelming majority of actively traded public debt in the world). These experts, who have unique experience with the most recent trends in fixed income markets, exchange information about techniques for government debt management and try to reach consensus on best practices in government debt management.

63. The WPDM has a long-standing program of Outreach in which the experience of OECD markets is shared with officials from non-Member countries who are responsible for government debt management. The policy dialogue with debt managers from outreach jurisdictions constitutes an integral part of the activities of the WPDM. Outreach activities are principally organised via two global forums

(i) the Annual OECD/World Bank Global Bond Market Forum, and
(ii) the Annual OECD Global Forum on Public Debt Management in Emerging Government Securities Markets.

64. Both global forums are held under the aegis of the WPDM. The first forum focuses on bond market problems and policy issues. This forum deals not only with government securities, but also considers other kinds of fixed income securities, such as those issued by government affiliated entities, corporate bonds and asset-backed securities. The second global forum addresses debt management policy issues and techniques, including their interface with the functioning of government securities markets.

65. The medium-term outreach strategy of the WPDM is to organise all outreach activities via the two global forums. Regional and country perspectives need therefore to be directly linked to these forums. Another aspect of the medium-term outreach strategy is to strengthen the co-operation with other relevant multilateral organisations and to expand and deepen the relations with non-member countries.

66. In view of the well-established programme in this sphere, it is proposed that MENA countries be invited to take part in the work of these groups.

Equity Markets Programme

67. The Development of Equity Markets calls for a special programme tailored to the specific needs of the MENA countries. This programme will concentrate on four principal topics:

- Institutional and Regulatory Infrastructure for Capital Markets Development;
- Developing Regional Equity Markets in MENA;
- Institutions and Instruments for the Finance of SMEs.
- Financing of Enterprise Creation and Enterprise Development.

68. The object of this programme is to identify the major challenges facing capital markets in the region, to agree on the necessary policy actions to be taken, and to engage in mutual surveillance of progress in implementing those actions. Relatively soon after the February Ministerial meeting, work will commence on developing a document tentatively titled 'Overview of Capital Markets in MENA Countries with Recommendations for Reform'. This work will be prepared jointly by the OECD Secretariat as well as experts designated by the MENA countries. Because of the multilateral nature of the project and the collaboration of experts from the OECD and MENA, the document will have added credibility and participating countries will have strong incentives to show progress. In 2006-2007 four expert workshops will be held with the following themes:

- Equity financing of Enterprise Creation and Enterprise Modernization;
- Institutions and Instruments for the Finance of SMEs.
- Integration of Capital Markets in MENA;
- Discussion of the Overview Document and Definition of Priorities for Reform;

69. These meetings will be organised in the standard OECD format with participation by officials, private sector representatives and independent researchers. The following paragraphs outline the substantive contents of the proposed workshops.

1. Discussion of the Overview Document and Definition of Priorities for Reform

70. This workshop will take a broad view of the project for 2006-2007. It will produce a document assessing the current situation of the capital markets of MENA countries, with an emphasis on equity markets, highlighting areas in which reforms are most needed. The objective of this meeting is for experts to agree on the specifics of a reform agenda, emphasising legal, regulatory and institutional reforms.

71. Among the topics covered would be a) the overall environment for investment including legal, accounting and tax environment, b) the creation and institutional development of the necessary official agencies for capital market oversight and the enactment of necessary laws and regulations, c) broadening and deepening the range of investment products, including the role of Islamic finance, d) development of institutional savings, e) fostering competition and liberalisation in capital markets, including access for foreign intermediaries and investors.

72. One option for the process of mutual surveillance would be to develop an inventory of the highest priorities facing individual countries with an assessment of each country's progress in implementation over

the specified period. It should be noted that this fact-finding exercise would entail a substantial commitment of resources.

2. Integration of Capital Markets in MENA

73. There should be significant potential for additional integration among MENA capital markets. The MENA countries include countries at various income levels, countries with large current surpluses and those with large borrowing requirements. Moreover, many countries with high savings, which had traditionally invested their surpluses in the major global financial centres, are now seeking to place an increased share of assets within the region. Integration would enable investors throughout the region to achieve more portfolio diversification, while users of capital could improve borrowing terms. At the same time, deeper markets would enable more companies to move from bank to equity finance. At this point, several countries have devoted considerable efforts to developing their national capital markets, but the small size and narrow range of investment possibilities in national markets makes it difficult to achieve adequate portfolio diversification.

74. The OECD has considerable experience on this subject, since the organisation has promoted enlarged market access and liberalisation of financial markets among its Members. Many OECD countries have experimented with linkages among exchanges, cross-listing, and development of alternative trading systems. Additionally, OECD countries have made significant efforts at promoting financial market integration, both among all OECD countries and in smaller groupings such as the EU or the Nordic countries. Capital market integration includes regional platforms for securities trading.

Among the items that could be considered for the agenda are:

a) state of integration of MENA capital markets;

b) policies toward establishment national treatment regarding intermediaries and rules regarding cross border investment;

c) plans to develop regional platforms in MENA; and

d) experience of other regions with cross listing, linkages and supranational trading platforms.

3. Equity Financing for Enterprise Creation and Enterprise Modernization

75. This activity will focus on methods of finance for two kinds of companies: 1) established traditional companies that are seeking to approach the public markets and 2) new high potential growth companies, especially in high tech sectors.

76. The SME sector in many MENA countries tends to employ large numbers of workers, but with low levels of investment per worker and tends to be concentrated in low technology sectors. Levels of transparency and disclosure tend to fall short of international norms. SMEs have tended to utilise either informal finance or the banking system. Even then, in many MENA countries, public banks still dominate the financial system and favour state enterprises and larger well connected industrial firms. As a consequence, SMEs are forced to rely heavily on owners equity and retained earnings to finance their business. Partly as a result, the dynamic SMEs that have been in the forefront of the transformation of the economic landscape in most OECD countries, and that have been major factors in diffusing technological change, have not been important drivers of progress in MENA countries.

77. New financing techniques, such as private equity and venture capital can be highly relevant to both these categories of company. Private equity can help traditional firms that are in need of restructuring, those that require capital increases or that face succession problems in transforming themselves from traditional family controlled companies into companies that are suitable for listing on public markets. Venture capital, which can be defined as a special form of private equity suited to the needs of newly formed high growth companies, has developed techniques whereby entrepreneurs, venture capitalists and investors can interact so as to provide equity finance to firms with higher than average growth potential. This is especially true for firms having the capability to incorporate new technology and/or business models. Such firms have the potential to make higher than average contributions to structural transformation and employment generation.

78. The experience of the OECD countries indicates that the equity market can make a contribution to the development of the SME sector. High growth SMEs, even those with negative cash flows, are particularly well suited to equity finance. In addition, there are special techniques such as business angels and venture capital finance that are particularly relevant to dynamic SMEs which can make a particularly large contribution to economic diversification and job creation.

79. The MENA region has some advantages as well as some clear disadvantages. On the one hand, the large volumes of assets that are available in the region for investment through equity bear a considerable resemblance to the foundations and endowments which have been among the longest standing suppliers of funds to the venture capital market. Private equity may be well suited to Islamic financing techniques.

80. Equity finance to high growth firms will address the issue of exit vehicles. These vehicles include Initial Public Offering (IPOs) as well as "trade sales" to strategic investors. In the latter context, one of the main exit vehicles consists of strategic investments by foreign firms. A high amount of global FDI takes the form of mergers and acquisitions. While the MENA region has a large pool of capital that is potentially available to support a large volume of IPOs, the region does not have a good record in attracting FDI. The need to improve the climate for FDI will undoubtedly be an important determinant of whether venture capitalists can achieve successful exits. Most governments have an array of programs to support venture capital in particular. It is essential that official incentives be structured so as to offer the proper incentives for investing in this sector.

81. The topics that will be covered in this workshop include a) the general environment for entrepreneurship b) legal and regulatory infrastructure for private equity and venture capital c) activities of venture capitalists and private equity specialists d) sources of funding e) development of exit vehicles" and f) effective government policies to support private equity.

4. Institutions and Instruments for the Finance of SMEs

82. This workshop will review the potential of various categories of financial institutions to supply funds to SMEs. In many countries, informal financial markets are significant suppliers of financial resources to SMEs. The prevalence of such alternative financing channels may reflect a general macroeconomic and institutional framework that gives sectors other than SMEs privileged access to the formal financial system or that imposes such high costs on entrepreneurs that they prefer to operate outside the formal system. For instance, rates of taxation may be high, while the ability of the authorities to collect taxes may be low. At the same time, formal financial intermediaries may be committed to supporting the government sector and large enterprises. This dilemma is compounded if there are close bank-industry linkages or where many banks are government owned.

83. Other things equal, it is preferred that financial operations be conducted in the formal sector. However, it must be recognised that an approach that is predominantly based on strict enforcement is not likely to be effective and could result in undesirable side effects. The effort to encourage enterprises in the informal sector to move into the formal sector should be based on policies that strengthen the formal sector and provide positive incentives to operate in that sector.

84. Among formal institutions, most SMEs continue to depend upon bank finance. That process is facilitated in part by the market's greater familiarity with established names compared with smaller enterprises. SMEs generally lack the track record needed to transform their credit obligations into marketable securities. Consequently, SME loans tend to remain on the balance sheets of the lending banks. Smaller banks are considered to be particularly important in this regard.

85. SMEs are well suited to the specificities of banks. Banks specialise in lending to borrowers for which publicly available information about their credit histories is limited or lacking and in financing activities that are difficult to assess and thus are subject to a large degree of subjectivity. To survive in competitive markets, primary lenders must be able to distinguish better credit risks from poorer ones and set their loan terms accordingly. Banks, for example, are usually good at assessing credit quality in deciding whether or not to extend credit. The result of this assessment usually dictates the amount of interest charges and other fees for borrowers. Banks also use non-price terms to reduce the risk of default and mitigate other agency costs. Firms with a proven track record fare better, since over the course of a relationship with a borrower, a repayment history is accumulated and a bank can accumulate an exclusive information set based on multiple assessments of financial reports, detailed discussions with owners/managers, or loan contract re-negotiations. Banks, thus, are in a position to monitor the borrowers on an ongoing basis.

86. SME so-called "life style" companies, i.e. those with individual or family ownership and limited growth prospects, are also well suited to bank finance. They have established cash flows, collateral and proven track records.

Commercial banks need to be structured to lend to SMEs in terms of":

1. Appropriate Ownership & Governance Structure;
2. Adequacy of Credit Skills;
3. Flexibility in Credit Pricing.

Other Private Institutions Can At Times Supplement Banks:

1. Micro Finance Institutions;
2. Credit Cooperatives;
3. Savings Institutions;
4. Leasing & Factoring Companies.

Most governments have sizeable programmes to provide SMEs with funding though:

1. Direct loans;
2. Guarantees;
3. Risk sharing arrangements;
4. Specialised agencies;

5. Facilities administered by private financial institutions.

Questions to be addressed:

1. What has been the performance of MENA countries with respect to bank lending to SMEs?
2. What are the major impediments to bank ending to SMEs?
3. What determines whether official lending and guarantee programmes succeed?
4. Can we agree on a set of best practices?
5. How can Islamic finance be adapted to support SMEs?

ANNEX

RESTRICTIONS ON PURCHASE OF DOMESTIC SHARES BY NON-RESIDENTS IN MENA COUNTRIES[4]

Algeria reports unspecified controls on equity purchases by non-residents. Non-residents may invest in bonds or other debt securities in Algeria; transfers abroad of proceeds from these investments are allowed, but they must be affected through an authorised intermediary.[5]

In ***Bahrain***, GCC nationals have since 1999 been allowed to own up to 100 per cent (previously 49 per cent) and non-GCC nationals up to 49 per cent (previously 24 per cent) of the listed shares of a Bahraini joint-stock company. The percentage of ownership by non-GCC nationals may be increased, subject to approval by special resolution from the Minister of Commerce and Industry. Previous conditions requiring foreign individuals to be resident in Bahrain for one year to be eligible to acquire shares in a Bahraini company and to own a maximum of 1 per cent of a company's issued shares were lifted in 1999.[6] Non-GCC nationals may purchase, sell, or own up to 100 per cent of the shares in the Arab Banking Corporation, the Bahrain International Bank, Investcorp Bank, the Bahrain Middle East Bank, Taib Bank, Shamil Islamic Bank and the Arab Insurance Group. Unspecified restrictions are reported on the issuance of bonds or other debt securities. Further non-residents are allowed to own buildings and property only in locations specified in the Council of Ministers Regulation No. 5/2001, which include most of the prestigious and tourist areas. In accordance with Legislative Decree No. 2/2001, commercial, tourism, and industrial companies, as well as banking and financial institutions that are licensed to operate in Bahrain, may own real estate without restriction. [7]

There are controls on all credit transactions of residents with non-residents in ***Djibouti***, including transactions in the form of guarantees, sureties, and financial backup facilities within the limits established by the banking regulations for the purpose of complying with the prudential standard on customer risk. Djibouti reports no restrictions on capital and money market instruments;[8] however, the country does not appear to have an active capital market.[9]

In ***Egypt***, there are no controls under the Foreign Exchange Law and Regulations on the issuing of securities by non-residents. Trading in securities denominated in foreign currencies must be settled in foreign currencies. The foreign exchange market may be used for transferring proceeds associated with the sale of both Egyptian securities and foreign securities. Approval of the Capital Market Authority is

4. Taken from Investment Climate and Regulation of International Investment in MENA Countries, report prepared for Working Group 1, Output 1 of the MENA-OECD Investment Programme.

5. IMF (2005).

6. WTO (2000).

7. IMF (2005).

8. IMF (2005).

9. UNDP (2003).

required for issuing bonds. Further shareholders by residents or non-residents in any bank in Egypt that exceed 10 % of the bank's capital require approval from the CBE Board of Directors. [10]

Jordan reports no restrictions on capital and money market instruments.[11] However, the Amman Stock Exchange (one of the region's largest stock markets, with 42 per cent foreign share ownership) states that companies in the construction contracting, commercial and commercial services and mining sectors are subject to a ceiling of 50 per cent foreign ownership of the paid-up capital.[12] Further non-resident investments are limited to a maximum of 49% ownership or 50% subscription in shares in the following major sectors: commerce and trade services, construction, contracting, and transportation. The amount of investment in any one project must total at least JD 50,000. Investments in the following sectors are not permitted for non-residents: investigation and security, quarrying and mining, waste removal, sport clubs, and road transportation of goods and passengers.

Kuwait reports unspecified restrictions on capital and money market transactions, including local sale or issue of shares and bonds by non-residents.[13] Since May 1988, GCC citizens have been permitted to purchase stocks on the Kuwaiti Stock Exchange (KSE). Cross trading with the Bahrain Stock Market began on 15 March 1998. The KSE also has similar agreements with Egyptian and Lebanese stock markets. Investors in these countries are now permitted to buy and sell shares listed on each other's exchanges through their brokers. In May 1999, an agreement of co-operation was signed between the KSE and the Jordanian Stocks Authority for stock issuing and circulation. This agreement encouraged registration of listed companies in the two bourses, and boosted cooperation and the exchange of expertise.[14] The Indirect Foreign Investment Law passed in August 2000 allows foreigners to own 100 per cent of all listed shareholding companies, except banks, in which foreigners may hold no more than 49 per cent of the shares; foreign investors require central bank approval to own more than five per cent of a Kuwaiti bank.[15]

In ***Lebanon***, non-resident banks, financial institutions and money dealers must obtain approval from the Banque du Liban (BDL) when purchasing treasury securities denominated in Lebanese pounds or certificates of deposit from the BDL. Funds used to purchase treasury securities or certificates of deposit must originally have been Lebanese pounds that were converted from foreign exchange specifically for this purpose. Further since January 7, 2004, the ceiling on foreign ownership of shares of non-bank financial institutions was lifted (previously, a ceiling of two-thirds of shares applied).[16]

In ***Morocco***, the issuing of capital market securities by non-residents is subject to authorization. There are no controls on the sale of Moroccan securities by non-residents. Proceeds from such sales may be transferred freely, provided that the relevant purchases are financed by foreign exchange inflows or other comparable means. In other cases, the proceeds must be deposited in a convertible dirham account and

10. IMF (2005).

11. IMF (2005).

12. www.ammanstockex.com.

13. IMF (2005).

14. Kuwait Information Office in the United States, www.kuwait-info.org.

15. United States Commercial Service.

16. IMF (2005).

may be transferred abroad over a five-year period. The issue of bonds or other debt securities by non-residents in Morocco is prohibited.[17]

Foreign ownership in ***Omani*** companies is generally limited to 70 per cent, but it may be raised to 100 per cent; this limit is set on a case-by-case basis. A non-resident portfolio investor may not hold more than 10 per cent of the shares in an Omani country. Investment in business firms in Oman by non-residents requires prior approval. Foreign ownership is generally limited to 70%, but it may be raised to 100% in certain cases.[18]

Qatar has issued a new Investment Law (Law No. 25 of 1990, which restricted all foreign-ownership to a maximum of 49% and did not allow foreigners to lease property or invest in privatised public services. Under the 2000 Investment Law, a company can be 100% foreign owned in selected sectors, such as agriculture, industry, tourism, education, health, and natural resources, subject to prior government approval and provided that the company is duly established. Foreign equity is limited to 49% in the remaining sectors; foreign investment is still not allowed in banking, insurance, commercial representation, and purchase of real estate.[19] Law No. 19 for 1995 on industrial regulations allows non-Qatari nationals to invest in the commercial, industrial, agriculture and services sectors provided that Qatari nationals hold not less than 51 per cent of the total capital. When the invested foreign capital is wholly owned by a non-Qatari party, it is mandatory to appoint a Qatari services agent. GCC business people are subject to the same provisions of the law that applies to Qatari nationals.[20]

Holding of shares of listed ***Saudi Arabian*** joint-stock companies is restricted to Saudi Arabian nationals, Saudi Arabian corporations and institutions, and citizens of the GCC. Indirect portfolio investment in shares issued by Saudi Arabian joint-stock companies is allowed for foreign investors through mutual funds managed by Saudi banks. There are no controls on portfolio investment in Saudi Arabian government securities. Non-residents must seek permission of the Minister of Commerce to sell or issue securities within Saudi Arabia. There are no controls on the repatriation of proceeds from the sale of securities issued by non-residents.[21]

There is no market in medium- and long-term government bonds in ***Syria***. Bonds are issued on an as-needed basis to government-owned banks to supplement their capital base. The only money-market instruments available in Syria are investment bonds issued by the Popular Credit Bank (PCB) as agent of the government. The bonds, which carry an interest rate of 9 per cent a year, were issued with a 10-year maturity but have a short-term effective holding period as they are redeemable after three to six months. They may be purchased only by non-bank Syrian residents and by the PCB itself.[22]

Stocks may be acquired freely with foreign exchange transferred from abroad by foreign non-residents in companies established in ***Tunisia***. Non-residents may freely sell shares of companies established in Tunisia, however there are controls on all transactions in capital and money market instruments. They may also transfer freely net real proceeds from the sale of shares that were purchased with foreign exchange transferred from abroad for an investment made in accordance with the legislation in force. The purchase

17. IMF (2005).

18. IMF (2005).

19 WTO, Trade Policy Review Qatar (2005).

20. State of Qatar Ministry of Foreign Affairs, http://english.mofa.gov.qa.

21. IMF (2005).

22. IMF (2005).

by non-resident foreign nationals of debt securities issued by the state or by companies resident in Tunisia is subject to approval. Non-residents may freely acquire shares of Tunisian mutual funds with foreign exchange transferred from abroad. However, the approval of the HIC is required if the acquisition raises the foreign ownership to more than 50 per cent of the mutual fund's capital. Non-residents may freely transfer net real proceeds from sales of Tunisian mutual fund shares acquired with foreign exchange transferred from abroad.[23]

At least 51 per cent of shares of ***UAE*** corporations must be held by UAE nationals or organisations. Companies domiciled in free zones are exempt from this requirement and may be up to 100 per cent foreign owned. Purchases of collective investment securities by GCC residents are exempt from controls. Further non-residents may not acquire more than 20% of the share capital of any national bank.[24]

Yemen reports controls on capital transactions, however certain instruments such as money market and derivatives are exempt.[25]

23. IMF (2005).

24 IMF (2005)

25. IMF (2005).

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