Sizing up financial sectors in the Middle East and North Africa

A recent IMF study proposes policies that could improve the financial sector's performance in the Middle East and North Africa region. While the study finds that financial development varies considerably across the region, it is clear that more needs to be done to reinforce the institutional environment and promote nonbank financial sector development. Susan Creane, Rishi Goyal, and Randa Sab discussed their main findings and methodology with Jacqueline Irving of the IMF Survey.

IMF SURVEY: Compared with most other developing country regions, the Middle East and North Africa performed well but ranked far behind East Asia. What accounts for this sharp difference in financial sector development?


Stephen Jaffe/IMF

Susan Creane

CREANE: We based our regional comparisons on available quantitative data, since the kind of information we used in our more comprehensive index is not easily available over time or for other countries. These data show that for the Middle East and North Africa region, credit to the private sector was about 40 percent of GDP in 2002; in contrast, credit to the private sector in East Asia averaged over 100 percent of GDP. Since both theory and empirical research suggest that the availability of financing spurs growth, these numbers alone are striking.

Our analysis also found that the institutional environment is a key driver of financial development. A look at some of the best-known cross-country databases, such as the *International Country Risk Guide*'s ratings or the Heritage Foundation's index of economic freedom, shows that East Asian countries on average score notably above Middle Eastern and North African countries on these variables, including government involvement, protection of property rights, and ease of loan recovery. And, excluding the region's best performers (the Gulf Cooperation Council or GCC countries, Lebanon, and Jordan), the gap is sharply wider.

IMF SURVEY: What accounts for the uneven progress on financial sector reforms across the Middle East and North Africa region?

GOYAL: The role of the state seems to be key in accounting for the considerable variation across the region. The more financially developed countries tended to feature smaller or no monetary financing of the fiscal deficit, a smaller degree of public ownership of financial institutions, and greater use of indirect monetary policy instruments such as open market operations. These countries also implemented stronger prudential regulations and supervision of the financial sector; developed higher-quality human resources, including management and financial skills; and maintained a stronger legal environment.

IMF SURVEY: You found that the incomplete development or nonexistence of secondary markets for government securities hinders broader use of open market operations by central banks. Does sharia, which forbids the earning of interest under Islamic law, play a role here? Or have some countries developed an Islamic alternative to conventional treasury bills?

SAB: Alternative instruments to conventional treasury bills that are compliant with Islamic financial principles have been developed in recent years and are playing important roles in some of the region's countries. Iran has issued Government Participation Certificates for funding government operations, while Sudan has issued central bank and government bills known as Central Bank Musharaka Certificates and Government Musharaka Certificates, respectively. Nevertheless, secondary markets for these instruments remain underdeveloped.

Our paper does not specifically analyze the impact of sharia on financial development, but some countries, such as Sudan, have recently developed quite interesting instruments and markets. Sudan's financial development index rating,

Constructing new financial development measures

The IMF study surveys IMF country economists on financial development issues in 20 Middle Eastern and North African countries during 2000–03 on six main themes: banking sector development, nonbank financial development, regulation and supervision, financial openness, and institutional quality, as well as the monetary sector and monetary policy. The research team also drew on macroeconomic and financial time-series data from the IMF's *International Financial Statistics* and *World Economic Outlook*, and the World Bank's *World Development Indicators*, as well as measures of institutional development from the PRS Group's *International Country Risk Guide* and the Heritage Foundation. To better assess financial sector development in each country according to the six themes, the authors applied this data to develop new indices that go beyond the simple and "standard" quantitative indicators and monetary aggregates used in the existing literature on financial development in the report.

including on the monetary development theme, improved sharply in our 2002–03 survey, compared with 2000–01, which we associate with the government's policy of macroeconomic stabilization and reform.

IMF SURVEY: To what extent are countries in the region developing sharia-compliant financial products as a means of developing their financial sectors?

CREANE: Islamic banking and finance is very important for financial sector development in the region—particularly for those countries, such as Iran and Sudan, where all financial transactions must be done in accordance with Islamic principles. In the majority of the other countries, there are either Islamic banks or windows at conventional commercial banks dealing with Islamic products. In the GCC and some other countries, the rapid global growth in Islamic finance has spurred interest in creating complex Islamic financial products and markets in investment banking, offshore banking, fund management, and Islamic insurance.

IMF SURVEY: The region scored relatively well on financial regulation and supervision yet relatively poorly on the strength of institutional environments. Don't these findings seem somewhat at odds?

GOYAL: Countries that performed relatively well on regulation and supervision also tended to rate relatively well on the institutional environment. This was part of a more general pattern where countries at higher levels of financial development, on average, outperformed countries at lower levels for each of the six themes (see box). This finding on relative rankings within each theme should not be surprising: financially more advanced countries were more developed, on average, in every area.

Comparisons across themes are more challenging, since they entail absolute rather than relative rankings and depend on the rating scale as well as data availability. So it is easier to contrast a country's performance on a particular theme with another country's performance on the same theme than it is to compare any one country's performance across two different themes.

Nevertheless, the finding that countries scored relatively well on regulation and supervision, yet relatively poorly on overall institutional strength, may not be all that puzzling when one considers the role of public financial institutions. Countries in which the financial sector is dominated by public sector institutions rated well on regulation and supervision relative to their institutional environment index, arguably because, by definition, such financial systems are regulated and supervised.

Weak institutional environments in many cases reflect inadequate systems for protecting and enforcing property rights. And some countries with banking sectors dominated by large foreign banks that are supervised by home authorities in countries with more developed financial sectors scored relatively better on financial supervision than on their institutional environments. Also, data limitations constrained us from measuring potentially important differences in countries' loan classification standards and capital quality.

Michael Spilotro/IMF

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Stephen Jaffe/IMF

Randa Sab

IMF SURVEY: Do your findings point to a prioritization of steps that Middle Eastern and North African countries might take to strengthen their institutional environments?

SAB: We do not recommend particular priorities or steps per se, but we do urge them to combine prudent macroeconomic policies with structural reforms.

Macrostabilizing measures, such as following prudent fiscal and monetary policies—including maintaining low inflation—should be complemented by a structural environment that enables financial development. Countries should concentrate their efforts on those areas that have been weakest. For some countries, this means the government should reduce its involvement in the financial system, including by cutting back on public ownership of financial institutions, reducing its intervention in credit allocation, and minimizing monetary financing of budget deficits. At the same time, it should enhance competition, invest in human resources, promote nonbank financial development, and strengthen institutional quality, particularly the legal environment. In several countries, reforms should also seek to improve the quality of the judicial system, reduce bureaucracy, and strengthen property rights. ■

Copies of *Financial Sector Development in the Middle East and North Africa*, IMF Working Paper 04/201, are available for $15.00 each from Publication Services (see page 48 for ordering details) or on the IMF's website (*www.imf.org*).