

**ECONOMIC AND SOCIAL COMMISSION FOR WESTERN ASIA**

**PROGRESS MADE BY ESCWA MEMBER COUNTRIES IN THE  
IMPLEMENTATION OF THE MONTERREY CONSENSUS**

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## **Preface**

This study was initiated by the Globalization and Regional Integration Division of the Economic and Social Commission for Western Asia (ESCWA) in order to monitor and follow up on the progress of ESCWA member countries with regard to implementing their obligations under the Monterrey Consensus that was the outcome of the International Conference on Financing for Development (Monterrey, Mexico, 18-22 March 2002). This study addresses the challenges facing ESCWA member countries in facilitating financing for development and recent progress made in the region.

During the preparation of the study, ESCWA sought the assistance of Ms. Salwa Elantary and Mr. Ahmed Ghoneim who worked as consultants on the case studies.



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## Executive summary

During the International Conference on Financing for Development (Monterrey, Mexico, 18-22 March 2002), participants recognized that Official Development Assistance (ODA) falls short of providing the development financing needed to meet the Millennium Development Goals (MDGs). Specifically, a minimum of \$50 billion a year of additional aid for developing countries is needed to reach the MDGs by the target date of 2015, which represents nearly double the current levels of ODA. There was a general consensus during that Conference that market forces alone cannot provide the financing necessary to achieve the MDGs. The Monterrey Consensus on Financing for Development, which emanated from that Conference, identified six leading actions aimed at mobilizing financial resources for developing countries, thereby facilitating the successful achievement of MDGs on poverty reduction. These six leading actions are as follows: (a) mobilizing domestic financial resources for development; (b) mobilizing international resources for development, namely, foreign direct investment (FDI) and other private flows; (c) international trade as an engine for development; (d) increasing international financial and technical cooperation for development; (e) external debt; and (f) addressing systemic issues: enhancing the coherence and consistency of the international monetary, financial and trading systems in support of development.

Moreover, the Monterrey Consensus encouraged the establishment of a forum to follow up on and monitor the progress made in implementing the various agreements and commitments reached at the Conference. Within that context, signatory countries have committed themselves to remain fully engaged to the process at national, regional and international levels.

In the ESCWA region, despite significant progress made by member countries in implementing the Monterrey Consensus, bottlenecks still exist in crucial areas of national economies. Given the interrelated nature of the six actions of the Monterrey Consensus, a lack of efficiency in one sector can adversely affect other sectors. For example, an underdeveloped banking sector that forces companies to operate on a cash-only basis or to finance imports through company-owned resources can stifle anticipated financial gains from trade liberalization policies. ESCWA member countries need therefore to pursue a coordinated policy approach in implementing the Monterrey Consensus.

In terms of mobilizing savings, ESCWA member countries have largely focused on privatizing public sector entities, reforming the bank sector and promoting capital markets. In particular, regional stock markets have enjoyed spectacular growth over the past few years. This ongoing trend can be attributed to a number of factors, including the following: (a) comparatively high global oil prices and revenues; (b) strong earnings and dividends of listed companies; (c) low regional interest rates; (d) declines in non-performing loans at banks; and (e) excess liquidity arising from worker remittances and repatriated Arab capital in the wake of the terrorist attacks of 11 September 2001 on the United States of America.

However, despite a recent flurry of activity by ESCWA members aimed at stimulating domestic capital markets, these continue to face a range of challenges, including the modest size of capital markets relative to national economies; low trading volumes; inadequate financial disclosure by listed companies; inadequate legal and institutional frameworks; lengthy clearance and settlement delays; a lack of investor protection; barriers to foreign and intraregional investors; and limited links to global financial markets. Additionally, equity markets in the ESCWA region remain underdeveloped compared to financial markets in other developing and emerging economies.

In the period 2002-2004, all ESCWA member countries experienced a growth in their bank assets, with the most substantial value of assets recorded in the banking sector of Saudi Arabia. Bank reforms have largely focused on promoting international accounting and disclosure standards, enhancing existing legal and regulatory frameworks, facilitating the entry of foreign financial institutions and strengthening supervision, in addition to automating trading, settlement, clearing and money transfer systems. However, despite these efforts, the banking sector continues to suffer from a number of structural problems. Chiefly, service costs to customers are relatively high and are not competitive with international banks. Moreover, while there is a proportionately large number of banks in relation to the population, economies and size of the region, these are typically dominated by one or more large banks that are often State-owned or family-owned enterprises. Additionally, the banking sector across the ESCWA region suffers from a large number of non-performing

loans, which can be traced to inferior loan portfolios and poor corporate governance. Historically, limited Government regulation and supervision of the banking sector has resulted in weak disclosure of bank records, inconsistent and inaccurate data collection, and inconsistent record-keeping methodologies with international practices. Some banks in the ESCWA region still rely on manual payment systems, which lead to clearing delays, lost records and bounced checks. There is consequently an urgent need to modernize the banking sector across the Arab region by adopting e-commerce and information technology (IT).

In the past decade, ESCWA member countries have increased their efforts aimed at attracting FDI and at repatriating Arab capital invested outside the region. Within the context of the latter, estimates suggest that countries of the Gulf Cooperation Council (GCC) currently possess surplus capital of up to \$1.4 trillion invested outside the Arab region, particularly in the United States and Europe, while Saudi Arabia alone could have up to \$750 billion invested abroad. Repatriating even a portion of Arab capital can boost the financial resources available for economic development and poverty alleviation in the ESCWA region.

Moreover, ESCWA member countries have boosted their efforts to attract FDI, fully aware that such investments provide recipient countries with funds for development, and expose firms in developing countries to new technologies and improved managerial skills that raise productivity and competitiveness of domestic industries. In the ESCWA region, regulatory and legislative reforms are currently being undertaken, including the modification of existing investment laws and the establishment of autonomous agencies for promoting investments. In 2003, FDI inflows to ESCWA member countries amounted to some \$2.8 billion, which represents a very modest 0.5 per cent share of the global \$560 billion FDI flows. This significantly low level of FDI can be attributed to various factors, including ongoing regional conflicts, slow economic reforms, weak governmental institutions, administrative barriers, and underdeveloped infrastructure and financial sectors.

Significant progress has been made by ESCWA member countries in the area of trade liberalization, encompassing a number of fronts, namely, regional integration, interregional bilateral agreements and membership in the World Trade Organization (WTO). ESCWA member countries are opting for dissimilar routes towards liberalization whereby members of WTO are undertaking unilateral measures to liberalize further their economies, and non-WTO members are either undertaking reforms in preparation of WTO accession or they have joined regional trade agreements that remove intra-Arab trade barriers. ESCWA members are all engaged in the Greater Arab Free Trade Area (GAFTA), which was revived in 2001, and are all committed towards eliminating tariff barriers according to the agreed timeframe under GAFTA. Signatories of GAFTA that currently comprise 17 out of the 22 members of the League of Arab States (LAS) successfully eliminated intra-Arab customs duties as of 1 January 2005. However significant work remains on non-tariff barriers and trade in services.

Similarly, the establishment of the Customs Union of the Cooperation Council for the Arab States of the Gulf, commonly referred to as the GCC Customs Union, is another success story in the area of liberalization of regional trade. The GCC sub-region has a combined market of some 33 million people and a combined GDP that exceeds that of the 17 GAFTA members. The GCC Customs Union was implemented in January 2003 by eliminating intra-GCC tariffs and by adopting a common external tariff of 5 per cent. The member countries of the GCC continue to work on standardizing regulations and on coordinating fiscal and monetary policies in order to form a monetary union by 2007, thereby leading to the adoption of a single GCC currency by 2010. This high level of economic integration, similar to the European Union (EU), is achieved by synchronizing macroeconomic policies. Specifically, the key targets for deeper economic integration were agreed upon, namely, inflation, interest rates, foreign reserves, budget deficits and debt to GDP ratios. It was mutually agreed to use the United States dollar as a currency peg and it was reaffirmed in December 2004 that the United States dollar would be used as a joint stabiliser for the GCC currencies. Work is ongoing to harmonize the legal and institutional frameworks needed to establish a GCC central bank. Eventually, the countries of the GCC will need to form a joint monetary body to supervise financial and monetary matters and to regulate the common currency.

Across the Arab region, there have been moves to replace import substitution policies that protect inefficient domestic industries, particularly State-owned enterprises, with more efficient policies that facilitate trade. While this shift in the Arab region has been comparatively slower than in other developing

regions, a number of bilateral north-south trade agreements have already been negotiated over the past decade. Most prominently, the Euro-Mediterranean Partnership Agreements are aimed at forming a free trade area by 2010 between the EU and 12 southern Mediterranean countries, including five ESCWA members, namely, Egypt, Jordan, Lebanon, Palestine and Syrian Arab Republic. In addition to its Euro-Mediterranean Partnership Agreement, Jordan negotiated a free trade agreement with the European Free Trade Association (EFTA), which was implemented in September 2002.

Moreover, the United States of America launched a new trade initiative to deepen its relations with the Middle East, with the eventual goal of establishing a free trade area by 2013. Within that context, the United States negotiated trade and investment agreements (TIFAs) with Bahrain, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates and Yemen. Furthermore, in 1996, the United States authorized Qualifying Industrial Zones (QIZs) to promote production-sharing between Israel, Jordan and Palestine under the Israel-United States Free Trade Area Agreement of 1985. Since 1999, a total of 13 QIZs were designated in Jordan that, in the period 2000-2004, resulted in a dramatic expansion by 1,400 per cent of Jordanian exports from those zones to the United States market. Additionally, Egypt, Israel and the United States signed a QIZ agreement in December 2004, which is set to open the United States market to qualifying Egyptian products. While a bilateral free trade agreement (FTA) with the United States has eluded Egypt for many years, two other ESCWA members, namely, Bahrain and Jordan, have been more successful in that area. The FTAs were signed in 2000 between Jordan and United States; and in 2004, coming into force January 2005, between Bahrain and the United States.

In the context of the Doha Development round of the WTO negotiations, developing countries have expressed concerns with regard to the limited market access for their commodity exports, particularly agricultural products. Currently, WTO includes seven ESCWA members who have been actively participating in the negotiations. Three other ESCWA members, namely, Lebanon, Saudi Arabia and Yemen, are in the process of negotiating their accession packages; and Iraq, which was granted observer status in February 2004, requested to begin negotiation procedures for its accession to WTO in October 2004.

Debt financing is an important element of financing for development, and sustainable debt management is essential for opening international credit markets to developing countries. Total external debt for the ESCWA region was \$539 billion in 2003, down modestly from \$549 billion in 2002. The average ratio of public debt to national income in the ESCWA region remained high by international standards, at approximately 103 per cent in 2003. Several countries in the region are struggling with heavy debt burdens, namely, Egypt, Iraq, Jordan, Lebanon, Syrian Arab Republic and Yemen. In 2005, the Syrian Arab Republic reached an agreement on the settlement of its public debt owed to the Russian Federation, with a cancellation of some 73 per cent of the \$13.4 billion Syrian debt and a staggered repayment of the remaining \$3.6 billion over a 10-year period.

Yemen, which represents the only least-developed country in the ESCWA region, has never qualified for debt relief under the Heavily Indebted Poor Countries Initiative (HIPC), despite a significantly high public debt, estimated at 96 per cent of export value in 2003. While Yemen is trying to implement fiscal austerity measures to better match expenditures with available revenue, recent civil unrest in response to fuel subsidy reductions places fiscal austerity policies in jeopardy.

The debt in Iraq was a major topic on the agenda of the Summit of the Group of Eight (G8) industrialized countries (Sea Island, United States, 8-10 June 2004). The Paris Club of Industrial Country Creditors agreed to cut the Iraqi debt by 80 per cent, and called on Arab countries to join them in providing debt relief for Iraq.

During the 1990s, ODA flows declined as a percentage of donor country income. While developed countries pledged to provide a minimum of 0.7 per cent of their national incomes as aid, on average only 0.25 per cent has been provided. In the ESCWA region, ODA has not been a consistent or reliable source of development financing given that such assistance has been tied to political policy goals of donor countries. Financial and technical assistance to the ESCWA region is facilitated through a diverse assortment of international organizations, regional institutions and individual countries in the form of loans, grants and technical expertise for long-term and short-term development projects. However, international aid has

traditionally been project-linked or politically motivated, and needs to take better account of the development needs of the region. Regional sources of development aid, particularly from the oil-exporting countries of the Gulf sub-region, are better placed in terms of regional knowledge to provide loans and grants for projects that directly impact regional economic and social development.

In order to meet their Monterrey Consensus obligations and promote financing for development, ESCWA member countries must focus at the following:

- (a) Persist with the reforms of the banking and capital market sectors;
- (b) Accelerate the privatization of State-owned assets, particularly in the banking sector;
- (c) Standardize financial terminology, rules and regulations;
- (d) Introduce deposit insurance schemes to encourage domestic savers;
- (e) Promote an internationally competitive insurance industry;
- (f) Require financial sector disclosure, auditing and good corporate governance;
- (g) Promote the adoption of IT, management information systems and e-commerce in financial markets;
- (h) Encourage private sector companies, particularly family-owned enterprises, to make better use of equity financing;
- (i) Draft new laws and regulations that promote an investor-friendly environment;
- (j) Coordinate WTO negotiation position with other developing countries;
- (k) Adopt trade policies and negotiate for trade agreements that are pro-development;
- (l) Eliminate non-tariff barriers that reduce the gains from trade liberalization;
- (m) Provide training for relevant Government officials in sustainable debt management;
- (n) Improve the efficiency of ODA by funding productive projects and by coordinating development efforts between ministries;
- (o) Institute tax reforms that raise collection efficiency and broaden the tax base;
- (p) Adopt coherent macroeconomic policies that support development goals.

## ABBREVIATIONS AND EXPLANATORY NOTES

ADSM	Abu Dhabi Securities Market
AMF	Arab Monetary Fund
AMU	Arab Maghreb Union
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
ATM	automated teller machine
BIT	bilateral investment treaty
BOT	build-operate-transfer
CAR	Capital Adequacy Ratio
CMA	Capital Market Authority
DESA	Department of Social Affairs
DFM	Dubai Financial Market
DMFAS	Debt Management Financial and Analysis System
ENP	European Neighbourhood Policy
ESCWA	Economic and Social Commission for Western Asia
EU	European Union
FDI	foreign direct investment
FTA	free trade agreement
GAFI	General Authority for Investment and Free Zones
GAFTA	Greater Arab Free Trade Area
GATS	General Agreement on Trade and Services
GATT	General Agreement on Tariffs and Trade
GCC	Gulf Cooperation Council
GDP	gross domestic product
GSP	Generalized System of Preferences
GSTP	Global System of Trade Preferences
IAS	International Accounting Standards
ICFD	International Conference on Financing for Development
IFCG	International Finance Corporation Global Index
IIT	intra-industry trade
IMF	International Monetary Fund
IOM	International Organization for Migration
IPO	initial public offering
IPR	intellectual property right
IT	information technology
JICA	Japan International Cooperation Agency
KSE	Kuwait Stock Exchange
LAS	League of Arab States
M1	measure of the money supply that includes currency and checking accounts
M2/GDP	broad money to gross domestic product
MDG	Millennium Development Goal
MEFTA	Middle East Free Trade Area Initiative
MSM	Muscat Securities Market
NAFTA	North American Free Trade Agreement
NBK	National Bank of Kuwait
NCB	National Commercial Bank
NGO	non-governmental organization
NIB	National Investment Bank
ODA	Official Development Assistance
POS	point-of-sale
QIZ	Qualifying Industrial Zone
RCA	Revealed Comparative Advantage Index
RTA	regional trade agreement
SAMA	Saudi Arabian Monetary Agency

## ABBREVIATIONS AND EXPLANATORY NOTES *(continued)*

SASEC	Saudi Arabian Securities and Exchange Commission
SME	small- and medium-sized enterprise
SPS	Sanitary and Phytosanitary
SSM	Saudi Stock Market
TBT	Technical Barriers to Trade
TIFA	trade and investment framework agreement
TRI	Trade Restrictiveness Index
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
WBI	World Bank Institute
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

References to dollars (\$) are to United States dollars, unless otherwise specified.

## I. BACKGROUND ON THE MONTERREY CONSENSUS ON FINANCING FOR DEVELOPMENT

Intergovernmental bodies, particularly the United Nations, the World Bank and the International Monetary Fund (IMF), have worked for decades to identify the root causes of poverty and underdevelopment across the developing world, and to set goals for these countries and their donors aimed at solving the key challenges facing global development. Unfortunately, the poorest of the poor continued to fall through the safety nets and the income distribution gap continues to widen.

In the twentieth century, these international organizations had been perceived by developing countries as putting forth policies that promoted the development and employment goals of the industrialized countries. Both the trade liberalization policies of the multilateral trading system and the flows of Official Development Assistance (ODA) from North to South were considered politically motivated, rather than aimed directly at reducing poverty and promoting sustainable development. In recognition of the shortcomings of past attempts to solve the multitude of development issues, the United Nations Millennium Declaration was adopted, which resulted in the Millennium Development Goals (MDGs) with the following clear objectives: (a) to halve the proportion of people living under poverty between 1990 and 2015; (b) to improve primary education; (c) to eliminate gender disparity in education; (d) to reduce infant and maternal mortality; (e) to reverse the spread of HIV/AIDS, malaria and other diseases; (f) to ensure environmental sustainability; and (g) to develop a global partnership between developed and developing countries.

As a result of follow-up monitoring activities to measure the implementation of MDGs, studies have revealed that current trends in economic growth and development fall significantly short of the set target of 2015 for poverty reduction. Developing countries continue to face significant challenges that are beyond their means, including deficiencies in structural, legislative and regulatory frameworks; and severe shortfalls in development finance to fund their development projects. The cost of financing the MDGs globally poses a problem in itself; financing, in fact, is the central issue. For example, the global cost for the most prominent MDG, namely, to halve poverty by 2015, has been estimated at twice the current annual allocation of \$50 billion in foreign aid. If the MDGs are not met by that target date, an additional 56 million children are projected to die of starvation and preventable disease in the intervening period, and one billion people are predicted to subsist on less than \$1 a day.<sup>1</sup>

Consequently, the priority for achieving the MDGs was redirected towards identifying the necessary sources of financing for development. A new global consensus was needed to attain the MDGs set forth by the international community, according to which all countries committed themselves to cooperate in eradicating poverty, achieving sustained economic growth and promoting sustainable development. The new consensus calls for partnerships at all levels to address the challenge of raising financing for development, and summons the international community to make the international monetary, financial and trading systems more coherent by working to improve global economic governance and strengthen the leadership role in development played by the United Nations. At the International Conference on Financing For Development (Monterrey, Mexico, 18-22 March 2002), participants recognized that ODA alone falls short of providing the necessary development financing to meet the MDGs. While a minimum of \$50 billion a year of additional aid for developing countries is needed to reach the MDGs by the target date of 2015, a mere \$16-18 billion a year in additional aid commitments have been pledged to 2006.<sup>2</sup> Reconciling needed financing for development with limited ODA therefore requires discretionary policies by both developed and developing countries aimed at ensuring that the benefits of globalization reach the developing countries by opening new avenues for development financing.

Within that context, the United Nations organized the second High-level Dialogue on Financing for Development (New York, 27-28 June 2005) to review the status of implementation and tasks ahead within

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<sup>1</sup> ESCWA, "Report on the follow-up on the implementation of the International Conference on Financing for Development in the ESCWA region" (E/ESCWA/GRID/2003/38), p. 4.

<sup>2</sup> M. Baird and S. Shetty, "Getting there", *Finance & Development* (December 2003), which is available at: [www.imf.org/external/pubs/ft/fandd2003](http://www.imf.org/external/pubs/ft/fandd2003).

the framework of the Monterrey Consensus; and to follow up on the first High-level Dialogue, which was held in 2003. During that follow-up Dialogue, the regional commissions of the United Nations, including ESCWA, international and private sector stakeholders, and Government officials reported on the progress made in implementing the Monterrey Consensus.<sup>3</sup> In particular, the regional commissions illustrated their leadership roles under the Monterrey Consensus in terms of providing a wide variety of follow-up activities aimed at assisting their member countries.<sup>4</sup> Within that framework, ESCWA organized a number of capacity-building workshops on debt statistics and debt management, in cooperation with the United Nations Conference on Trade and Development (UNCTAD); created a database on foreign direct investment (FDI); hosted the Expert Group Meeting on the Regional Dimension of the Monterrey Consensus: Financing for Development (Beirut, 6-8 June 2005); and published various substantive studies.<sup>5</sup>

During the High-level Dialogue, three ESCWA members, namely Palestine, the Syrian Arab Republic and the United Arab Emirates, addressed a number of shortcomings that continue to constrain the volume and efficient use of sources of financing for development. First, they stressed the need for the international will to be strengthened in order to develop an integrated world strategy for creating development finance. Developed countries were called upon to honour their commitments of providing 0.7 per cent of national income for aid, with 0.15-0.20 per cent to be allocated to the least-developed countries, as well as cancelling the debts of the least-developed countries and separating this aid from ODA.<sup>6</sup>

With regard to the rules-based global trading system, these three ESCWA members called for improved equality among WTO members, improved market access for developing countries, and support for the accession of developing countries to WTO. It was pointed out that domestic resources of developing countries are also important sources of finance that need to be encouraged domestically by increasing national investment, research and development, and women participation in development. As a major recipient of aid, Palestine highlighted its steps towards economic and political reforms, with the private sector playing a key role in the economic recovery. However, ongoing regional conflicts and limited access to regional and international markets continue to hinder economic development in Palestine.

Additional insights from participants included the need for international assistance aimed at countering the brain drain and capital flight from developing countries, which is particularly relevant for the Middle East. Roundtable discussions on the six activities of the Monterrey Consensus illustrated some lessons learned since the Conference in Monterrey, as well as serious challenges that continue to face the global community in implementing the Monterrey Agreement. Selected points by participants at the High-Level Dialogue in 2005 included the following:<sup>7</sup>

(a) Weak institutions and poor governance in developing countries were cited as constraints to mobilizing domestic savings for development;

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<sup>3</sup> More information on the High-level Dialogue is available at: [www.un.org/esa/ffd/HLD-2005.html](http://www.un.org/esa/ffd/HLD-2005.html).

<sup>4</sup> Note by the Secretary-General, "Implementation of the Monterrey Consensus: a regional perspective" (7 June 2005).

<sup>5</sup> These studies by ESCWA include the following: "Responding to globalization: stock market networking for regional integration in the ESCWA region" (E/ESCWA/GRID/2003/37); "Policies aimed at attracting foreign direct and intraregional investment in the ESCWA region: improving the climate for foreign direct investment and mobilizing domestic savings – case studies of Bahrain, Jordan and Yemen (E/ESCWA/GRID/2003/28); "External debt management and the debt situation in the ESCWA region: case studies on Jordan and Lebanon (E/ESCWA/GRID/2004/5); "Development and institutional reform of financial markets: issues and policy options for the ESCWA region (E/ESCWA/EAD/2004/5); "Report on the follow-up on the implementation of the International Conference on Financing for Development in the ESCWA region" (E/ESCWA/GRID/2003/38); and "Annual review of developments in globalization and regional integration in the countries of the ESCWA region, 2004" (E/ESCWA/GRID/2004/6).

<sup>6</sup> Press release by the General Assembly, "World community must honour – even go beyond – commitments on trade, debt, finance to achieve anti-poverty goals, General Assembly told" (GA/10366), which is available at: [www.un.org/News/Press/docs/2005](http://www.un.org/News/Press/docs/2005).

<sup>7</sup> Ibid.

(b) Remittance flows are larger than official figures reveal, perhaps as much as 2-3 times higher, according to the International Organization for Migration (IOM). However, there is a lack of specialized banking to service remittance flows. The reform of banking systems that reduce transfer costs for migrant worker savings promotes the investment of remittances;

(c) FDI flows continue to move between developed countries and a limited number of developing countries that have traditionally benefited from FDI;

(d) There is a need to encourage more micro-credit as a form of FDI, given that, by its nature, such credit contains a poverty-eradication dimension;

(e) A more ambitious Doha Development Round is needed with the following aims: (i) to increase market access for products from developing countries, particularly agricultural products; (ii) to eliminate subsidies and quotas; (iii) to promote south/south trade; and (iv) to adjust assistance for developing countries;

(f) A pro-poor approach must be taken on trade liberalization, given that trade agreements can work against the most vulnerable in society;

(g) Increased financial and technical assistance need to be complemented by better management;

(h) Increases in ODA need to be new sources, rather than resulting from reductions in emergency relief, debt relief or prior commitments;

(i) Loans must be used more effectively to establish the necessary infrastructure for developing countries, rather than merely to service debt;

(j) A first priority of the international financial system is to protect against shock. For example, gaps in financial infrastructures have left commodity-dependent countries open to external shocks;

(k) Overhauling the global money-lending institutions is needed, with more focus on commerce, finance and trade;

(l) Recalibration of the financial architecture, namely, the global financial institutions, is needed such that it weighs in favour of developing countries, with closer coordination between the World Bank, IMF and the Economic and Social Council (ECOSOC).

## II. AN OVERALL ASSESSMENT OF PROGRESS MADE BY ESCWA MEMBER COUNTRIES IN IMPLEMENTING THE MONTERREY CONSENSUS

Since the International Conference on Financing for Development (Monterrey, Mexico, 18-22 March 2002), the progress made in the ESCWA region in implementing the Monterrey Consensus has been essential in terms of stimulating development finance in the region. That progress has differed at a national level whereby some ESCWA member countries have made greater strides than others. Within that framework, the more successful ESCWA members can be used as examples to guide other developing countries that face similar challenges and resource limitations, particularly in the areas of financing economic development and poverty reduction programmes.

However, bottlenecks still exist in crucial areas of national economies. Given the interrelated nature of the six actions of the Monterrey Consensus, a lack of efficiency in one sector can adversely affect other sectors. For example, an underdeveloped banking sector that forces companies to operate on a cash-only basis or to finance imports through company-owned resources can stifle anticipated financial gains from trade liberalization policies. ESCWA member countries need therefore to pursue a coordinated policy approach in implementing the Monterrey Consensus.

This chapter provides an overview of the recent progress made by ESCWA member countries in adopting policies that facilitate the growth of financing for development. In-depth case studies on the mobilization of domestic financial resources and trade as an engine for growth are described in chapters III and IV, respectively.

### A. DOMESTIC FINANCIAL RESOURCES

The financial sector plays several crucial roles in both developed and developing economies, namely: (a) encouraging domestic savings by providing investment opportunities; (b) channelling funds from savers to borrowers; (c) screening private and public sector projects on behalf of investors, thereby providing sound financial information that promote informed choices and reduce investor risk; (d) providing payment and settlement services to investors and borrows at reasonable transaction costs; (e) managing the accounts of lenders and borrowers, and collecting outstanding loans; (f) providing financial channels for remittances from overseas workers; and (g) providing vital financial services to support other sectors of the economy.

An underdeveloped financial sector becomes a bottleneck and hinders the growth and development of all sectors of the economy. Financial resources in the ESCWA region are channelled through a number of financial markets, including private, public and Islamic banks; financial institutions; capital markets; and bond markets. Additional domestic financial resources are mobilized through the repatriation of Arab capital assets invested abroad, worker remittances, pension funds and insurance, and taxes.

Ultimately, all domestic sources of finance depend on regional savings. Savings rates in the ESCWA region vary considerably among countries, particularly between the capital-surplus countries of the Gulf Cooperation Council (GCC) and the more diversified economies. In addition, there is a significant outflow of savings from the ESCWA region that is invested abroad.<sup>8</sup> Mobilizing household savings in the ESCWA region requires a number of measures by Governments aimed at building investor trust in the financial sector. Private companies are equally responsible for fostering a good investment climate to mobilize savings rates in the region. Actions that build investor trust include fully disclosing financial statements, providing easy access to financial records through the Internet or the regular publishing of financial statements, adopting international accounting standards, and diversifying investment opportunities.

Arab investors send capital outside the region in part because of the comparatively limited options available to them in their own countries. They are attracted, among many other factors, by the sheer number

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<sup>8</sup> Within that context, it is estimated that as many as 200,000 Arab investors send their capital outside the region. ESCWA, "Responding to globalization: stock market networking for regional integration in the ESCWA region (E/ESCWA/GRID/2003/37), p. 1.

of choices available to them in developed financial markets outside the region, by the low transaction costs and by the security of their investments. Governments across the region can work together with the private sector to identify investment instruments that could be introduced at a regional level, in addition to any barriers that exist to such investments. For example, developing national currency bond markets can stimulate household savings. Moreover, Governments need to provide transparent regulations for the banking sector and stock markets, modern legal frameworks and guaranteed enforcement of financial regulations in order to protect the interests of investors. Additional measures to increase savings rates include mandatory pension funds and compulsory insurance. Equally, taxation is a form of forced savings that can contribute towards developing finance on the proviso that tax revenues are used for productive projects. Appropriate legal, economic and socio-cultural environments are necessary to encourage domestic and international savers to participate in regional stock markets and banking sectors. It is necessary to issue laws that secure the rights of investors and savers, thereby creating trust.

ESCWA member countries have taken a number of steps to modernize their financial markets and are continuing to move ahead with legal, regulatory and macroeconomic reforms that will enable other sectors to benefit from improved access to domestic financial resources. However, the domestic financial markets in the ESCWA region remain underdeveloped relative to other developing regions and continue to constrain growth in related sectors that rely on financial services, which causes an outflow of capital from the region.

### 1. *Capital markets in the ESCWA region*

Developing countries across the world face obstacles in terms of forming viable domestic capital markets. While emerging stock markets in developing countries have the advantage of being close to the investor and of offering investment opportunities in the local market, there are a number of characteristics that are typically lacking in the stock markets of developing countries, including as follows: (a) transparency; (b) accountability; (c) liquidity; (d) low transaction costs; (e) investor protection; and (f) modern clearance and settlements procedures. These issues must be addressed if the stock markets of developing countries are to compete with international financial markets.

In the ESCWA region, the recent reforms in the legal, regulatory and macroeconomic areas have been most evident in the countries of the GCC. For example, the Capital Market Authority in Saudi Arabia issued laws in 2005 that authorized brokerage firms to trade shares outside the national banking sector for the first time, thereby raising efficiency and transparency of the capital market.<sup>9</sup> In addition, Saudi Arabia authorized the equal treatment for citizens of the GCC for the purpose of purchasing and exchanging stocks on the Saudi Stock Market (SSM).<sup>10</sup> Similarly, Qatar began to open its stock market to foreign investors in 2005 by allowing foreign investors to own a maximum of 25 per cent of shares in publicly traded Qatari companies.<sup>11</sup>

Arab stock markets have enjoyed spectacular growth over the past few years. This ongoing trend can be attributed to a number of factors, including the following: (a) comparatively high global oil prices and revenues; (b) strong earnings and dividends of listed companies; (c) low regional interest rates; (d) declines in non-performing loans at banks; and (e) excess liquidity arising from worker remittances and repatriated Arab capital in the wake of the terrorist attacks of 11 September 2001 on the United States of America.

SSM remains the regional giant in terms of market capitalization, followed by the Abu Dhabi Securities Market (ADSM) and the Kuwait Stock Exchange (KSE), in second and third positions, respectively (see table 1). However, Egypt had the highest number of listed companies, which reflects the diversified nature of its economy. The capital market authority in the United States accredited the Cairo and Alexandria Stock Exchanges (CASE) in April 2003 as an overseas registered bank notes market. This accreditation is set to give confidence to foreign investors and could further raise the trading volumes and

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<sup>9</sup> *Zawya*, "Saudi Arabia: CMA issues new laws for setting up brokerage firms" (20 July 2005), which is available at: [www.zawya.com](http://www.zawya.com).

<sup>10</sup> *Zawya*, "Saudi shares now open to GCC citizens" (5 April 2005), which is available at: [www.zawya.com](http://www.zawya.com).

<sup>11</sup> *The Financial Express*, "Qatar opens bourse to foreigners", Vol. No. REGD No. DA 1589 (5 April 2005).

liquidity of the Egyptian capital markets. After Egypt, the next highest levels of listed companies of the regional capital markets were the Amman Stock Exchange, KSE and Muscat Securities Market (MSM).

TABLE 1. CAPITAL MARKETS IN THE ESCWA REGION, 23 MAY 2005

Financial Market	Market capitalization (millions of \$)	Number of listed companies
Abu Dhabi Securities Market	101 108	43
Amman Stock Exchange	28 744	192
Bahrain Stock Exchange	16 942	45
Beirut Stock Exchange	2 696	32
Doha Securities Market	69 075	30
Dubai Financial Market	67 159	20
Egypt Capital Market	51 484	766
Kuwait Stock Exchange	97 138	140
Muscat Securities Market	9 763	124
Palestine Securities Exchange	2 344	26
Saudi Stock Market	488 657	75

Source: Arab Monetary Fund (AMF), "Daily summary" (23 May 2005), which is available at: [www.amf.org.ae](http://www.amf.org.ae).

There is ongoing cross-border cooperation among Arab countries in terms of promoting intraregional investment and stock market networking. For example, Egypt and Morocco signed a five-year memorandum of understanding in January 2004 aimed at facilitating cooperation between their two capital markets, with the goal of attracting investors and of consolidating bond issues and circulation. Similarly, in 1999, Jordan and Kuwait signed a cross-listing memorandum to allow national companies from those two countries to list in their respective capital markets. Moreover, the National Association of Securities Dealers Automated Quotation (NASDAQ) hosted training workshops on capital markets technology and electronic markets in July 2000 for capital market representatives from Bahrain, Egypt, Jordan, Kuwait, Palestine and United Arab Emirates. Additionally, in 2002, a cooperation protocol was signed between Egypt, Jordan, Malta and Tunisia to set up a Mediterranean stock exchange, called the BorzaMed Project.<sup>12</sup> In the same spirit, the countries of the GCC began discussions in 2005 on establishing a joint stock market, which requires the six member countries of that sub-region to coordinate stock market procedures and rules.<sup>13</sup> Furthermore, the Union of Arab Stock Exchanges and Securities Commissions continues to work towards the formation of a unified stock exchange for the entire Arab region.

However, despite this flurry of activity by ESCWA members aimed at stimulating domestic capital markets, these continue to face a range of challenges, including as follows: (a) the modest size of capital markets relative to national economies; (b) low trading volumes; (c) inadequate financial disclosure by listed companies; (d) inadequate legal and institutional frameworks; (e) lengthy clearance and settlement delays; (f) a lack of investor protection; (g) barriers to foreign and intraregional investors; and (h) limited links to global financial markets. Additionally, equity markets in the ESCWA region remain underdeveloped compared to financial markets in other developing and emerging economies. The linkages between Arab capital markets in terms of cross-border trades and their links with international financial markets remain weak.

## 2. Banking sector in the ESCWA region

The banking sector in the ESCWA region plays a critical role in regional development. The sector, which includes private, public and Islamic banks, facilitates financing for both private and public sector projects; presents a venue for domestic savers; and provides financial services to the other sectors of the economy. The banking sector in Saudi Arabia has the largest value of assets, at \$174.8 billion in 2004, followed by United Arab Emirates, Egypt and Bahrain in second, third and fourth positions, respectively (see table 2). All ESCWA member countries experienced a growth in their bank assets between 2002 and 2004.

<sup>12</sup> *Jordan Times*, "Int'l regulatory standards and Arab capital markets" (14 February 2005).

<sup>13</sup> *Arab News*, "GCC plans joint stock market" (20 April 2005).

TABLE 2. GROWTH OF BANK ASSETS IN THE ESCWA REGION, 2002-2004  
(Millions of United States dollars)

Country	Total assets, 2002	Total assets, 2003	Total assets, 2004
Bahrain	73 996	100 934	101 944
Egypt	83 651	99 177	111 943
Jordan	21 325	22 146	25 100
Kuwait	56 936	63 855	64 800
Lebanon	54 547	62 344	65 000
Oman	11 332	11 733	12 723
Qatar	17 210	20 907	25 282
Saudi Arabia	135 523	145 381	174 769
Syrian Arab Republic	23 245	25 685	28 382
United Arab Emirates	90 279	99 907	112 661
Yemen	2 694	3 065	3 593

Source: *Union of Arab Banks Magazine* (November 2004).

The banking sector in the ESCWA region continues to suffer from a number of structural problems.<sup>14</sup> Chiefly, service costs to customers are relatively high and are not competitive with international banks. Moreover, while there is a proportionately large number of banks in relation to the population, economies and size of the region, these are typically dominated by one or more large banks that are often State-owned or family-owned enterprises. Additionally, the banking sector across the ESCWA region suffers from a large number of non-performing loans, which can be traced to inferior loan portfolios and poor corporate governance. Historically, limited Government regulation and supervision of the banking sector has resulted in weak disclosure of bank records, inconsistent and inaccurate data collection, and inconsistent record-keeping methodologies with international practices. Some banks in the ESCWA region still rely on manual payment systems, which lead to clearing delays, lost records and bounced checks.

In the light of these structural difficulties facing the Arab banking sector, ESCWA member countries have launched a number of reforms.<sup>15</sup> These include reforming macroeconomic policies, adopting indirect monetary control instruments, harmonizing monetary policies and financial systems, developing modern legal and supervisory frameworks, and liberalizing the banking sectors. In Egypt, for example, a consolidation of the numerous small banks is projected in the short term as banks fail to meet the minimum capital requirement of 500 million Egyptian pounds required under the recent Banking Law of June 2003.<sup>16</sup> Egyptian banks need to increase their capital to that required level before mid July 2005 to, which was extended by the Central Bank of Egypt beyond the initial deadline of end 2004.<sup>17</sup> In Saudi Arabia, the National Commercial Bank (NCB) is being transformed into an Islamic bank, thereby increasing the availability of Islamic banking services to meet domestic and regional demand. Approximately 80 per cent of the services by NCB will follow profit-and-loss-sharing techniques to comply with Sharia Law. In the Syrian Arab Republic and under legislation passed in 2001, private banks became authorized to include foreign stockholders on the proviso that Syrian ownership amounts to at least 51 per cent. This was the first banking sector privatization scheme since 1963, when the banking sector was nationalized. In 2004, the Syrian Arab Republic licensed its first foreign bank to operate domestically. The entry of foreign banks into the Syrian Arab Republic is set to strengthen the domestic financial market, which lacks sufficient capital to finance large private projects and discourages investment by foreign companies that require modern banking services

<sup>14</sup> ESCWA, "Report on the follow-up on the implementation of the International Conference on Financing for Development in the ESCWA region" (E/ESCWA/GRID/2003/38), p. 12.

<sup>15</sup> ESCWA, "The financial sector in the ESCWA region: the current status and prerequisites for strengthening and development" (E/ESCWA/OES/2002/6), p. 2.

<sup>16</sup> *Reuters/Gulf News*, "Egypt's banking system is still weak, says S&P" (19 June 2005).

<sup>17</sup> Given that the deadline can be extended up to three years, it is not yet clear if the deadline of July 2005 will be enforced. *Arab News*, "Capital increase move puts pressure on Egyptian banks" (14 March 2005).

to operate. Unfortunately, low incomes and a general lack of trust in private banks has slowed development of the banking sector in the Syrian Arab Republic. Moreover, foreign banks have expressed legal concerns with regard to the ability by private banks to collect on bad debts. In June 2005, a law was passed opening the insurance market to foreign companies for the first time in 40 years, giving insurance customers an alternative to the State-owned Syrian Insurance Company.<sup>18</sup> Almost concurrently, in May 2005, the Syrian Arab Republic authorized the establishment of Islamic banking to stimulate domestic savings and attract intra-Arab investment.<sup>19</sup>

## B. FOREIGN DIRECT INVESTMENT

ESCWA member countries have boosted their efforts to attract FDI, fully aware that such investments provide recipient countries with funds for development, and expose firms in developing countries to new technologies and improved managerial skills that raise productivity and competitiveness of domestic industries. Moreover, FDI can open access to global markets through production-sharing between domestic and international companies. Integration into world financial markets is therefore crucial for attracting FDI. In the ESCWA region, regulatory and legislative reforms are necessary to attract international and intraregional investment, including modernizing existing investment laws and establishing autonomous investment promotion agencies.

In 2003, FDI inflows to ESCWA member countries amounted to some \$2.8 billion, which represents a very modest 0.5 per cent share of the global \$560 billion FDI flows.<sup>20</sup> Across the Arab region, this share was 1.5 per cent of global FDI flows, amounting to \$8.6 billion inflow.<sup>21</sup> All developing countries received \$172 billion in 2003, representing 31 per cent of world FDI inflows. With the exception of Bahrain, the ratio of FDI inflows to gross domestic product (GDP) in ESCWA member countries was below average for developing countries from other regions. Bahrain, with inflows estimated at \$517 million dollars in 2003, was the most successful ESCWA member at attracting FDI (see table 3).

TABLE 3. FOREIGN DIRECT INVESTMENT IN THE ESCWA REGION, 2003

Country	FDI inflows (millions of \$)	FDI to GDP ratio
Bahrain	517	72.4
Egypt	237	26.2
Jordan	379	28.3
Kuwait	67	1.2
Lebanon	358	11.0
Oman	138	12.6
Qatar	400	16.0
Saudi Arabia	208	12.1
Syrian Arab Republic	150	9.5
United Arab Emirates	480	4.4
Yemen	(89)	11.1

Source: ESCWA, "Annual review of developments in globalization and regional integration in the countries of the ESCWA region, 2004" (E/ESCWA/GRID/2004/6), tables 2 and 4.

<sup>18</sup> W. Rasmussen, "Syria set to open untapped insurance market to international competition" *The Daily Star* (6 July 2005).

<sup>19</sup> *Arab News*, "Syria approves Islamic banks" (5 May 2005).

<sup>20</sup> ESCWA, "Annual review of developments in globalization and regional integration in the countries of the ESCWA region, 2004" (E/ESCWA/GRID/2004/6), pp. 4-5.

<sup>21</sup> S. Zein, "Foreign direct investment in financing development: ESCWA's role in enabling members to have more accurate FDI data", which was presented at the Expert Group Meeting on Regional Dimension of the Monterrey Consensus: Financing for Development (Beirut, 6-8 June 2005).

This significantly low level of FDI can be attributed to various factors, including ongoing regional conflicts, slow economic reforms, weak governmental institutions, administrative barriers, and underdeveloped infrastructure and financial sectors.

In the past decade, ESCWA member countries have increased their efforts aimed at attracting FDI and at repatriating Arab capital invested outside the region. Within the context of the latter, estimates suggest that countries of the GCC currently possess surplus capital of up to \$1.4 trillion invested outside the Arab region, particularly in the United States and Europe, while Saudi Arabia alone could have up to \$750 billion invested abroad.<sup>22</sup> Repatriating even a portion of Arab capital can boost the financial resources available for economic development and poverty alleviation in the ESCWA region.

Aiming to increase the low level of FDI, countries across the region have sought to change the investment climate. For example, Egypt modified its Investment Incentives and Guarantees Law in March 2004 in order to streamline the bureaucratic process facing investors. Pursuant to that Law, the necessary licences for new projects, which previously required authorization by 37 different Egyptian authorities, are now issued by a single entity, namely, the General Authority for Investment and Free Zones (GAFI).<sup>23</sup> In Dubai, the United Arab Emirates, Law No. 9 was promulgated in 2004 under which financial free zones could be established.<sup>24</sup> These zones allow foreign banking and financial activities through licensed branches of companies and institutions, and joint stock companies. Moreover, insurance services in the financial free zones are confined to reinsurance activity.

Additionally, Saudi Arabia followed through with its obligations to liberalize financial services under its WTO accession package by awarding licences to foreign banks.<sup>25</sup> However, the latest draft of the WTO accession package for Saudi Arabia excludes FDI in the oil sector, which will negatively impact the volume of FDI expected to enter Saudi Arabia. Furthermore, that country approved a capital markets law in 2004, which establishes the Saudi Arabian Securities and Exchange Commission (SASEC) aimed at protecting investor interests, regulating the capital market and licensing non-bank financial intermediaries.<sup>26</sup>

Similarly, Qatar issued a decree in June 2004 to allow foreign ownership of property in selected residential areas through a scheme that authorizes 99-year leases, with possible extensions for an additional 99-year period. This is expected to have an indirect effect on FDI, given that property rights are an important component for attracting investment by foreign companies.<sup>27</sup> In Kuwait, the banking sector was given a boost by two laws, namely, Foreign Direct Capital Investment Law No. 8 of 2001 and Law No. 28 of 2004.<sup>28</sup> Within that framework, the Central Bank of Kuwait grants licences to international banks, with the proviso that, within 3 years of operation, a minimum of 50 per cent of staff working in these foreign banks must be nationals of Kuwait.<sup>29</sup> In Bahrain, the rules regulating the domestic insurance market were amended in 2004,

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<sup>22</sup> *Kuwait News Agency*, "Up to 1,400 billion US dollars of GCC money invested abroad" (14 April 2005).

<sup>23</sup> *Arab News*, "Egypt announces reforms to attract FDI" (28 February 2005).

<sup>24</sup> Dubai International Financial Centre (DIFC), "DIFC receives final legislative approval from Dubai Government" (17 September 2004), which is available at: [www.difc.ae/press\\_room/2004/148.html](http://www.difc.ae/press_room/2004/148.html).

<sup>25</sup> The first bank to receive such a licence was the Deutsche Bank in 2003. *AME Info*, "Saudi Arabia opens up its banking sector" (13 October 2003), which is available at: [www.ameinfo.com/29521.html](http://www.ameinfo.com/29521.html).

<sup>26</sup> *The Banker*, "Capital markets law sends Saudi Arabia into new era" (2 July 2003), which is available at: [www.thebanker.com](http://www.thebanker.com).

<sup>27</sup> For more information, see *Property World*, which is available at: [www.propertyworldme.com/content/html/761.asp](http://www.propertyworldme.com/content/html/761.asp).

<sup>28</sup> MSI, "Foreign banks' operation in Kuwait" (10 June 2005), which is available at: [www.msi-network.com/content/cmsdoc234.asp](http://www.msi-network.com/content/cmsdoc234.asp).

<sup>29</sup> In addition to authorizing full ownership of their businesses to foreign nationals, the Foreign Direct Capital Investment Law No. 8 of 2001 provides foreign investors with a 10-year tax exemption. Al-Ayoub & Associates, "License under the Foreign Investment Law" (17 August 2005), which is available at: [www.al-ayoub.org/newlaws3.html](http://www.al-ayoub.org/newlaws3.html).

whereby foreign companies can operate as insurance brokers without a Bahraini partner.<sup>30</sup> This is set to encourage FDI inflows and improve efficiency in the financial sector. Moreover, at a sub-regional level, the six countries of the GCC are undertaking cooperative measures aimed at establishing a monetary union by 2007 and a single currency by 2010. The necessary legal and institutional frameworks for harmonizing and modernizing their financial sectors could attract FDI and repatriate capital from outside the GCC sub-region.

Similarly, ESCWA plays a key regional role by providing training in FDI statistics. Countries in the region, which generally lack the capacity to collect and analyse FDI statistics, benefit from the technical assistance provided by ESCWA in terms of gathering, recording, reporting and disseminating FDI statistics. Such assistance is pivotal in building national FDI databases. Moreover, the information provided by these national FDI databases is invaluable to policymakers for promoting growth of FDI in the region.

Within that context, ESCWA and UNCTAD collaborated on a number of national training workshops in 2003 and 2004 for relevant Government officials in five ESCWA member countries, namely, Bahrain, Jordan, Oman, Saudi Arabia and Syrian Arab Republic. These officials learned how to build and maintain FDI databases using international methodological standards and specialized computer software. The adoption of international methodologies for collecting FDI data is the first essential step in the process of identifying bottlenecks that hinder investors and prevent vital inflows of FDI. Similar training workshops could be organized in the future to include other ESCWA member countries.

### C. INTERNATIONAL TRADE

Across the region, trade liberalization policies have encouraged export growth as a source of financing for development. This progress encompasses a number of fronts, including regional integration, interregional bilateral agreements and participation by ESCWA member countries in WTO. However, while there have been moves to replace import substitution policies that protect inefficient domestic industries with more efficient policies that facilitate trade, this shift in the region has been comparatively slower than in other developing regions. This late adoption of trade liberalization has put ESCWA member countries behind in the global movement towards freer trade in goods and services. For example, according to the Trade Restrictiveness Index (TRI) by the IMF, which ranges from the least restrictive 1 to the most restrictive 10, countries of the southern Mediterranean score 7.8, which is significantly more restrictive than Africa at 4.9 or Latin America at 4.2.<sup>31</sup> The largest share of interregional trade flows among ESCWA member countries in 2003 are attributed to oil exporting countries, particularly Saudi Arabia and the United Arab Emirates (see table 4). Lebanon and Yemen had the lowest volumes of interregional trade flows in the ESCWA region in 2003.

Despite these challenges, ESCWA member countries are committed to liberalizing trade, and various bilateral north-south trade agreements were negotiated with developed countries in order to access markets for exports. The most prominent examples of bilateral trade liberalization in the ESCWA region are the hub-and-spoke agreements between the European Union (EU) and countries of the southern Mediterranean. This new generation of Euro-Mediterranean Partnership Agreements are part of a long-range plan to form a Euro-Mediterranean free trade zone by 2010, as agreed by the 27 Euro-Mediterranean Partners in the Barcelona Declaration of 1995. However, the success of a free trade zone relies on successful intraregional integration among the southern Mediterranean partners. Out of the 12 Mediterranean partners, five are from the ESCWA region, namely, Egypt, Jordan, Lebanon, Palestine and Syrian Arab Republic; three are non-ESCWA Arab countries, namely, Algeria, Morocco and Tunisia; the Libyan Arab Jamahiriya currently has observer status; and the countries of the GCC are negotiating with the EU as a bloc.

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<sup>30</sup> Office of the United States Trade Representative, "Foreign trade barriers", which is available at: [www.ustr.gov/Trade\\_Agreements/Regional/MEFTA](http://www.ustr.gov/Trade_Agreements/Regional/MEFTA).

<sup>31</sup> *ArabicNews.com*, "Major economic problems face the Arab states: stronger reform needed", which is available at: [www.arabicnews.com](http://www.arabicnews.com).

TABLE 4. INTERREGIONAL AND INTRAREGIONAL TRADE FLOWS, 2003  
(Millions of United States dollars)

Country	Interregional trade flows	Intraregional trade flows
Bahrain	15 378	2 519
Egypt	29 180	2 632
Jordan	10 329	2 703
Kuwait	26 163	1 970
Lebanon	8 882	1 494
Oman	16 849	2 379
Qatar	19 649	887
Saudi Arabia	138 025	8 975
Syrian Arab Republic	15 060	2 173
United Arab Emirates	90 750	6 342
Yemen	10 128	1 874

Source: ESCWA, "Annual review of developments in globalization and regional integration in the countries of the ESCWA region, 2004" (E/ESCWA/GRID/2004/6), table 10.

Jordan signed a free trade agreement with the countries of the European Free Trade Association (EFTA), which comprises Iceland, Liechtenstein, Norway and Switzerland. This agreement was implemented in September 2002 and calls for tariff reductions on industrial and agricultural products over a continuous 12-year period.

Similarly, as part of the trade strategy by the United States to deepen trade relations with the Middle East, that country is working on the Middle East Free Trade Area Initiative (MEFTA) aimed at establishing a free trade area by the target date of 2013. Within that framework, the United States successfully negotiated trade and investment framework agreements (TIFAs) with Bahrain, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates and Yemen. Iraq is the most recent TIFA partner, signing the agreement on 11 July 2005.<sup>32</sup>

Furthermore, in 1996, the United States authorized Qualifying Industrial Zones (QIZs) to promote production-sharing between Israel, Jordan and Palestine under the Israel-United States Free Trade Area Agreement of 1985. Since 1999, a total of 13 QIZs were designated in Jordan that resulted in a dramatic expansion of Jordanian exports from those zones to the United States market from \$72.8 million in 2000 to \$1,092 million in 2004, representing an increase of 1,400 per cent.<sup>33</sup> The majority of this export growth was under the QIZ programme. For example, Jordanian QIZ exports to the United States rose from \$369 million in 2002 to \$927 million in 2004, while Jordanian exports under the FTA with the United States rose from \$13 million in 2002 to \$21 million in 2004.<sup>34</sup> Furthermore, the regional production-sharing stimulated by the QIZs has been beneficial to the participating countries in terms of export growth and job creation.

Additionally, Egypt, Israel and the United States signed a QIZ agreement in December 2004, which is set to open the United States market to qualifying Egyptian products. Growth of Egyptian exports to the United States market are projected to emulate those of Jordanian exports and are set to have a positive impact on Egyptian economic growth and unemployment.

Similarly, Bahrain signed an FTA with the United States in May 2004, which came into force January 2005. Within the framework of this agreement, the exports expected to gain the most are in the areas of

<sup>32</sup> Office of the United States Trade Representative, "United States and Iraq sign trade and investment framework agreement", which is available at: [www.ustr.gov/Trade\\_Agreements/Regional/MEFTA](http://www.ustr.gov/Trade_Agreements/Regional/MEFTA).

<sup>33</sup> United States International Trade Commission, "All import commodities: customs value by customs value for Jordan", which is available at: [www.usitc.gov](http://www.usitc.gov).

<sup>34</sup> Ibid.

textiles, insurance and Islamic finance. Oman and the United Arab Emirates launched negotiations for comparable FTAs in March 2005.

Participation in global multilateral trade liberalization through WTO continues to increase in the ESCWA region. Seven out of 13 ESCWA member countries are full members of the WTO. However, ESCWA members, like other developing countries, continue to face obstacles in implementing their WTO accession packages from the Uruguay Round. Developing countries also expressed concerns with regard to increased market access for their exports in the current Doha Development Round, particularly in the area of agricultural trade liberalization. Iraq was granted observer status in February 2004, and in October 2004 the Government of Iraq formally requested to begin procedures for its accession to WTO. Three ESCWA members, namely, Lebanon, Saudi Arabia and Yemen, are currently in the process of negotiating their accession packages.

Table 4 above illustrates that intraregional trade flows remain low relative to interregional trade. This can be partly attributed to the large share of export value of oil and gas to industrialized countries outside the region. However, even the diversified economies in the region have relatively low shares of intraregional trade.

The Greater Arab Free Trade Area (GAFTA) was revived at the Arab Summit (Amman, 27-28 March 2001), and membership currently includes 17 out of the 22 member countries of the League of Arab States (LAS). These 17 members are as follows: Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libyan Arab Jamahiriya, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Sudan, Syrian Arab Republic, Tunisia, United Arab Emirates and Yemen.<sup>35</sup> The GAFTA members successfully eliminated intra-Arab customs duties as of 1 January 2005, which was accelerated from the original target date of 2007. While GAFTA is set to create a combined market of 254 million people, there remains work to be done on other obstacles to intra-GAFTA trade, including the rules of origin, non-tariff barriers and a dispute settlement mechanism. Within that context, in February 2004, Egypt, Jordan, Morocco and Tunisia signed the Agreement for the Establishment of a Free Trade Zone between the Arabic Mediterranean Nations, equally referred to as the Agadir Agreement. The four members are currently taking the necessary measures to implement the FTA, scheduled to take effect in 2006. Once implemented, the Arab Mediterranean FTA will create an integrated market of some 100 million people.

Similarly, the establishment of the GCC Customs Union is another success story in the area of liberalization of regional trade. The GCC sub-region has a combined market of some 33 million people and a combined GDP that exceeds that of the 17 GAFTA members. The GCC Customs Union was implemented in January 2003 by eliminating intra-GCC tariffs and by adopting a common external tariff of 5 per cent. The member countries of the GCC continue to work on standardizing regulations and on coordinating fiscal and monetary policies in order to form a monetary union by 2007, thereby leading to the adoption of a single GCC currency by 2010. This high level of economic integration, similar to the EU, is achieved by synchronizing macroeconomic policies. Specifically, the key targets for deeper economic integration were agreed upon, namely, inflation, interest rates, foreign reserves, budget deficits and debt to GDP ratios. It was mutually agreed to use the United States dollar as a currency peg and it was reaffirmed in December 2004 that the United States dollar would be used as a joint stabilizer for the GCC currencies. Work is ongoing to harmonize legal and institutional frameworks necessary to establish a GCC central bank. Eventually, the countries of the GCC will need to form a joint monetary body to supervise financial and monetary matters and to regulate the common currency.

Despite recent enthusiasm by ESCWA members to embrace regional and interregional trade liberalization, major domestic hindrances remain, particularly for intra-Arab trade. These obstacles include non-tariff barriers, legal frameworks, administrative and fiscal inconsistencies, and transport bottlenecks. All these factors combine to dampen export-driven growth and development in the region.

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<sup>35</sup> *ArabicNews.com*, "Greater free Arab trade zone in effect as of today" (1 January 2005), which is available at: [www.arabicnews.com](http://www.arabicnews.com).

#### D. EXTERNAL DEBT RELIEF AND DEBT MANAGEMENT

Debt financing is an important element for mobilizing the financial resources necessary for public and private investment, economic development and poverty reduction. Sustainable debt management requires that the financing needs of the State and its payment obligations are met at the lowest possible cost over the medium to long run, consistent with an acceptable level of risk. Government debt management begins in the debt management office, as part and parcel of overall economic policymaking. In addition, the State needs to ensure coordination between debt financing policies and overall macroeconomic goals, including sound fiscal and monetary policies, coherent exchange rate and interest rate policies, and financial market measures and regulations that encourage savers and investors to hold the public debt. Good macroeconomic policy reduces investor uncertainty, particularly for long-term commitments, and encourages financial inflows. Governments need to link their expected debt service burden from additions to external debt, the heightened risk of default from higher debt levels, and the budgetary opportunities opened by debt financing to stimulate economic growth and development. For better policy coherence at a national level, effective intra-governmental communication and dialogue are essential. Specifically, the ministries that are responsible for designing infrastructure projects aimed at implementing programmes of economic and social development must coordinate among themselves and with the ministry of finance and the central bank of a given country, thereby ensuring maximum efficiency from debt funding and sustaining debt as a long-term source of financing for development.<sup>36</sup>

Debt financing has several facets, which are potentially both positive and negative. Fiscal debt, particularly long-term debt, can be beneficial in terms of promoting economic growth through wise investment choices by the State, thereby providing an important component of nationwide financial resources for development. Public debt spent productively on infrastructure and poverty reduction projects prevents a debt crisis situation from arising.<sup>37</sup> Maintaining credit-worthiness is important for developing countries, given that they will continue to need access to loans to finance long-term economic development goals. This is particularly true of large projects that cannot be financed by underdeveloped private banking sectors, and of projects whose public goods component does not lend itself to private sector investment. In cases where growth did not occur at the expected levels, thereby resulting in lower than expected revenues, Governments need fresh access to credit in order to refinance existing debt. Government defaults on public debt can negatively impact credit available for private sector borrowers in developing countries. Consequently, fiscal debt that is mismanaged can be a burden to the economy in terms of both the mounting debt servicing burdens and the outflows of valuable foreign exchange earnings, and of the implications for private sector access to international credit.

For a country facing unsustainable external debt serving burdens or a debt crisis, the State could be compelled to institute austerity measures by reducing vital governmental services. In the recent case of fuel subsidies in Yemen, official attempts to reduce public subsidies resulted in riots and deaths. Similarly, Egypt and Jordan have both faced civil unrest in the past decade when these countries tried to reduce food and fuel subsidies in response to low Government revenues relative to unsustainable external debt servicing burdens. Unsustainable external debt can threaten to slow economic growth and could even increase the poverty level. Sound use of debt financing as part and parcel of a coordinated macroeconomic policy framework is imperative for ensuring that external debt financing stimulates economic growth and reduces poverty.

The need for debt relief and sustainable debt management for developing countries burdened by debt has been addressed at the international level through various meetings and programmes, including as follows: (a) the Paris Club and the London Club of creditors; (b) the Heavily Indebted Poor Countries Initiative (HIPC); (c) the Debt Management Financial and Analysis System (DMFAS) Programme by UNCTAD; and (d) the Monterrey Consensus on Financing for Development. The ultimate burden of sustaining debt management falls on individual Governments by promoting sound fiscal policies that

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<sup>36</sup> A. Shebaro, "Sustainable debt management in the ESCWA region: case study of Lebanon", which was presented at the Expert Group Meeting on Regional Dimension of the Monterrey Consensus: Financing for Development (Beirut, 6-8 June 2005).

<sup>37</sup> E. Baldacci, B. Clements and S. Gupta, "Using fiscal policy to spur growth", *Finance and Development*, vol. 40, No. 4 (December 2003), p. 31, which is available at: [www.imf.org/external/pubs/ft/fandd2003](http://www.imf.org/external/pubs/ft/fandd2003).

rationalize expenditures and revenues, and extract maximum development benefits from debt equity that is invested in productive projects. Some factors are outside the control of debt-burdened Governments, including regional conflicts, natural disasters, and the negative impacts arising from the volatility of exchange rates. In the case of developing countries that are the most heavily burdened by debt, the international community of donors sometimes opts for the cancellation of debt as the most viable solution to prevent an economic and social crisis.

Total debt for the ESCWA region was \$539 billion in 2003, down modestly from \$549 billion in 2002.<sup>38</sup> The average ratio of public debt to national income in the ESCWA region remained high by international standards, at approximately 103 per cent in 2003. Several countries in the region are struggling with heavy debt burdens, namely, Egypt, Iraq, Jordan, Lebanon, Syrian Arab Republic and Yemen (see table 5). The debt crisis in the ESCWA region is exacerbated by the use of budget deficits to provide a minimum level of public services, despite the high level of unemployment, poverty and limited tax revenues in the region. Recent commitments assumed by ESCWA member countries under multilateral and regional trading agreements have placed additional burdens on Governments to replace lost tariff revenues through borrowing.

TABLE 5. EXTERNAL DEBT IN THE ESCWA REGION, 2003

Country	External debt (millions of \$)	Debt to GNI (percentage)	Debt to export value (percentage)
Egypt	31 388	38	133
Jordan	8 387	85	118
Lebanon	18 598	103	378
Oman	3 886	..	31
Syrian Arab Republic	21 566	105	266
Yemen	5 377	54	96

Source: The World Bank, "GenderStats: database of gender statistics", which is available at: <http://devdata.worldbank.org>.

Over the past few years, Lebanon has adopted a debt policy of swapping high-cost domestically denominated debt for cheaper foreign-currency denominated debt. Lebanon successfully negotiated debt rescheduling with its major international creditors at the Paris I and II Conferences (2001 and 2002, respectively).<sup>39</sup> The Paris debt management plan adopted by Lebanon and its creditors included privatization, deficit-reductions and a debt-swap. This plan was partially implemented through the sale of Eurobonds in 2002. In 2004, the Government approved another debt swap for Eurobonds. On the fiscal side, Lebanon implemented a value-added tax to broaden its revenue base. However, plans to raise revenues by privatizing State-owned assets and to reduce spending by 10 per cent in 2003 were less successful. Failure to implement the fiscal reforms agreed in the Paris I and II Conferences threatens the sustainability of Lebanon's external debt and reduce the likelihood of future bail-outs by international creditors. The Lebanese external debt was \$18.6 billion in 2003, representing 103 per cent of national income and 378 per cent of export value. Lebanon continues to rely on debt restructuring as the mainstay of its debt management programme.

In Egypt, while the primarily domestic debt was \$31.4 billion in 2003, or 38 per cent of national income, it accounted for 133 per cent of export value. There appears to be little hope of reducing the Egyptian debt burden in the near future. The Egyptian budget deficit is expected to rise in the fiscal year 2004/05, given the sanction for a 21 per cent increase in expenditures over the 2003/04 budget, which resulted primarily from rising subsidies and high debt-servicing costs. Revenues are expected to rise by a modest 5 per cent, and the Parliament in Egypt approved a corporate and personal income tax cut from 40 to

<sup>38</sup> ESCWA, *Survey of Economic and Social Developments in the ESCWA Region, 2003-2004* (E/ESCWA/EAD/2004/4).

<sup>39</sup> ESCWA, "External debt management and the debt situation in the ESCWA region: case studies on Jordan and Lebanon" (E/ESCWA/GRID/2004/5).

20 per cent in 2005.<sup>40</sup> While the Egyptian debt is primarily domestic and is not therefore facing balance of payment constraints, it is nevertheless a heavy burden on the Egyptian economy.

The domestic and external debt in Jordan dropped 4.6 per cent between April 2003 and April 2004. Major success was achieved in reforming the military and civil service pension system of that country in order to rein in Government expenditures. However, the debt burden remains high, with an estimated debt to national income ratio of 85 per cent. The ratio of external debt to total export value was 118 per cent in 2003. Regional conflicts continue to affect adversely national income growth, particularly in the light of Jordan's lost exports to Iraq.

In the Syrian Arab Republic, the lion's share of the \$21.6 billion external debt is owed to the Russian Federation. In 2005, the Syrian Arab Republic reached an agreement on the settlement of this debt, with a cancellation of some 73 per cent of the \$13.4 billion Syrian debt and a staggered repayment of the remaining \$3.6 billion over a 10-year period. A significant portion of this remainder, amounting to \$2.1 billion, is set to be paid into a Syrian bank to the account of the Russian Federation and with the intention of reinvesting the funds in the Syrian economy by purchasing Syrian products.<sup>41</sup>

Yemen, which represents the only least-developed country in the ESCWA region, has never qualified for debt relief under HIPC, despite a significantly high public debt, estimated at 96 per cent of export value in 2003. Despite its status as an oil-exporting country, its large population, low per capita income and low stage of development relative to other countries of the region, puts Yemen in great need of financing for development. While Yemen is trying to implement fiscal austerity measures designed by the IMF to better match expenditures with available revenue, recent civil unrest in response to fuel subsidy reductions places fiscal austerity policies in jeopardy. Moreover, while the Parliament in Yemen approved a general sales tax in December 2003, the usefulness of the new tax in generating revenues is questionable, particularly given the underdeveloped nature of the national economy and the large informal sector.

The debt in Iraq is estimated at some \$120 billion, with an oil revenue base of merely \$20 billion, thereby resulting in a heavy debt-to-earnings burden for the national economy. That debt was a major topic on the agenda of the Summit of the Group of Eight (G8) industrialized countries (Sea Island, United States, 8-10 June 2004). The Paris Club of Industrial Country Creditors agreed to cut the Iraqi debt by 80 per cent, and called on Arab countries to join them in providing debt relief for Iraq.<sup>42</sup>

Sustainable debt management remains a significant challenge for some ESCWA member countries. At particular risk are those countries that are experiencing high levels of poverty and unemployment, and that lack sufficient Government revenues to finance development projects aimed at alleviating poverty and stimulating economic growth. Sustainable management of debt financing requires sufficient future Government revenues to pay for such development projects, in addition to fiscal responsibility on the expenditures side. Within that context, the economies of the ESCWA region continue to suffer from a shortage of revenues, small regional markets, regional instability that discourages investment, and huge requirements for infrastructure and social services. Debt relief from international creditors must be an additional financial resource to the region, above the levels of ODA that was pledged in the Monterrey Consensus.

ESCWA has contributed to sustainable debt management in the region by raising awareness of Government officials in the region of the role played by debt financing in the overall financing for development under the umbrella of the Monterrey Consensus; and by sponsoring a number of activities that contributed to information sharing and capacity building on debt relief external debt management. Within the context of the latter, the activities by ESCWA focused on the following: (a) producing debt studies with country-level analyses by regional experts; (b) conducting jointly with UNCTAD a number of national

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<sup>40</sup> *Reuters/TradeArabia News Service*, "Egypt slashes income tax" (6 June 2005).

<sup>41</sup> *The Russia Journal*, "Russia and Syria agree on debt" (26 January 2005), which is available at: [www.russijournal.com](http://www.russijournal.com).

<sup>42</sup> *Khaleej Times*, "Schroeder calls on Arab nations to cancel Iraqi debt" (1 March 2005).

training workshops on debt statistics and debt management; and (c) monitoring and reporting on the activities of ESCWA members in the area of sustainable debt management.

#### E. INTERNATIONAL FINANCIAL AND TECHNICAL COOPERATION

Every developing country needs to identify its own, unique development strategy that fosters its economic and social growth. However, such efforts cannot succeed without an internationally enabling environment. The developed countries must play a pivotal role in providing financial and technical resources. During the 1990s, ODA flows declined as a percentage of donor country income. While developed countries pledged to provide a minimum of 0.7 per cent of their national incomes as aid, in practice this aid amounted to an average of 0.25 per cent.<sup>43</sup> ODA flows available to ESCWA member countries come from bilateral country donors; international organizations; special programmes provided by north-south trading agreements, including, for example, the Euro-Mediterranean Partnership; and from Arab regional development funds.

Unfortunately, ODA is often politically motivated and can be subject to reductions during global economic downturns. Consequently, ODA has not been a consistent or reliable source of development financing for the ESCWA region. For example, the bilateral aid by the United States to the Middle East has gone primarily to Israel and Egypt. This aid began in the 1950s when the United States started supplying loans and grants for both economic and military development to four ESCWA members, namely, Egypt, Jordan, Iraq and Lebanon. In the 1970s to 1990s, Iraq was replaced by Palestine and the Syrian Arab Republic as recipients of aid by the United States. Egypt was and remains to this day the largest recipient of such aid in the ESCWA region. Egypt received a total of \$884 million in aid from the United States in the period 1950-1970, and \$53 billion in the period 1970-2001.<sup>44</sup>

Similarly, aid from the United States to Jordan rose significantly over the same periods, from \$696 million in 1950-1970, to a total of \$4.6 billion in 1970-2001. This aid was more modest in Lebanon, estimated at \$120 million in 1950-1970, rising to \$744 million in 1970-2001; and most modest in Iraq, which received \$95 million in 1950-1970. Palestine and the Syrian Arab Republic received \$703 million and \$539 million, respectively, in the period 1970-2001.

The structure of aid to the region by the United States is changing in the twenty-first century. For example, \$348 million in aid to Jordan in 2004 fell under the programme by the United States Agency for International Development (USAID) aimed at providing microcredit, particularly to women entrepreneurs; developing trade development; and promoting economic growth through other, broad-based programmes. United States aid to Egypt is still weighted on the military side, with a total of \$1.3 billion in 2003 allocated to military assistance compared to the modest \$575 million in economic aid. An additional \$300 million grant was allocated to Egypt in 2003 for economic losses suffered as a result of “regional unrest”, and as a reward for trade, fiscal and monetary reforms undertaken by Egypt. Recently, this aid across the region has also been linked to cooperation with the policy goals of the United States in the international war on terror and in the ongoing conflict in Iraq. For example, in the period 2002-2004, aid to Jordan and Oman increased to annual averages of \$790 million and \$106 million, respectively.

Another major bilateral donor to the ESCWA region is Japan. While aid from Japan is significantly smaller in volume compared to the contributions by the United States, funds provided by Japan International Cooperation Agency (JICA) are more evenly distributed among ESCWA members and target such important regional development issues as post-conflict reconstruction, water resource management, environmental conservation, economic diversification and human resources promotion. Aid distributed by JICA to the ESCWA region totalled some 5.3 billion Japanese yen in 2003.<sup>45</sup> Egypt and the Syrian Arab Republic

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<sup>43</sup> The World Bank, *World Development Indicators, 2005*, which is available at: [www.worldbank.org/data/wdi2005](http://www.worldbank.org/data/wdi2005).

<sup>44</sup> J.M. Sharp, “U.S. foreign assistance to the Middle East: historical background, recent trends, and the FY2005 Request”, Congressional Research Service (18 March 2004), which is available at: [www.hfienberg.com/keshher/mideast.htm](http://www.hfienberg.com/keshher/mideast.htm).

<sup>45</sup> Japan International Cooperation Agency (JICA), “Middle East peace process is the most critical issue” in *Annual Report, 2004*.

received the largest regional shares of this ODA; and other recipients include Bahrain, Iraq, Jordan, Lebanon, Oman, Palestine, Saudi Arabia and Yemen.

The EU supplies financial and technical assistance to Arab countries through its Euro-Mediterranean Partnership Agreements within the framework of the Barcelona Declaration of 1995. A new generation of FTAs were negotiated between the EU and 12 southern Mediterranean countries in the past decade, including the following five from the ESCWA region: (a) Egypt, signed in 2001; Jordan, signed in 1997; Lebanon, signed in 2002, but still awaiting ratification; Palestine, signed in 1997; and Syrian Arab Republic, signed in 2004.

Financial assistance from the EU to its southern Mediterranean partners accounted for the highest share of ODA from the Union. Between 1995 and 1999, the EU distributed 3,435 million euros to countries in the southern Mediterranean states; and for the period 2000-2006, an additional 5,350 million euros were allocated.<sup>46</sup> Arab countries received further indirect support, grants and loans from the EU, with approximately one third of the MEDA I funds distributed between 1997 and 1999 targeted at industrialization projects.<sup>47</sup> Of these funds, Egypt received 30 per cent for the Egyptian Industrialization Programme. In 2001, MEDA II was launched and again Egypt received the largest share. The Jordanian Industrial Modernization Programme began in July 2001 and a similar project was launched in Lebanon. Under the Barcelona Process, the EU financial and technical assistance to southern Mediterranean partners is targeted at improving regulatory frameworks for small- and medium-sized enterprises (SMEs) that are the backbone of private sector development and job creation in these countries.

International organizations, particularly the World Bank, IMF and the United Nations, are another source of grants and loans to ESCWA member countries. For example, the World Bank approved a \$20 million emergency structural assistance grant to Palestine; and the United Nations Development Programme (UNDP) signed a \$200,000 banking cooperation agreement with the Syrian Arab Republic in 2004 aimed at providing technical assistance to the Central Bank of Syria. While these grants are useful for project-related development, they are not consistent sources of aid that can be fit into the long-term social and economic programmes of countries designed to promote sustainable development. International organizations have a more important role to play by promoting global stability, particularly in financial markets. Global links between developed and developing country economies can provide resources to developing countries by opening channels for investment funds and access to international credit, or they can injure developing countries by transmitting shocks through the international community. It is estimated that a reduction by 1 per cent in output growth of the Group of Seven (G-7) Industrialized Countries can lead to an average reduction of growth in developing countries of 0.4 per cent.<sup>48</sup>

There is therefore a need for developing countries to take a proactive stance in educating themselves in the key areas of the Monterrey Consensus. They must actively engage the world community to promote their economic development goals. ESCWA member countries are playing an increasingly bigger global role, bringing more visibility to the special development needs of the ESCWA region. Representatives from ESCWA members have participated in a number of recent meetings within the framework of financing for development, including the following: (a) the Arab Ministerial Meeting on Preparation of Arab Countries for the Fifth WTO Ministerial Conference (Beirut, 24-25 July 2003), which was organized by ESCWA; (b) the Fifth WTO Ministerial Conference (Cancun, Mexico, 10-14 September 2003); (c) the first High-level Dialogue on Financing for Development (New York, 29-30 October 2003); (d) the Special High-level Meeting with Bretton Woods Institutions and WTO (New York, 26 April 2004); (e) the High-level Round

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<sup>46</sup> More information on the MEDA Programme is available at: [www.europa.eu.int/comm/external\\_relations/euromed/meda.htm](http://www.europa.eu.int/comm/external_relations/euromed/meda.htm).

<sup>47</sup> R. Miller and A. Mishrif, "The Barcelona Process and Euro-Arab Economic Relations: 1995-2005", vol. 9, No. 2, Article 6, *The Middle East Review of International Affairs* (June 2005).

<sup>48</sup> A. Shamseldin, "Incorporating financing for development in the microeconomic policy and development strategy of developing countries: with special examples from ESCWA member countries", which was presented at the Expert Group Meeting on Regional Dimension of the Monterrey Consensus: Financing for Development" (Beirut, 6-8 June 2005).

Table on Innovative Financing for Development (Sao Paulo, Brazil, 15 June 2004); and (f) the second High-level Dialogue on Financing for Development (New York, 27-28 June 2005).

Moreover, international contributions can play a key role in the development of the ESCWA region, particularly by providing debt relief to the countries hardest hit by regional conflicts. External debt remains a substantial burden for some ESCWA members and a major obstacle to development. Debt relief releases limited Government revenues, which in turn can focus on such urgent development projects as building infrastructure, particularly in poor and rural areas; promoting small- and medium-sized projects that raise national productivity; providing training and employment for the youth in the region; and developing programmes aimed at reducing poverty for women and other marginalized members of society. Cancelling debts is most critical for some ESCWA members, particularly Iraq and Palestine to help reconstruction efforts in those conflict areas; Yemen, which represents the only least-developed country in the ESCWA region; and, to some extent, the debt-burdened countries of Egypt, Jordan and Lebanon.

Financial and technical cooperation with the countries of the ESCWA region is facilitated through a diverse assortment of international organizations, regional institutions and individual countries in the form of loans, grants and technical expertise for long- and short-term Arab development projects. However, international aid has traditionally been project-linked or politically motivated, and needs to take better account of the development needs of the region. Regional sources of development aid, particularly from the oil-exporting countries of the Gulf sub-region, are better placed in terms of regional knowledge to provide loans and grants for projects that directly impact regional economic and social development.

Within that context, ESCWA provides a vital information link between its members and such international organizations as the Department of Social Affairs (DESA), UNCTAD and WTO. ESCWA has facilitated capacity building for Government officials in terms of highlighting ways for them to benefit from international organizations and of assisting them to participate in multinational activities, including preparing ESCWA members for WTO negotiations and providing technical assistance to countries that are in the process of acceding to WTO.

Additionally, ESCWA provides forums for dialogue between regional and international stakeholders, including, for example, the Expert Group Meeting on the Regional Dimension of the Monterrey Consensus: Financing for Development (Beirut, 6-8 June 2005). The report of that Meeting was distributed to international organizations, regional and international experts, and Governments in the ESCWA region.<sup>49</sup> In addition to bringing together stakeholders for in-depth roundtable discussions on financing for development in the ESCWA region, this Meeting prepared Government participants for subsequent meetings on that topic, which were convened in New York in June and September 2005.

#### F. ADDRESSING SYSTEMIC ISSUES

The successful mobilization of financial resources is linked to a functioning economy, which in turn is dependent on three key factors, namely: (a) stable, flexible and transparent domestic monetary and financial systems; (b) overall macroeconomic climate; and (c) global financial markets. Owing to advances in communications, transport technology, and the liberalization of trade and investment policies, economies have become interlinked and can more easily be pulled into financial crisis originating in other countries. Excessive volatility in the global financial markets can have a negative effect on flows of financial resources to developing countries. Consequently, a stable global economy can be enhanced through the adoption of international standards and the coordination of monetary, financial and trade policies, thereby providing better opportunities for developing countries in terms of obtaining financial resources for development. In the areas of good governance and the adoption of transparent economic policies, the ESCWA region continues to lag behind other developing countries. As a result, their economies persistently suffer from lost financial opportunities, particularly in attracting FDI and keeping Arab capital in the region. Financial

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<sup>49</sup> ESCWA, "Report of the Expert Group Meeting on Regional Dimension of the Monterrey Consensus: Financing for Development" (E/ESCWA/GRID/2005/WG.1/9).

resources for development, both domestic and foreign, favour regions that possess the competitive advantage of good governance and that are consistent with internationally recognized business practices.

According to the Government Effectiveness indicator by the World Bank Institute (WBI), many ESCWA member countries scored poorly relative to the rest of the world.<sup>50</sup> This measure of effectiveness includes bureaucratic competence and the quality and delivery of public services. Among ESCWA members, the countries of the GCC scored the highest, along with Jordan. Moreover, Bahrain, Qatar, Oman, and United Arab Emirates were ranked among the top 50 countries in the world with regard to good governance. By stark contrast, Iraq, Palestine and Yemen had the lowest rankings in the ESCWA region and were near the bottom of the world rankings.

In April 2005, the United Arab Emirates announced plans to revise its existing company laws in order to bring them in line with WTO requirements.<sup>51</sup> A willingness to modernize and fine-tune economic laws and regulations reflects the attitude and policy environment that put the United Arab Emirates on the top of the good governance list among countries in the Arab region.

Furthermore, the activities of the GCC as a bloc provide a positive example, particularly in terms of establishing coherent and consistent monetary, fiscal and trade policies. This process was initiated on 25 May 1981 with the ratification of the charter that established the GCC; and was followed, in 1983, by the abolition of intra-GCC customs duties. A unified band of tariffs ranging from approximately 4-15 per cent was adopted on extra-GCC imports in 1988; and the formation of the GCC Customs Union was completed on 1 January 2003, with the adoption of a common external tariff of 5 per cent on imports from outside the GCC sub-region.<sup>52</sup>

As mentioned above, the six countries of the GCC are planning to deepen their economic integration by forming a monetary union and eventually a common market. A higher level of economic integration is achieved by synchronizing macroeconomic policies that influence investment and economic development. The countries of the GCC are working jointly on measures and procedures needed to establish such a monetary union. The key targets for deeper economic integration were agreed upon, namely, inflation, interest rates, foreign reserves, budget deficits and debt to GDP ratios.<sup>53</sup> The Committee of Governors of Central Banks and Monetary Agencies in the GCC, which was established in 1983, carried out discussions in the period 1983-1988, focusing on a common currency peg. In the 1990s, the central banks and monetary authorities of the GCC began to coordinate their financial, monetary and banking policies in preparation for the implementation of a monetary union. It was mutually agreed to use the United States dollar as a currency peg; and it was reaffirmed in December 2004 that the United States dollar would be used as a joint stabilizer for the GCC currencies.<sup>54</sup> In 2001, the governors of the central banks agreed to a deadline of 2005 for setting the maximum levels for budget and current account deficits, public debt, interest rates and inflation necessary for the monetary union. Additionally, a deadline of 2010 was proposed for the adoption of a common currency.

Work is ongoing to harmonize the legal and institutional frameworks needed to establish a GCC central bank. Eventually, the countries of the GCC will need to form a joint monetary body to supervise financial and monetary matters, and to regulate the common currency. Within that context, synchronized exchange rates have already been implemented. Current discussions include whether or not to allow national banks in member countries to operate freely within the GCC sub-region; and the competitiveness of smaller banks, particularly in the wake of monetary union, which could lead to mergers with larger banks.

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<sup>50</sup> *The Lebanon Weekly Monitor* (27 June - 2 July 2005), p. 4.

<sup>51</sup> *Zawya*, "Company laws to meet WTO rules" (12 April 2005), which is available at: [www.zawya.com](http://www.zawya.com).

<sup>52</sup> *Middle East Economic Survey*, "GCC finally agrees on timing of tariff unification and common currency", vol. XLV, No. 1 (7 January 2002), which is available at: [www.mees.com](http://www.mees.com).

<sup>53</sup> *Reuters*, "GCC central bankers set targets for monetary union" (20 March 2005).

<sup>54</sup> *TradeArabia News Service*, "Bahrain sticks to dollar peg" (19 July 2005).

The anticipated benefits arising from a monetary union of the GCC and common currency include the following: (a) lower costs of banking services for residents of that sub-region; (b) reduction in foreign exchange transaction costs and exchange rate risk, thereby saving time and money; (c) increased competitiveness of companies in the GCC given the projected economic stability and transparency in monetary policy; (d) lower costs to the banking sector resulting from a common currency; and (e) new trading and investment opportunities in a unified and expanded GCC market. These features could attract foreign investors to the GCC, thereby enhancing efforts aimed at diversifying the current, oil-dependent economies. The costs borne by the countries of the GCC from a monetary union include the loss of control with regard to domestic monetary, fiscal and exchange rate policies, as well as restrictions on budgetary policies.

In terms of coordinating trade policies, the countries of the GCC are currently negotiating a bilateral FTA with the EU under the Euro-Mediterranean Partnership Agreement. The GCC is negotiating as a bloc, rather than as individual countries, which provides the member countries with more bargaining power during negotiations with the larger EU.<sup>55</sup> Some discord has occurred between the members of the GCC Customs Union following the signing of an FTA between Bahrain and the United States. According to Saudi Arabia, which is opposed to this bilateral agreement, this FTA between Bahrain and the United States potentially gives greater market access to providers of financial services from the United States than to their counterparts in the member countries of the GCC Customs Union. However, the Union is unlikely to take action against Bahrain given that both Oman and the United Arab Emirates are in the process of negotiating similar bilateral agreements with the United States.<sup>56</sup>

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<sup>55</sup> The European Union and the Gulf Cooperation Council aim to complete the negotiations by the end of 2005. See the Joint Communiqué following the 15<sup>th</sup> GCC-EU Joint Council and Ministerial Meeting (Manama, 5 April 2005).

<sup>56</sup> See chapter IV for a more detailed analysis of these issues.

### III. RECENT PROGRESS MADE BY ESCWA MEMBER COUNTRIES IN PROMOTING DOMESTIC FINANCIAL RESOURCES FOR DEVELOPMENT

To varying degrees, ESCWA member countries rely on a limited number of resources to finance domestic expenditures. Such resources comprise exports of oil and gas in the case of Egypt, the countries of the GCC and Yemen; remittance income and foreign assistance in the case of Egypt, Jordan and Yemen; and tourism and rent in the case of Egypt, Jordan and Lebanon.<sup>57</sup> Consequently, ESCWA member countries are vulnerable to shocks in those sectors. According to the World Bank, this vulnerability is “economy wide, as externally-induced sudden changes in earnings from tourism, workers’ remittances and exports of oil and natural gas affect the balance of payments. However, the largest volatility arises from official transfers impacting particularly strongly on Government financing.”<sup>58</sup> Within that context, in 2003, foreign grants represented approximately 31.2 per cent of total public revenues in Jordan compared to a modest 3 per cent in both Egypt and Yemen.<sup>59</sup>

Given that oil and gas are non-renewable natural resources, the income derived from them is set to decline as reserves are gradually depleted. If the growth of national income is to be maintained, other forms of capital will have to be created in order to replace the income from these depleting resources. Economies that depend on oil and gas therefore need to build “genuine saving”, which is defined as gross national saving, minus depreciation of capital stock and minus depletion of natural resources.<sup>60</sup> Available data show that ESCWA member countries can be divided into four groups, according to the rate of gross domestic savings, namely: (a) the high savings rate group of countries of the GCC, whose rates of domestic savings range between 25 per cent of GDP in Kuwait and 42 per cent in Saudi Arabia; (b) the high savings rate group of non-GCC countries, namely Iraq and the Syrian Arab Republic, with rates of domestic savings amounting to 28 per cent and 27 per cent of GDP in 2002, respectively; (c) the low savings rate group, namely Egypt and Yemen, with rates of domestic savings in the range of 13-18 per cent of GDP, compared to the global average saving rate of 24.5 per cent and the developing countries average saving rate of 30.7 per cent,<sup>61</sup> and (d) the negative savings rate group, represented by Jordan at -0.6 per cent of GDP and Palestine at -44.7 per cent of GDP in 2002.

TABLE 6. SAVINGS TO GDP RATIO IN ESCWA MEMBERS, 2001, 2002 AND 2003  
(Percentage)

Country or territory	2001	2002	2003
Bahrain	34	34	..
Egypt	13	14	14
Iraq	21	27	..
Jordan	(4)	(0.6)	..
Kuwait	25	18	25
Lebanon	(9)	(9)	..
Oman	35	34	34
Palestine	(43)	(45)	..
Qatar	55	51	..
Saudi Arabia	35	37	42

<sup>57</sup> Egypt, in particular, generates income from tourism and charges related to the Suez Canal.

<sup>58</sup> The World Bank, *Country economic memorandum – Egypt: Issues in sustaining economic growth, summary report*, Report No. 16207-EGT (15 March 1997), p. 2.

<sup>59</sup> Central Bank of Jordan, *Monthly Statistical Bulletin* (January 2005), p. 44; Central Bank of Yemen, *Review of Monetary and Banking Developments, 2004*, p. 16; and Central Bank of Egypt, *Monthly Statistical Bulletin* (January 2005), p. 62.

<sup>60</sup> The World Bank, *Country economic memorandum – Egypt: Issues in sustaining economic growth, summary report*, Report No. 16207-EGT (15 March 1997), p. 15.

<sup>61</sup> International Monetary Fund (IMF), “World economic outlook, September 2004: The global demographic transition”, *World Economic and Financial Surveys*, pp. 269-270

Table 6 (continued)

Country or territory	2001	2002	2003
Syrian Arab Republic	27	28	..
United Arab Emirates	37	33	36
Yemen	18	17	13

Sources: International Monetary Fund (IMF), International Financial Statistics (IFS) online service (February 2005); League of Arab States and Arab Monetary Fund, *Unified Arab Economic Report, 2003* (in Arabic); Ministry of Foreign Trade and Industry in Egypt, *Monthly Economic Bulletin, January 2005*, p. 1; Central Bank of Jordan, *Monthly Statistical Bulletin* (January 2005), p. 86; Central Bank of Kuwait, *Quarterly Statistical Bulletin* (July-September 2004), p. 92; Central Bank of Oman, *Annual Report 2003*, p. 110; Saudi Arabian Monetary Agency (SAMA), *Fortieth Annual Report 2004*, p. 455; and Central Bank of the United Arab Emirates, *Annual Report 2002* and *Annual Report 2003*.

Notes: Two dots (..) indicate that data are not available or are not separately reported.

Parentheses ( ) indicate negative values.

#### A. MOBILIZING DOMESTIC SAVINGS

The main channels for mobilizing domestic savings in a given economy are as follows: (a) taxation; (b) appropriation of surplus from public entities; (c) public debt instruments; (d) social insurance schemes; and (e) financial intermediary institutions. The experience of ESCWA member countries with regard to these different channels is reviewed below.

##### 1. Taxation

Taxes are supposed to be one of the main channels for mobilizing involuntary saving. However, in the countries of the GCC, taxation is a comparatively recent phenomenon. Its timid introduction some 15 years ago was closely associated with the drop in oil revenues and the emergence of budget deficits in those countries. Moreover, tax revenues represented a small percentage of total public finance in 2003, constituting a modest 2 per cent of total public revenues in Kuwait; 7 per cent in Oman; 9 per cent in the United Arab Emirates; 12 per cent in Bahrain; and 21 per cent in Yemen (see table 7). In most cases, taxes were first levied on international transactions. In 2003, customs duties represented 74 per cent of tax revenues in Kuwait; 35 per cent in the United Arab Emirates; 30 per cent in Oman; and 29 per cent in Yemen. There is still much resistance to the introduction of income taxes. In Kuwait, for example, there has been little progress in the evolution of the income tax law, with both the Cabinet and National Assembly reluctant to approve it.<sup>62</sup> In Saudi Arabia, the new Income Tax Law of 2004, pertains mainly to foreign residents and non-residents for whom the income tax rate is 20 per cent. However, workers in the area of natural gas investment are subject to an income tax rate in the range of 30-85 per cent. The latter rate is equally levied on workers in the production of gas and hydrocarbons.<sup>65</sup>

In ESCWA member countries that are not in the GCC, taxes represent the major source of revenue for public finance that, by the end of 2003, amounted to 68 per cent of total public revenues in Lebanon;<sup>64</sup> 66.5 per cent in Egypt; and 44 per cent in Jordan. Tax systems in those countries rely heavily on consumption taxes. The share of income taxes to total tax revenue was 40 per cent in Egypt;<sup>65</sup> and a modest 18 per cent in Jordan.<sup>66</sup> A new income tax law is currently under preparation in Egypt is aimed at increasing revenues without imposing additional burdens.

<sup>62</sup> F. al-Zanki, "Taking on the world", *MEED* (4-10 February 2005), p. 40.

<sup>63</sup> Saudi Arabian Monetary Agency (SAMA), *Fortieth Annual Report 2004*, p. 57.

<sup>64</sup> Association of Banks in Lebanon, *Annual Report 2003/2004*, p. 129.

<sup>65</sup> Central Bank of Egypt, *Annual Report 2002/2003*, p. 74.

<sup>66</sup> Central Bank of Jordan, *Monthly Statistical Bulletin* (January 2005), p. 46.

## 2. Appropriation of surplus from public entities

Oil and gas revenues constitute the main source of public finance in the GCC, amounting to 88 per cent of total public revenues in Kuwait; 79 per cent in Saudi Arabia; 75 per cent in the United Arab Emirates; 70 per cent in both Oman and Yemen; and 63 per cent in Qatar.

TABLE 7. MAIN REVENUES FOR PUBLIC FINANCE, 2002 AND 2003  
(Percentage)

Country	2002		2003	
	Taxes	Oil revenue	Taxes	Oil revenue
Bahrain	11.6	67.3	..	..
Egypt	49.7	..	49.7	..
Jordan	49.2	..	43.6	..
Kuwait	2.2	84.4	2.2	88.4
Lebanon	68.0	..	68.0	..
Oman	6.5	75.7	6.5	70.1
Qatar	..	68.4	..	63.7
Saudi Arabia	..	78.0	..	78.8
United Arab Emirates	12.0	71.5	8.7	75.1
Yemen	22.0	66.0	21.0	70.2

Sources: Bahrain Monetary Agency, *Annual Report 2002*, p. 15; Ministry of Foreign Trade and Industry in Egypt, *Monthly Economic Bulletin* (January 2005), p. 12; Central Bank of Jordan, *Monthly Statistical Bulletin* (January 2005), p. 46; Central Bank of Kuwait, *Quarterly Statistical Bulletin* (July-September 2004), p. 60; Association of Banks in Lebanon, *Annual Report 2003/2004*, p. 129; Central Bank of Oman, *Annual Report 2003*, pp. 36-37; Central Bank of Qatar, *Annual Report 2003*, p. 35; Saudi Arabian Monetary Agency (SAMA), *Fortieth Annual Report 2004*, p. 166; Central Bank of the United Arab Emirates, *Annual Report 2003*, p. 25; and Central Bank of Yemen, *Review of Monetary and Banking Developments 2004*, p. 16.

Note: Two dots (..) indicate that data are not available or are not separately reported.

In Egypt, surplus transfers accounted for more than 20 per cent of total public revenues in the fiscal year 2002/03, originating from such State-owned economic entities as the Suez Canal and the Central Bank; public sector banks; the Egyptian General Petroleum Corporation; and fee income related to the management of companies in the public business sector.<sup>67</sup> Improved productivity of the public business sector is clearly a crucial factor in increasing domestic savings. The main road chosen by ESCWA member countries towards achieving this goal was privatization. Several countries of the GCC announced plans to privatize various sectors, including telecommunications, electricity, oil and gas distribution, postal services, railroads, water distribution, public transport and, in some cases, air transport and sewage system.

Moreover, private and foreign direct investment in infrastructure projects on a build-operate-transfer (BOT) basis was very much encouraged in Kuwait, Oman, Qatar and United Arab Emirates. On January 2003, a total of 30 per cent of the Saudi Telecom Company was offered for public subscription, divided as follows: 20 per cent of the shares were offered to Saudi citizens; and 10 per cent were allocated to the Retirement Pension Directorate and the General Organization for Social Insurance.<sup>68</sup>

In September 2004, Egypt offered shares in ten public enterprises, operating in the areas of housing, pharmaceuticals, food industries, chemical industries and textiles. By the end of October 2004, the number of privatized companies amounted to 207 companies, and the resulting total proceeds amounted to 10.8 billion Egyptian pounds.<sup>69</sup> A study conducted by the World Bank on a sample of public enterprises in Egypt

<sup>67</sup> Central Bank of Egypt, *Annual Report 2002/2003*, pp. 73-74.

<sup>68</sup> Saudi Arabian Monetary Agency (SAMA), *Fortieth Annual Report 2004*, pp. 133-134.

<sup>69</sup> Ministry of Foreign Trade and Industry in Egypt, *Quarterly Economic Digest, October-December 2004*, p. 112-114.

concluded that privatization and commercialization were expected to increase savings with a magnitude of 2.4 per cent of GDP.<sup>70</sup> The results proved to be most sensitive to variations in investment and it was emphasized that the design of privatization transactions needed to “commit the new owners to an investment programme, where appropriate”.<sup>71</sup> Within the context of public finance, the impact of privatization depends on the net outcome of the flow of funds the State receives from sale proceeds and taxes on privatized firms, and on the flow of funds the State relinquishes through privatization.<sup>72</sup>

### 3. *Public debt instruments*

Public debt instruments are non-existent in Bahrain, Qatar, Saudi Arabia and United Arab Emirates. Governments refer to withdrawals from their international reserves rather than to domestic public debt. In all other ESCWA member countries, the issue of treasury bills and bonds is a common practice. These debt instruments are mainly bought by banks whose share of total outstanding balances in 2003 amounted to 91 per cent in Kuwait;<sup>73</sup> 53 per cent in Jordan;<sup>74</sup> and 46 per cent in Lebanon.<sup>75</sup> In Yemen, by the end of 2002, pension funds accounted for 55 per cent of the total outstanding balance of treasury bills, and banks accounted for the remaining 45 per cent.<sup>76</sup> In Egypt, the banks’ share in the total outstanding balance of treasury bills and of treasury bonds amounted to 99 per cent and 85.3 per cent, respectively, by the end of 2003.<sup>77</sup>

Given that both pension fund contributions and the major part of bank deposits belong to the household sector, household savings are indirectly mobilized by public debt instruments. Moreover, a part of these savings can be mobilized directly when public debt instruments are listed and traded on the capital market, which is seldom the case in ESCWA member countries. The nominal value of Government bonds traded on the Egyptian capital market represented a modest 7 per cent of total domestic public debt instruments by the end of June 2003.<sup>78</sup> Equally in Egypt, investment certificates represent an important vehicle for the mobilization of long-term household savings. These certificates, which were first introduced in the 1960s, are issued and managed on behalf of the Government by the largest public sector commercial bank, namely, the National Bank of Egypt. The net proceeds from these certificates are directed to the National Investment Bank (NIB), which in turn offers long-term loans and equity finance to the Government and to public entities. At the end of the fiscal year 2003/04, these proceeds and accumulated interest amounted to 66.9 billion Egyptian pounds, constituting 23.1 per cent of the total resources of NIB.<sup>79</sup>

### 4. *Social insurance schemes*

In general, social insurance schemes represent an important channel for the mobilization of long-term savings. In Saudi Arabia, total invested funds of the General Organization for Social Insurance amounted to 19 billion Saudi riyals by the end of 2002. A total of 67.9 per cent of these funds was invested in the real estate and finance sectors, compared to 16.9 per cent in manufacturing industries, 13.6 per cent in social services, 1 per cent in trading and hotel activity, 0.5 per cent in transport and communication, and 0.1

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<sup>70</sup> The World Bank, *Country economic memorandum – Egypt: Issues in sustaining economic growth, summary report*, Report No. 16207-EGT (15 March 1997).

<sup>71</sup> *Ibid.*

<sup>72</sup> This amounts to a calculation based on taxes and dividends from public enterprises minus subsidies made to them.

<sup>73</sup> Central Bank of Kuwait, *Quarterly Statistical Bulletin* (July-September 2004), p. 33.

<sup>74</sup> Central Bank of Jordan, *Monthly Statistical Bulletin* (January 2005), p. 46.

<sup>75</sup> Association of Banks in Lebanon, *Annual Report 2003/2004*, p. 130.

<sup>76</sup> Central Bank of Yemen, *Review of Monetary and Banking Developments, 2004*, p. 20.

<sup>77</sup> Central Bank of Egypt, *Annual Report 2002/2003*, p. 23.

<sup>78</sup> *Ibid.*, p. 34.

<sup>79</sup> Central Bank of Egypt, *Monthly Statistical Bulletin* (January 2005), p. 75.

per cent in agriculture and fishing. The Organization has equity participations, either as a founder or a shareholder, in 48 companies.<sup>80</sup>

As a step towards confronting evasion and increasing contributions, the new mechanism of the Social Insurance System in Saudi Arabia, which became effective in 2002, requires all private firms to provide a certificate for fulfilling the conditions set by the General Organization for Social Insurance. Moreover, firms that have one or more workers are compelled to be covered by the Social Insurance System. Consequently, the total number of firms covered by the System recorded a 59.5 per cent increase over the preceding year to reach 57,300.<sup>81</sup> While demographic trends can present a positive factor to the Social Insurance System, unemployment represents a threat. Official estimates of the unemployment rate in Saudi Arabia were 9.7 per cent in 2002, compared to 8.3 per cent in 2001. Within that context, the Support Programme for Training and Employment, which was launched in 2002, is aimed at replacing foreign workers with Saudi nationals.<sup>82</sup>

In Oman, the number of citizens registered with the Public Authority for Social Insurance rose from 159,100 in 2002 to 173,900 in 2003. While Omani workers account for 80.5 per cent of total employment in the public sector, expatriate workers constitute 92.3 per cent of total employment in the private sector. Cumulatively, Omani nationals represent a modest 23.3 per cent of the total workforce.

In Egypt, the Social Insurance System provides one of the most important sources of long-term savings. The operating surplus of the System is invested through NIB in Government projects. At the end of the fiscal year 2003/04, the total deposits with NIB for the Social Insurance System amounted to 194.1 billion Egyptian pounds, constituting 67 per cent of the total resources of NIB. However, the sustainability of the system is threatened by several adverse factors, including, chiefly, partial and total evasion; past dues of the Government and public entities; the high rate of unemployment, which was estimated at 10 per cent in 2004; the consequences of privatization; the introduction of early retirement systems; and historically low investment returns. According to some studies, the System can only survive if NIB repays its debts to the scheme once the cash flow turns negative, which is expected to occur in 2008.<sup>83</sup>

#### 5. *Financial intermediary institutions*

Apart from compulsory private savings, which are mobilized by the social insurance system, and business sector savings, which are directly reinvested, the main part of voluntary private savings is mobilized through financial intermediary institutions. Individuals often prefer to deposit their savings in banks because of the resulting liquidity and the limited information required for judging the likely return on such an investment. They turn to private pension funds and life insurance companies to obtain annuities to protect against an uncertain life span and to provide financial security to their families. Additionally, small investors often find mutual funds a convenient means of diversifying investment in risky securities. Individuals can also invest directly in business assets through the purchase of corporate bonds or shares on the capital market.

Financial intermediation in ESCWA member countries is dominated by the banking system. Commercial insurance is insignificant and the size of the capital market is fairly modest in several ESCWA member countries. Comparative financial deepening ratios clearly indicate the relative weight of these respective sectors. In 2003, banking depth, as measured by the percentage of broad money to GDP (M2/GDP) amounted to 96.7 per cent in Lebanon, 92 per cent in Egypt, 83.6 per cent in Kuwait, 76.6 per cent in Bahrain, and 68.4 per cent in the United Arab Emirates.<sup>84</sup> In the same year, the percentage of total

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<sup>80</sup> Saudi Arabian Monetary Agency (SAMA), *Fortieth Annual Report 2004*, p. 302.

<sup>81</sup> *Ibid.*, p. 299.

<sup>82</sup> *Ibid.*, p. 320.

<sup>83</sup> O. Helmy, "Egyptian Social Insurance System" (in Arabic), *The Egyptian Center for Economic Studies* (December 2003), p. 11.

<sup>84</sup> These calculated percentages are based on data provided by the Association of Banks in Lebanon, *Annual Report 2003/2004*; Ministry of Foreign Trade and Industry in Egypt, *Monthly Economic Bulletin, January 2005*; Central Bank of Kuwait, *Quarterly Statistical Bulletin* (July-September 2004); Bahrain Monetary Agency, *Annual Report 2003*; and IMF, *International Financial Statistics* (February 2005).

insurance premiums to GDP was less than 1 per cent in Egypt, Saudi Arabia, Syrian Arab Republic and Yemen; hovered around 1 per cent of GDP in Kuwait, Oman, Qatar and United Arab Emirates; and was in the range of 2.2-2.9 per cent in Bahrain, Jordan and Lebanon.<sup>85</sup> Stock exchanges are still non-existent in the Syrian Arab Republic and Yemen. At the end of 2003, the stock exchange capitalization as a percentage of GDP was a modest 8.4 per cent in Lebanon; 33.6 per cent in Oman; 38 per cent in Abu Dhabi, the United Arab Emirates; and 41 per cent in Egypt (see table 7).

The Monterrey Consensus recognized the need to “strengthen and develop the domestic financial sector by encouraging the orderly development of capital markets through sound banking systems and other institutional arrangements aimed at addressing development financing needs, including the insurance sector and debt and equity markets”.<sup>86</sup> The measures taken and policies adopted by the respective ESCWA member countries to promote and develop their two main financial sectors, namely, banks and capital markets, are discussed in detail below.

## B. PROMOTING DOMESTIC BANKING SYSTEMS

The basic role of financial intermediation in any economy is to facilitate the flow of funds from individual savers to business investors. This role includes primarily mobilizing savings; channelling investment funds to firms; providing efficient payment and settlement services at low transaction costs; managing risks related to corporate activities; screening alternative investment projects; and monitoring borrowers to ensure that the loans are efficiently used, thereby improving capital allocation and average capital productivity. The banking system in ESCWA member countries comprises more than 400 institutions, which largely provide commercial banking and, to some extent, investment and Islamic banking operations. During the past few years, ESCWA members have embarked on bank reform programmes aimed at enhancing the operating efficiency of their banking systems, increasing their contestability, and strengthening prudential regulations, supervision and corporate governance. The ultimate goal is to improve the efficiency of financial intermediation, thereby facilitating the flow of funds from individual savers to business investors at low transaction costs.

### 1. *Bank reforms in ESCWA member countries*

The pace and scope of bank reforms have varied from one country to another. The salient measures in that respect are summarized below.

#### (a) *Strengthening prudential regulations and supervision*

The main aim of prudential regulations and bank supervision is to reduce the risk of bank failure, prevent systemic risks, and ensure that banks are adequately capitalized and professionally managed.<sup>87</sup> Strengthening prudential regulations and bank supervision helps to ensure sound bank performance, which translates into better allocation of funds and risk management. In effect, the official prudential supervisors act as delegated monitors for depositors who seek more protection for their money. Generally, a well-supervised banking system is expected to be more trustworthy for savers and more capable of mobilizing resources for financing development.<sup>88</sup>

The monetary authorities in several ESCWA member countries have already taken important measures to improve both the framework of prudential regulation and the effectiveness of supervision, in line with

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<sup>85</sup> *Al-Iktissad wal-amal* (March 2005), p. 102.

<sup>86</sup> Note by the Secretariat, “Draft outcome of the International Conference on Financing for Development (1 March 2002), p. 4.

<sup>87</sup> Z.A. Bahaa Eldin and M. Mohieldin, “On prudential regulation in Egypt” in *Financial Development in Emerging Markets: The Egyptian Experience*, *The Egyptian Center for Economic Studies* (Cairo, 1998), p. 111.

<sup>88</sup> Basel Committee on Banking Supervision, “Core principles for effective banking supervision” (September 1997), p. 22; and the World Bank, “Finance for growth: policy choices in a volatile world” (2001), p. 90.

international standards. While these have been adopted to varying degrees from one country to another, the salient prudential regulations include capital adequacy ratios in accordance with the Basel Capital Accord;<sup>89</sup> reserve and liquidity requirements; asset classification and provisioning requirements; concentration limits for maximum exposure to a single borrower; concentration limits for placements in correspondent banks abroad; and foreign currency exposure limits.

The Central Bank of Egypt raised the minimum capital adequacy ratio to 10 per cent as from December 2002, compared to the requirement of 8 per cent under the Basel Accord. A new banking law was enacted in 2003 aimed at applying the Basel standards with regard to controlling and supervising banks, and ensuring efficient management and follow up of the different stages of the credit process.<sup>90</sup> The Credit Risk Department within the Central Bank of Egypt became automated and electronically linked to individual banks, thereby providing them with online access to updated information on certain borrower's exposure, on classified indebtedness relating to the whole banking system and on black lists of credit card customers.

Similarly, the Bank Credit and Statistical Bureau System, which is run by the Central Bank of Oman, was upgraded in 2004 in order to provide information on the prospective and existing credit record of borrowers and on collateral and real-time status of classified loans.<sup>91</sup> In Bahrain, new software was acquired in 2002 aimed at helping examiners from the Bahrain Monetary Agency to undertake relevant examination procedures and to record the results on-site. In Saudi Arabia, credit classification and provisioning requirements were enforced in 2004. Moreover, the Saudi Arabian Monetary Agency (SAMA) took serious measures to pursue and close companies and offices that were conducting banking business without appropriate licences. Before the introduction of the Capital Market Law of 2003, so-called briefcase bankers from Bahrain and the United Arab Emirates offered financial products and services to Saudi nationals.

(b) *Compliance with international standards*

Compliance with international standards has become an essential prerequisite for any bank seeking to mobilize foreign savings. The credit worthiness of national banking systems is often assessed by international rating agencies; and the rank assigned to a certain bank determines its ability to obtain credit lines from international banks and the level of interest rate it pays. Compliance with international standards is one of the main factors that are taken into consideration during the assessment process.<sup>92</sup> Procedures to combat money-laundering were strictly enforced on banking systems in Oman in 2002; in Bahrain, Lebanon and Saudi Arabia in 2003; and in Jordan and Egypt in 2004.

Moreover, efforts aimed at applying international standards for corporate governance were particularly evident in Jordan and Egypt. Within the context of the former, the *Bank Directors' Handbook of Corporate Governance* was issued in 2004, which defined the responsibilities of the boards with regard to their shareholders, depositors and other stakeholders; and the functions of internal control, internal audit and independent external audit systems. Accordingly, credit and investment policies approved by the boards of private banks were submitted to the Central Bank of Jordan. In Egypt, the boards of directors of State-owned banks and a number of private banks were reshuffled in 2003, thereby ensuring a majority of independent or non-executive directors, many of whom with expertise in private joint venture and/or foreign banking. The new Banking Law of 2003 established internal audit committees, which comprised non-executive board members. Boards were required to prepare comprehensive credit and investment policies, with clear authority limits for credit and investment officers.

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<sup>89</sup> The Basel Capital Accord was introduced in 1988 by the Basel Committee on Banking Supervision stipulating a minimum capital standard of 8 per cent of risk-weighted assets. The new Capital Adequacy Accord, equally referred to as Basel (2), is set to become effective at the end of 2006 and stipulates that banks must hold a minimum capital standard to cover credit risk, market risk and operational risk. More information is available at: [www.bis.org/aboutbcbs.htm](http://www.bis.org/aboutbcbs.htm).

<sup>90</sup> Law No. 88 of 2003 on the Central Bank, banking system and currency.

<sup>91</sup> Central Bank of Oman, *Annual Report 2003*, pp. 62-63.

<sup>92</sup> Moody's Investors Service, "Banking System Outlook – Egypt" (February 2005), p. 10.

(c) *Contestability and entry of foreign banks*

Banking systems in the ESCWA area reveal a high degree of concentration. In Saudi Arabia, the National Commercial Bank constitutes approximately 22 per cent of the total assets of banks in that country. In Egypt, four banks in the public sector banks account for 50 per cent of the whole banking system, which comprises 52 operating banks. In Lebanon, the largest five banks hold 49 per cent of the total assets and deposits of the banks in that country.<sup>93</sup> Similarly, in Qatar and Oman, the largest banks in those two countries account for 45 per cent and 35 per cent of total assets, respectively.<sup>94</sup>

The establishment of a more contestable climate whereby banks compete to attract savers and borrowers is expected to force banks to reduce lending interest rates, at least for large customers; improve the quality of their services; introduce new savings instruments and diversified lending techniques; enhance payment and settlement systems; and modernize banking technology, thereby resulting in better financing for development. In order to increase competition and enhance contestability, active privatization programmes and new banking laws were introduced during the past few years aimed at increasing the shares of domestic and foreign private sectors in several ESCWA banking systems.

In Egypt, the divestiture of stakes by the public sector in joint venture banks has resulted in a higher degree of market access to foreign international banks. In the past three years, several international banks have gradually acquired up to 100 per cent of several small banks, including Société Générale, Barclays Bank, HSBC Bank and Crédit Agricole Indosuez. Additionally, the Government has announced steps to privatize the smallest of the State-owned banks, namely, the Bank of Alexandria.

Saudi Arabia is expected to issue an initial public offering (IPO) of 79 per cent of the State-owned National Commercial Bank, which represents the largest bank in the Arab region. Moreover, licences were granted in 2003 to three banks in the GCC;<sup>95</sup> and a branch licence was granted to Deutsche Bank in October 2004.<sup>96</sup> Non-Arab banks have long existed in ESCWA member countries, with the exception of Iraq and the Syrian Arab Republic. Within the context of the latter, the first three joint venture banks in the Syrian Arab Republic started operations in 2004; and licences were granted to four other Arab banks.<sup>97</sup> In Iraq, while licences were granted to six foreign banks in 2003, that number is not expected to grow until 2008.<sup>98</sup>

A total of seven out of the 13 ESCWA member countries have scheduled commitments to liberalize their financial services sectors in the context of WTO. These countries are as follows: Bahrain, Egypt, Jordan, Kuwait, Oman, Qatar and United Arab Emirates. Limitations on market access for foreign banks have been eased to varying degrees from one country to another.<sup>99</sup> While Kuwait made the most rigid offer, Oman moved to restrict foreign equity in joint venture banks to a maximum of 35 per cent of voting shares. The United Arab Emirates, which has no restrictions regarding the establishment of representative offices, granted new licences for bank branches or the expansion of activities of existing financial entities.

In Egypt, an economic-needs test was applied aimed at considering market access for branches of foreign banks. Wholly-owned foreign subsidiaries and joint venture banks were sanctioned with two provisos, namely, that the managing directors of such institutions possessed banking experience in Egypt of no less than ten years; and that on-the-job training would be provided to nationals.

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<sup>93</sup> Association of Banks in Lebanon, *Annual Report 2003/2004*, p. 139.

<sup>94</sup> These percentages are calculated from data in *Union of Arab Banks Magazine* (November 2004), pp. 187, 189 and 195.

<sup>95</sup> *The Banker*, "Springboard for growth" (Supplement March 2004), p. 15.

<sup>96</sup> *Ibid.*, p. 4.

<sup>97</sup> *The Banker*, "Arab banks' profits soar" (November 2004), p. 85; and *al-Iktissad wal-amal* (November 2004), p. 64-65.

<sup>98</sup> *Union of Arab Banks Magazine* (November 2004), p. 133.

<sup>99</sup> More information is available at: [http://docsonline.wto.org/GEN\\_viewerwindow.asp?D:DDFDDOCUMENTS/T/SCHD](http://docsonline.wto.org/GEN_viewerwindow.asp?D:DDFDDOCUMENTS/T/SCHD).

However, the entry of foreign banks into the ESCWA region does not necessarily lead to the improvement of finance for development. There are currently 38 foreign and joint-venture banks in Egypt. While the performance of these banks over the past 30 years has facilitated the transfer of modern banking technology, the introduction of new financial services and the improvement of human skills in the banking sector, the role of foreign banks has proved to be minimal with regard to finance for development. Specifically, these banks offer a modest average of 7 per cent of total bank credit; they tend to concentrate on top retail and corporate clients, and on the most profitable transactions; they reveal a reluctance to extend their branch networks outside Cairo and other large cities, or cater to small enterprises; and they charge excessively high interest rates and fees on consumer credit and retail services.<sup>100</sup>

(d) *Bank consolidation*

The equity capital of banks serves several purposes, namely: it provides a permanent source of funding for their operations; it is available to bear risk and absorb losses; and it provides a base for further growth.<sup>101</sup> Given that the current Capital Adequacy Ratio (CAR) is set at 8 per cent, the maximum credit a bank can offer is approximately 12.5 times its capital. Consequently, the increase in equity capital is a prerequisite for increasing financing for development while adhering to the international standards of sound performance.

Minimum capital requirements were raised in some ESCWA member countries, including Egypt, Jordan and Iraq, where banks suffered from weak capitalization. In Egypt, capital injections were made in March 2003 by the Government to six State-owned banks in order to help them achieve the regulatory minimum capital adequacy ratio of 10 per cent. Under the new Banking Law, minimum capital was raised from 100 million to 500 million Egyptian pounds; and operating capital for a branch of a foreign bank was raised to a minimum of \$50 million. In order to comply with the new requirements before the end of the grace period, which was set for mid-July 2005, smaller private sector banks announced some plans for voluntary mergers. Moreover, the Central Bank of Egypt announced in September 2004 a five-year programme for bank reform, which emphasized the consolidation of the banking system through mergers and acquisitions. The number of operating banks could be reduced from the current 52 to 25. Within that context, six ailing small banks have been singled out for compulsory mergers before the end of June 2005. The first such merger occurred in September 2004, involving Misr Exterior Bank with Banque Misr, the second largest State-owned bank.

Similarly, the largest bank in Oman, namely, Bank Muscat, concluded a merger with the National Bank of Oman in September 2004, thereby increasing its market share to 52 per cent.<sup>102</sup> Moreover, cross-border mergers and acquisitions were also evident in the countries of the GCC. In August 2004, Ahli United Bank of Bahrain announced the purchase of 40 per cent of Ahli Bank of Qatar; and the National Bank of Kuwait (NBK), which acquired 20 per cent of Grindlays Bank in Qatar, was renamed the International Bank of Qatar.<sup>103</sup> Bank consolidation translates into the creation of larger banks with a stronger capital base and a wider scope of services that can exert a positive effect on financing for development. However, legislative and institutional precautions are needed to ensure that the consolidation process does not result in more bank concentration and less competition.

## 2. *Bank performance in ESCWA member countries*

(a) *Mobilizing savings*

Total deposits in the banks of ESCWA member countries amounted to \$390.7 billion at the end of 2003, compared to \$345 billion in 2002, and \$292 billion in 2001. This represents an increase of 33.4 per cent over the two years (see table 8). This large growth can be largely attributed to the increase in

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<sup>100</sup> S. al-Antary, "The Egyptian banking system under the multilateral agreement for financial service: opportunities and threats" (in Arabic), *Center for Developing Countries Studies*, Faculty of Economics and Political Sciences (September 2004), p. 20-22.

<sup>101</sup> Basel Committee on Banking Supervision, "Core principles for effective banking supervision" (September 1997), p. 23.

<sup>102</sup> *The Banker*, "Arab banks' profits soar" (November 2004), p. 85.

<sup>103</sup> *Ibid.*

international oil prices and to the repercussions of the terrorist attacks of 11 September 2001 on the United States. Investors from the GCC have been reluctant to channel surplus capital to international capital markets; and some private investors abroad have sought more secure and less hostile investment environments in the Arab region.<sup>104</sup>

In terms of total deposits at the end of 2003, banks in Saudi Arabia were ranked first in the ESCWA region, accounting for more than 24 per cent of total deposits; followed by Egypt at 18 per cent; the United Arab Emirates at 17 per cent; Lebanon at 13 per cent; and Kuwait at 9 per cent. Cumulatively, the banking sectors from these five countries account for 81 per cent of total deposits in the ESCWA region.

TABLE 8. TOTAL BANK DEPOSITS IN ESCWA MEMBERS, 2002 AND 2003

Country or territory	Total bank deposits in 2002 (Billions of \$)	Total bank deposits in 2003 (Billions of \$)	Growth (Percentage)	Relative share (Percentage)
Bahrain	13.2	15.7	18.6	4.0
Egypt	57.6	70.3	22.0	18.0
Iraq	1.4	2.3	60.8	0.6
Jordan	13.2	14.1	6.4	3.6
Kuwait	32.9	35.9	9.1	9.2
Lebanon	44.2	51.0	15.4	13.1
Oman	7.2	7.4	2.7	1.9
Palestine	3.8	3.8	..	1.0
Qatar	12.6	14.6	15.7	3.7
Saudi Arabia	87.5	95.0	15.5	24.3
Syrian Arab Republic	12.4	13.3	7.9	3.4
United Arab Emirates	57.1	64.7	13.3	16.6
Yemen	2.2	2.6	18.7	0.6
Total	345.3	390.7	100.0	100.0

Source: *Union of Arab Banks Magazine* (November 2004), p. 195.

Note: Two dots (..) indicate that data are not available or are not separately reported.

The fact that banks in Egypt rank second in terms of deposits, ahead of their counterparts in Kuwait and the United Arab Emirates, is indicative of the traditional inclination of high net worth individuals in the Gulf sub-region to place their savings with international financial institutions abroad. According to estimates by the Inter-Arab Investment Guarantee Corporation, private Arab placements abroad currently amount to some \$1.4 trillion.<sup>105</sup>

In their efforts aimed at attracting Arab high net worth individuals, some banks in the ESCWA region, particularly in Kuwait, Lebanon, Saudi Arabia and United Arab Emirates, introduced private banking and asset management services as well as investment funds. In some cases, private banking institutions were established in Switzerland aimed at providing more security for Arab investors. Salient examples in that respect include the National Bank of Kuwait (Switzerland); Banque Banorient (Switzerland), which is the private banking arm of BLOM Bank in Lebanon; and the Lebanese Banque de la Méditerranée (Switzerland). However, in most cases, Arab private banking services depend on products provided by international banks and investment funds.<sup>106</sup>

<sup>104</sup> Inter-Arab Investment Guarantee Corporation, *Investment Guarantee Quarterly Bulletin* (in Arabic), 2004, p. 8; Central Bank of Qatar, *Annual Report 2003*, p. 71.

<sup>105</sup> Inter-Arab Investment Guarantee Corporation, *Investment Guarantee Quarterly Bulletin* (in Arabic), 2004, p. 7.

<sup>106</sup> *Al-Iktissad wal-amal*, "Private banking" (Special issue, May-June 2004).

From their perspectives, Arab high net worth individuals tend to place their savings outside the Arab region for a number of reasons, including, among others, better terms and greater security, and the lack of appropriate investment opportunities in domestic capital markets. The incentives for holders of such savings to repatriate their resources need to cover at least the following two factors: the general economic and financial climate in the ESCWA region; and the availability of a wide range of domestic financial investment vehicles as well as direct investment opportunities. This, in turn, is closely related to the existence of developed and active Arab capital markets, operating in a stable and predictable investment climate, to accommodate those with an interest in repatriating their funds. Apart from the Gulf sub-region, banks still depend on traditional forms of term deposits, savings accounts and certificates of deposits as their main instruments for mobilizing savings. In some cases, the regulatory framework allows banks to establish, albeit not to manage, investment funds. This applies, for example, to banks in Egypt.

Another important development is the expansion of Islamic banking and Islamic financial instruments during the past few years in most ESCWA member countries, particularly in the Gulf sub-region. In 2003, those countries comprised some 267 Islamic financial institutions, and mobilized approximately \$250 billion.<sup>107</sup>

(b) *Allocating credit*

The efficiency of banking systems in facilitating the flow of funds from savers to the various business sectors can be assessed by the ability of these systems to provide the business sectors with sufficient finance at low cost. Available data reveal that the total loans granted by the banking systems in the ESCWA region amounted to \$482 billion at the end of 2003, compared to \$429 billion in 2002, which represents an increase of 12.3 per cent; and the loans/deposits ratio amounted to an average of 74 per cent over those two years. Lebanon was the only country where total loans actually decreased. This can be largely attributed to the contraction of public sector loans, which fell by 21 per cent.<sup>108</sup>

Generally, the major part of bank loans in the ESCWA region is granted to the private business sector. The share of this sector in total loans currently amounts to an average of 90 per cent in Jordan and Saudi Arabia;<sup>109</sup> 94 per cent in Oman;<sup>110</sup> 82 per cent in Egypt;<sup>111</sup> 86 per cent in the United Arab Emirates;<sup>112</sup> 53-55 per cent in Lebanon, Qatar and Yemen;<sup>113</sup> and constitutes 100 per cent of loans by local banks offered to residents in Kuwait.<sup>114</sup>

The distribution of total loans by economic sectors reflects, to a large extent, the economic structure of the respective countries and the main fields where private business is active. Available data highlight the following:

(a) Trade and services rank first among the borrowing economic sectors, with an average share amounting to 46 per cent in Egypt; 45 per cent in Lebanon; 38 per cent in Jordan, the United Arab Emirates and Yemen; and 31 per cent in Saudi Arabia;

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<sup>107</sup> Inter-Arab Investment Guarantee Corporation, op. cit, p. 9.

<sup>108</sup> Association of Banks in Lebanon, *Annual Report 2003/2004*, p. 134.

<sup>109</sup> Central Bank of Jordan, *Monthly Statistical Bulletin* (December 2004), p. 26; and Saudi Arabian Monetary Agency (SAMA), *Fortieth Annual Report 2004*, p. 88.

<sup>110</sup> *Union of Arab Banks Magazine* (November 2004), p. 86.

<sup>111</sup> Central Bank of Egypt, *Monthly Statistical Bulletin* (February 2005), pp. 19-20.

<sup>112</sup> Central Bank of the United Arab Emirates, *Annual Report 2003*, p. 76.

<sup>113</sup> Association of Banks in Lebanon, *Annual Report 2003/2004*, p. 135; *Union of Arab Banks Magazine* (May 2004), p. 20; and Central Bank of Yemen, *Review of Monetary and Banking Developments, 2004*, p. 9.

<sup>114</sup> Central Bank of Kuwait, *Quarterly Statistical Bulletin* (July-September 2004), pp. 35 and 39.

TABLE 9. MAIN BORROWING SECTORS IN SELECTED ESCWA MEMBERS, 2003  
(Percentage)

Country	Sector					
	Industry	Trade	Services	Construction	Real estate	Personal loans
Egypt <sup>a/</sup>	35	21	25			12
Jordan	17	25	13	15	..	..
Kuwait	6	13	..	7	17	40
Lebanon <sup>b/</sup>	14		45	17	..	15
Oman	8.5	10	7		..	37
Qatar	2	12	5	3	8	28
Saudi Arabia	12	22	9	9	..	30
United Arab Emirates	7	29	9	14	..	2
Yemen	15	38	..	6	..	..

Sources: Central Bank of Egypt, *Monthly Statistical Bulletin* (January 2005), p. 19; Central Bank of Jordan, *Monthly Statistical Bulletin* (January 2005), p. 27; Central Bank of Kuwait, *Quarterly Statistical Bulletin* (July-September 2004), p. 39; Association of Banks in Lebanon, *Annual Report 2003/2004*, p. 142; Central Bank of Oman, *Annual Report 2003*, p. 67; Central Bank of Qatar, *Quarterly Statistical Bulletin* (December 2004), p. 28; Saudi Arabian Monetary Agency (SAMA), *Fortieth Annual Report 2004*, pp. 91-93; Central Bank of the United Arab Emirates, *Annual Report 2003*, p. 76; Central Bank of Yemen, *Review of Monetary and Banking Developments 2004*, p. 10.

Notes: Two dots (..) indicate that data are not available or are not separately reported.

a/ The construction and real estate sectors of Egypt are included in the services sector.

b/ The trade sector of Lebanon is included in the services sector.

(b) Personal loans rank first in several countries of the Gulf sub-region, amounting to 40 per cent of total loans in Kuwait; 37 per cent in Oman; 30 per cent in Saudi Arabia; 28 per cent in Qatar; and 23 per cent in the United Arab Emirates. Personal loans constitute 12 per cent and 15 per cent of total loans in Egypt and Lebanon, respectively. These loans represent mainly consumer loans for the purchase of such items as motor vehicles, durable goods and private residences; credit card loans; and loans for the purchase of securities. In Kuwait, the purchase of securities constituted approximately 22 per cent of total personal loans in 2003 and 2004;<sup>115</sup>

(c) The construction and real estate sectors also constitute a considerable percentage of total loans in some ESCWA member countries, amounting to 24 per cent in Kuwait; 17 per cent in Lebanon; 15 per cent in Jordan; 14 per cent in the United Arab Emirates; 11 per cent in Qatar; and 9 per cent in Saudi Arabia. In Egypt, data for loans in the construction and real estate sectors are consolidated in the services sector. According to the regulatory framework, real estate loans offered to this sector cannot exceed 5 per cent of total loans; and mortgage loans can constitute an additional 10 per cent;

(d) Industry ranks second in Egypt at 35 per cent and in Jordan at 17 per cent. Loans offered to this sector represent a modest 2 per cent of total loans in Qatar; 6-7 per cent in Kuwait and the United Arab Emirates; 12 per cent in Saudi Arabia; and 14-15 per cent in Lebanon and Yemen;

(e) Despite the poor level of disclosure with regard to loan distribution by size, available information indicates a high level of concentration in favour of large borrowers. Lebanon presents an extreme case whereby a modest 4.1 per cent of the total number of borrowers received 75 per cent of total loans, as of June 2003.<sup>116</sup> In Egypt, the latest disclosed data in that respect date back to March 2000 when the largest

<sup>115</sup> Ibid., p. 39.

<sup>116</sup> Association of Banks in Lebanon, *Annual Report 2003/2004*, p. 141.

28 borrowers obtained 13 per cent of the total credit offered to the private business sector; and loans granted to the largest eight borrowers represented 60 per cent of shareholders' equity in the entire banking system.<sup>117</sup>

Interest rates on bank loans and deposits are free in the ESCWA region, with the exception of the Syrian Arab Republic where interest rates are still fixed by the Central Bank. In Yemen, banks are free to set the interest rates on loans, while the Central Bank sets interest rates on deposits. Average interest rates on loans in most ESCWA member countries decreased steadily during the period 2001-2003 (see table 10). Despite this gradual drop, actual spreads of lending rates over deposit rates decreased only in Lebanon from 6.34 to 4.74 per cent, and Bahrain from 8.1 to 7.3 per cent. These spreads stabilized in Kuwait, the Syrian Arab Republic and Yemen at approximately 3, 5 and 6 per cent, respectively. By contrast, spreads actually increased in Jordan from 5.11 to 6.16 per cent, Oman from 4.73 to 5.86 per cent, and Egypt from 3.8 to 5.3 per cent.

TABLE 10. LENDING INTEREST RATES AND SPREADS IN SELECTED ESCWA MEMBER COUNTRIES, 2001-2003  
(Percentage)

Country	2001		2002		2003	
	Lending rate	Spread	Lending rate	Spread	Lending rate	Spread
Bahrain	10.8	8.1	8.5	7.2	8.6	7.3
Egypt	13.3	3.8	13.8	4.5	13.5	5.3
Jordan	10.9	5.1	10.2	5.8	9.3	6.2
Kuwait	7.9	3.4	6.5	3.3	5.4	3.0
Lebanon	17.2	6.3	16.6	5.6	13.4	4.7
Oman	9.2	4.7	8.6	5.7	8.2	5.9
Syrian Arab Republic	9.0	5.0	9.0	5.0	9.0	5.0
Yemen	18.0	6.0	18.0	6.0	18.0	6.0

Source: International Monetary Fund (IMF), International Financial Statistics (IFS) online service (February 2005).

In 2004, spreads ranged between a minimum of 3.37-3.48 per cent in Kuwait and Lebanon, to a maximum of 6-6.8 per cent in Bahrain and Yemen. Wide and increasing spreads can be functions of bank inefficiencies and/or high legal reserve requirements.<sup>118</sup> A bank with a poor asset quality and a high percentage of non-performing loans could try to mitigate the resulting negative effect on its profitability either by increasing lending rates or by lowering deposit rates. In both cases, the result is a wider nominal spread and an undue cost burden on good borrowers.

While the ratio of reserve requirements is certainly as high as 20-25 per cent of total deposits in most ESCWA member countries, bank inefficiencies equally play a leading role in widening spreads and increasing the cost of borrowing in several of these countries. Only a few central banks in the ESCWA region disclose the aggregate level of non-performing loans and the ratio of loan loss coverage. In Egypt, the ratio of non-performing loans to total loans amounted to 25.2 per cent in September 2004, and provisions covered only 54.1 per cent of the potential losses.<sup>119</sup> In Oman, while the non-performing loans of commercial banks accounted for 12.8 per cent of total loans as of December 2003, compared to 11.9 per cent in December 2002, loan loss coverage increased from 69.8 to 82.7 per cent in the same period.<sup>120</sup> In Yemen, non-performing loans amounted to 17.4 per cent of total loans in December 2004, compared to 19.45 and 22.6 per cent in 2003 and 2002, respectively. In Lebanon, non-performing loans constituted 12.8 per cent of total loans and loan loss coverage amounted to 71 per cent in December 2003.

<sup>117</sup> S. al-Antary, "Non-performing loans, stagnation and interest rates" (in Arabic), June 2003, p. 4.

<sup>118</sup> High legal reserve requirements increase the actual cost of funds, which needs to be covered by wide spreads.

<sup>119</sup> Ministry of Foreign Trade and Industry in Egypt, *Quarterly Economic Digest, October-December 2004*, p. 96.

<sup>120</sup> Central Bank of Oman, *Annual Report 2003*, p. 61.

(c) *Settling payments and money transfers*

The payment systems in several ESCWA member countries are still cash-oriented. Cash money represents the primary means of payment in Egypt, Jordan, Lebanon and Yemen. In the period 2001-2004, the currency in circulation as a percentage of means of payment (M1) amounted to averages of 77 per cent in Yemen, 72 per cent in Egypt, 54 per cent in Lebanon, and 49-57 per cent in Jordan.<sup>121</sup> These averages were considerably lower in the countries of the GCC where cheques, debit and credit cards, electronic means of payments and money transfers are more commonly used. Over the same period M1 averaged at 19 per cent in Bahrain, 25 per cent in Saudi Arabia and the United Arab Emirates, and 38 per cent in Oman (see table 11).

TABLE 11. CURRENCY IN CIRCULATION AS PERCENTAGE OF MEANS OF PAYMENTS (M1)  
IN SELECTED ESCWA MEMBER COUNTRIES, 2001-2004

Country	2001	2002	2003	2004
Bahrain	22	22	19	20
Egypt	71	71	72	72
Jordan	57	54	49	44
Kuwait	24	21	19	19
Lebanon	58	54	54	49
Oman	40	38	38	..
Qatar	33	31	19	18
Saudi Arabia	27	26	25	16
United Arab Emirates	27	25	24	..
Yemen	75	78	77	76

Sources: Bahrain Monetary Agency, *Quarterly Statistical Bulletin* (December 2004), p. 3; Central Bank of Egypt, *Monthly Statistical Bulletin* (January 2005), p. 12; Central Bank of Jordan, *Monthly Statistical Bulletin* (January 2005), pp. 6-7; Central Bank of Kuwait, *Monthly Monetary Statistics* (November 2004), p. 8, and *Quarterly Statistical Bulletin* (July-September 2004), p. 26; Association of Banks in Lebanon, *Annual Report 2003/2004*, p. 128; Central Bank of Oman, *Annual Report 2003*, p. 51; Central Bank of Qatar, *Quarterly Statistical Bulletin* (December 2004), p. 12; Saudi Arabian Monetary Agency (SAMA), *Fortieth Annual Report 2004*, p. 64; Central Bank of the United Arab Emirates, *Annual Report 2002* and *Annual Report 2003*; and Central Bank of Yemen, *Review of Monetary and Banking Developments 2004*, p. 4.

Note: Two dots (..) indicate that data are not available or are not separately reported.

The countries of the GCC are currently working towards the establishment of a unified Gulf network, thereby enabling residents of the sub-region to use their banking cards to execute banking operations through automated teller machines (ATMs) in any GCC country. In 2004, networks in five countries were already connected, namely, Bahrain, Kuwait, Qatar, Saudi Arabia and United Arab Emirates.<sup>122</sup>

In their attempts to diversify their operations, risks and revenue streams, banks in the ESCWA region have sought to expand their retail banking services. In addition to credit and debit cards, mobile banking and Internet banking have been growing. Moreover, electronic systems for nationwide and cross-border money transfers were established in several countries. Some banks in Yemen have arranged to be agents of leading international electronic fund transfer institutions.<sup>123</sup> In Egypt, banks have equally been keen to ensure speedy electronic means of transfer from Egyptian expatriates working in the Gulf sub-region. Within that context, several arrangements have been implemented to cover Kuwait, Saudi Arabia and the United Arab Emirates. Recently, some banks have issued "salary cards" in favour of major Egyptian companies in order

<sup>121</sup> M1 is a measure of the money supply that includes currency and checking accounts. M2 includes M1 plus savings deposits.

<sup>122</sup> The remaining network is in Oman. Saudi Arabian Monetary Agency (SAMA), *Fortieth Annual Report 2004*, p. 104.

<sup>123</sup> See, for example, the Yemen Commercial Bank, which is available at: [www.ycbank.com/](http://www.ycbank.com/).

to enable their employees to cash their salaries via ATMs and point-of-sale (POS) machines. Some banks have also started providing enquiry services on customer accounts, exchange rates and share prices on the stock exchange via mobile telephones and Internet sites. A total of 12 out of the 35 joint venture and foreign banks operating in Egypt have obtained licences from the Central Bank of Egypt to provide mobile and Internet banking services.

In August 2004, the Central Bank of Kuwait introduced a new automated real time settlement system to be used for payments and transactions between banks and financial institutions in Kuwait.<sup>124</sup> In another important development, the Swift network was adopted in cross-country bank transfers in Egypt, and the Central Bank of Egypt introduced electronic cheque clearing in 2003. The transition from a manual to a fully-automated and electronic cheque clearing system is equally underway in the Central Bank of Jordan.<sup>125</sup> The aim is to cut the time needed for a cheque to be cashed, which previously took more than two weeks. The development of rapid and secure payment systems needs heavy investments in IT and communication systems, given that these are a prerequisite for any expansion in retail banking business.

### C. PROMOTING DOMESTIC CAPITAL MARKETS

The promotion of domestic capital markets in ESCWA member countries can play a vital role in mobilizing domestic savings, repatriating Arab capital residing in international capital markets and attracting foreign savings. The principal role of a capital market is to make savings more readily and cheaply available to investors by creating liquidity and reducing transaction costs. For an investor, liquid security markets allow the acquisition of assets that can be sold quickly in case of need. Moreover, the markets can provide corporations with access to a larger pool of funds and better information regarding the relative cost of different means of financing an investment. Consequently, the development of active capital markets could provide investors with a wide range of instruments to finance investments, and savers could have more alternatives than bank deposits, precious metals or real estate.

Private capital dominates the total capital flows to developing countries, which, in 2003, was estimated at 87.7 per cent of total net capital flows to developing countries; and, at 75 per cent of net private flows, there is an increasing shift towards equity financing.<sup>126</sup> Consequently, the development of capital markets becomes essential in attracting private foreign savings. This is particularly important to ESCWA member countries, given that net private capital flows to the Middle East and North Africa have fallen from \$7.8 billion in 1997 to minus \$3.8 billion in 2003.<sup>127</sup> Liquid capital markets give an investor better exit options, thereby encouraging more FDI; and active trading of securities attracts portfolio investors. However, one of the principal rules to mitigate the risks inherent in foreign savings is to make them augment, rather than replace, domestic savings.<sup>128</sup> In fact, the deepening of capital markets as reflected by increased market capitalization to GDP, greater liquidity and less concentration of market activity on a few stocks, is an essential prerequisite to enable capital markets to absorb the increase in portfolio investments from both domestic and foreign sources, and mitigate against extreme movements of asset prices and the drastic reversal in portfolio flows.<sup>129</sup>

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<sup>124</sup> More information on the automated settlement system in Kuwait is available at: [www.cbk.gov.kw](http://www.cbk.gov.kw).

<sup>125</sup> More information on the Central Bank of Jordan is available at: [www.cbj.gov.jo](http://www.cbj.gov.jo).

<sup>126</sup> The World Bank, *Global development finance: harnessing cyclical gains for development – I: Analysis and summary tables, 2004*, p. 4.

<sup>127</sup> *Ibid.*, p. 8.

<sup>128</sup> The World Bank, *Country economic memorandum – Egypt: Issues in sustaining economic growth, summary report*, Report No. 16207-EGT (15 March 1997), p. 23.

<sup>129</sup> *Ibid.*

## 1. *Developing capital markets in ESCWA member countries*

The promotion of an effective and efficient capital market entails, among others, certain specific measures aimed at the following: (a) improving the legal environment with regard to market access; (b) ensuring fair trading and transparency in securities transactions; (c) developing central securities depository and investor protection schemes; (d) enhancing capacity to enforce securities regulations; (e) enhancing information disclosure systems; and (f) improving clearing and settlement systems.<sup>130</sup> A follow-up on actions undertaken by ESCWA member countries in that respect is presented below. It should be noted that active capital markets in the ESCWA region cover only nine out of the 13 ESCWA members. This excludes Palestine where trading activities are very modest owing to the political instability of the occupied territories; Iraq where trading was stopped after the invasion of that country in March 2003; and the Syrian Arab Republic and Yemen where preparations are still ongoing for the establishment of domestic stock exchanges.<sup>131</sup>

### (a) *Disclosing and disseminating information*

The confidence of investors and, consequently, their ultimate demand for corporate securities depend on the availability and accessibility of credible information on listed companies. In fact, the alleviation of the problems relating to information asymmetry between users and providers of funds represents a major challenge to the development of equity financing.<sup>132</sup> This is particularly important in the case of IPOs through which public funds are raised to finance companies. In order to subscribe to a given IPO, investors need reliable detailed information on all aspects of the company's past, present and future business. Equally, the availability of detailed and credible information on the value and earning power of listed companies, as deemed necessary to help investors choose between alternative opportunities in domestic and international capital markets, is one of the catalysts for attracting Arab private savings abroad. In order to ensure the confidence of the providers of funds and attract their savings, many efforts have been made by ESCWA member countries aimed at enhancing corporate disclosure and the availability of credible information.

These efforts focus on the following:

(a) Adopting or complying with the International Accounting Standards Committee (IAS). The globalization of capital markets created the need to unify financial reporting standards and requirements. Several capital markets in the ESCWA region require financial reporting according to IAS. For example, joint stock companies in Egypt have been required since 1997 to submit quarterly financial reports based on IAS to the Capital Market Authority (CMA) of that country.<sup>133</sup> Similar rules apply to the capital markets of Bahrain, Jordan and Lebanon;

(b) Establishing regulatory standards for disclosing and disseminating information. In the past few years, ESCWA member countries have paid special attention to the improvement of disclosure levels and criteria in compliance with international standards. The aim is to support the regulatory role of the capital markets and to provide equal opportunities to all participants. Within that context, most of Arab stock exchanges publish periodic bulletins and journals, thereby providing information on trade volumes, price indices, board resolutions and general market trends.<sup>134</sup> In December 2003, the Disclosure Standards of the Bahrain Monetary Agency came into effect, which required all listed companies to provide timely disclosure of all relevant information and to comply with IAS.<sup>135</sup> In Oman, the Capital Market Authority places

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<sup>130</sup> A. Shamseldin, "Capital market performance in Egypt: efficiency, pricing, and market-based risk management", *Financial Development in Emerging Markets: The Egyptian Experience* (Egyptian Center for Economic Studies, 1997), pp. 147-165.

<sup>131</sup> Inter-Arab Investment Guarantee Corporation, *Investment Climate in Arab Countries, 2003* (in Arabic), p. 32.

<sup>132</sup> The World Bank, "Finance for growth: policy choices in a volatile world" (2001), p. 7.

<sup>133</sup> Ministry of Foreign Trade in Egypt, *Quarterly Economic Digest, April-June 2003*, p. 68.

<sup>134</sup> Arab Monetary Fund, "The role of the Arab Monetary Fund in the development of Arab capital markets" (in Arabic), June 2003, p. 15.

<sup>135</sup> Arab Monetary Fund, *Quarterly Bulletin, fourth quarter 2003*, p. 19.

emphasis on the disclosure and transparency of the capital market.<sup>136</sup> In Qatar, the Doha Securities Market approved a new executive regulation in 2003, thereby requiring listed companies to submit quarterly reports on their activities and reducing the maximum time delay for submitting annual financial statements.<sup>137</sup> Moreover, capital markets in several ESCWA member countries have signed agreements with international specialized institutions, including Reuters and Bloomberg, to disseminate trading information online.<sup>138</sup> In some cases, updated information on trading activity is provided through official websites, including, for example, CMA in Egypt; and the Arab Financial Markets Network, which was established in September 2001 and is aimed at creating a virtual Arab stock exchange in cyberspace;

(c) Establishing rating agencies to evaluate the inherent risks in different investment instruments, which in turn can help to attract well-informed investors. Some ESCWA member countries have initiated steps towards the introduction and expansion of securities and corporate rating services, particularly Egypt and Oman. Moreover a specialized rating agency for Islamic financial institutions and products was established in Bahrain in 2002.<sup>139</sup>

(b) *Enhancing legal and regulatory frameworks*

The bias in the tax code against corporate securities in addition to inadequacies in terms of regulations, supervision, accounting, auditing, disclosure practices and protection of small investors all contribute towards the erosion of public confidence in the fairness and transparency of the market and impair the capacity of the securities market to mobilize savings.<sup>140</sup> During the past few years, ESCWA member countries have undertaken important measures to develop the legal and regulatory frameworks pertaining to their domestic capital markets, with the aim of increasing the attractiveness of investment in securities. Salient measures included the introduction and/or amendments to the main legislation relating to capital markets, namely: stock exchange laws and their executive regulations; corporate laws; investment laws; taxation treatment of listed joint stock companies and capital gains; and protection of the rights of investors.<sup>141</sup>

In Bahrain, a new corporate law was enacted in 2002 to grant private enterprises the right to merge or change the nature of their business without the need for prior consent from the Government. In 2003, standard conditions and licensing criteria for a broking company were modified, thereby allowing it to act as intermediary between financial institutions in arranging commodity, money market and securities transactions.<sup>142</sup> In Jordan, the Securities Law was amended in 2002 to allow the establishment of new stock exchanges alongside the Amman Stock Exchange, as well as the establishment of an independent fund to protect the rights of investors.<sup>143</sup> In Oman, ceilings on price movements or acquisition of shares in ailing companies were lifted in 2002, thereby allowing investors to purchase and restructure those companies.<sup>144</sup> In Saudi Arabia, the Capital Market Law was enacted in 2003 to provide for the separation between the control, supervisory and operational role of the market; and to create the Securities Disputes Settlement Committee and the Appeals Committee. A major development was the provision for trading in financial instruments other than shares, including bonds, trust units and financial derivatives.<sup>145</sup> In Egypt, the Settlement

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<sup>136</sup> This disclosure was pursuant to amendments to the Capital Market Law No. 80/98 and the Royal Decree No. 18/2002. Central Bank of Oman, *Annual Report, 2003*, p. 75.

<sup>137</sup> Inter-Arab Investment Guarantee Corporation, *Investment Guarantee Quarterly Bulletin* (in Arabic), 2004, p. 33.

<sup>138</sup> Arab Monetary Fund, "The role of the Arab Monetary Fund in the development of Arab capital markets" (in Arabic), June 2003.

<sup>139</sup> *Al-Iktissad wal-amal* (November 2004), pp. 56-58.

<sup>140</sup> The World Bank, "Egypt: financial policy for adjustment and growth", vol. I (20 September 1993), p. xlii.

<sup>141</sup> League of Arab States and Arab Monetary Fund, *Unified Arab Economic Report, 2003* (in Arabic), p. 127.

<sup>142</sup> Bahrain Monetary Agency, *Annual Report 2003*, p. 43.

<sup>143</sup> League of Arab States and Arab Monetary Fund, *Unified Arab Economic Report, 2003* (in Arabic), p. 128.

<sup>144</sup> *Ibid.*

<sup>145</sup> Arab Monetary Fund, *Quarterly Bulletin, fourth quarter 2003*, p. 30.

Guarantee Fund was established in 2003 aimed at protecting investors against defaults by capital market institutions; and the 5 per cent limit on price movements was removed for the top, most active 12 stocks in the market.<sup>146</sup>

The above mentioned legal and regulatory changes in ESCWA member countries reflect the attempts to widen the scope of investment opportunities, increase the potential gains from trading, improve the settlement of disputes and ensure the protection of the rights of investors, thereby encouraging savers to provide more funds for corporate finance.

(c) *Corporate governance*

As a part of their efforts aimed at protecting the interests of investors and at strengthening surveillance of financial intermediaries, several ESCWA member countries took important measures to ensure corporate governance. In Egypt, new listing and delisting rules of stocks on the Cairo and Alexandria Stock Exchanges were introduced in 2002. Listed companies were granted a grace period of a year to adapt to the new rules. The strict implementation of the new rules led to actual delisting of a number of companies in 2004. In May 2004, new market membership rules were introduced in order to ensure the quality of financial intermediaries.<sup>147</sup>

Moreover, priority has been given to upgrading the prudential regulations governing the activities of intermediary securities firms, including capital adequacy and code of conduct. In Jordan, the Securities Law of 2002 stipulated strict rules concerning the bookkeeping of financial intermediaries, thereby ensuring complete separation between their accounts and those of their clients.<sup>148</sup> In Oman, the Code of Corporate Governance was introduced in January 2003 to apply to both publicly-listed companies and mutual funds. The Code stipulates the composition and responsibilities of the board of directors, the role of the audit committee, audit and internal control functions, and the rules for related party transactions. Listed companies and mutual funds were required to submit an annual report on corporate governance.<sup>149</sup>

In order to ensure transparency and combat illegal insider trading of securities by company officials, online disclosure was enforced for any dealings in corporate shares conducted by board members.<sup>150</sup> The Capital Markets Supervision Directorate in the Bahrain Monetary Agency issued *Guidelines on Insiders* in October 2004, underscoring the duty of insiders to declare and restrict trading in the securities of listed companies. The aim is to avoid any conflict between the interests of insiders and listed companies, and to protect the interests of public investors.<sup>151</sup>

The ultimate goal of the enhancement of corporate governance is to build investor confidence in the management of listed companies as well as the fairness and transparency of the market, thereby alleviating one of the major impediments to the capacity of the capital market to mobilize savings.

(d) *Improving trading systems*

Efficient trading systems ensure the capacity of stock exchanges to handle large volumes of transactions and the fairness and transparency of trading operations.<sup>152</sup> Most trading operations in ESCWA member countries have been automated. Available data indicate that advanced electronic trading systems are

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<sup>146</sup> Ministry of Foreign Trade in Egypt, *Quarterly Economic Digest, April-June 2003*, p. 69.

<sup>147</sup> Ministry of Foreign Trade and Industry in Egypt, *Quarterly Economic Digest, October-December 2004*, p. 88.

<sup>148</sup> League of Arab States and Arab Monetary Fund, *Unified Arab Economic Report, 2003* (in Arabic), p. 128.

<sup>149</sup> More information is available at: [www.cma-oman.com](http://www.cma-oman.com).

<sup>150</sup> League of Arab States and Arab Monetary Fund, *Unified Arab Economic Report, 2003* (in Arabic), p. 128.

<sup>151</sup> Bahrain Monetary Agency, *Guidelines on Insiders* (Capital Markets Supervision Directorate, October 2004).

<sup>152</sup> A. Shamseldin, "Capital market performance in Egypt: efficiency, pricing, and market-based risk management", *Financial Development in Emerging Markets: The Egyptian Experience* (Egyptian Center for Economic Studies, 1997), p. 156.

applied in Bahrain, Egypt, Jordan, Kuwait, Lebanon, Oman, Palestine, Qatar, Saudi Arabia and United Arab Emirates.<sup>153</sup> The latest developments in this respect include the enhancement of electronic trading systems and the introduction of remote service activities through the Internet. In Oman, two platforms for the development of equity and debt capital markets were established in 2002.<sup>154</sup> In Jordan, intermediary companies were allowed to carry on customer trading orders based on proxy sent by email and other electronic media, as from 2004.<sup>155</sup> In Qatar, a new advanced electronic trading system was introduced in 2002, thereby enhancing the operational capabilities of the market.<sup>156</sup> In both Kuwait and Saudi Arabia, investors were allowed to place their trading orders through the Internet, as from 2002.<sup>157</sup>

(e) *Improving settlement and clearing systems*

The principle roles of settlement and clearing systems is to facilitate the transfer of securities ownership and to ensure that the delivery of securities and settlement of money take place simultaneously in order to protect the rights of investors. This represents a key element for the attraction of capital providers to the stock exchange.<sup>158</sup> Most ESCWA member countries have created separate institutions to perform settlement, central depository and clearing functions. Such institutions serve as central registrars for books, records and transfers of securities ownership. Interaction in the market is effected through simple financial settlement with no physical transfer of stocks. The clearing and settlement process is undertaken through a computer system linked to the stock exchange and the clearing banks. The aim is to facilitate trading activities, cut down settlement periods and reduce the errors and difficulties resulting from the loss, theft, forgery or destruction of documents. The actual clearing and settlement period in the capital markets of the GCC dropped to only one day. However, in Lebanon and Egypt, trade orders still take three days.<sup>159</sup>

2. *Performance of capital markets in ESCWA member countries*

In order to evaluate the capacity of capital markets in terms of attracting and allocating domestic and foreign savings, there is a need to review three key performance indicators, namely, market depth, liquidity and concentration.

(a) *Market depth*

The deepening of the capital market in a given economy is reflected by increased market capitalization to GDP. This ratio is supposed to indicate the increase in listed securities and/or their market value, thereby indicating the growing role of the capital market as a source of financing to economic agents and as an active system for the mobilization of domestic and foreign savings.

Available data on the respective stock exchanges of ESCWA members indicate a substantial increase in the ratio of market capitalization/GDP over the past few years (see table 12). During the period 2001-2003, the ratio of market capitalization/GDP increased from 71.5 to 110.2 per cent in Jordan, from 39.8 to 74.0 per cent in Saudi Arabia, from 13.3 to 33.6 per cent in Oman, and from 79.1 to 140.9 per cent in Kuwait. In Lebanon, the ratio rose from 7.5 per cent in 2001 and 8.4 per cent in 2003 to nearly 12 per cent in

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<sup>153</sup> League of Arab States and Arab Monetary Fund, *Unified Arab Economic Report, 2003* (in Arabic), p. 129; and ESCWA, "Responding to globalization: stock market networking for regional integration in the ESCWA region" (2003), p. 21.

<sup>154</sup> Bahrain Monetary Agency, *Annual Report 2003*, p. 44.

<sup>155</sup> Arab Monetary Fund, *Quarterly Bulletin, fourth quarter 2003*, p. 9.

<sup>156</sup> League of Arab States and Arab Monetary Fund, *Unified Arab Economic Report, 2003* (in Arabic), p. 129.

<sup>157</sup> *Ibid.*, pp. 128-129.

<sup>158</sup> A. Shamseldin, "Capital market performance in Egypt: efficiency, pricing, and market-based risk management", *Financial Development in Emerging Markets: The Egyptian Experience* (Egyptian Center for Economic Studies, 1997), pp. 158-159.

<sup>159</sup> ESCWA, "Responding to globalization: stock market networking for regional integration in the ESCWA region" (2003), p. 23; and League of Arab States and Arab Monetary Fund, *Unified Arab Economic Report, 2003* (in Arabic), p. 129.

2004. Equally, the ratio jumped in Egypt from 26.7 per cent in 2001 to 41 per cent in 2003, then to 49 per cent in 2004.

TABLE 12. STOCK EXCHANGE INDICATORS IN SELECTED ESCWA MEMBER COUNTRIES

Stock exchanges	Listed companies	Market capitalization/GDP (Percentage)		Turnover ratio <sup>a/</sup> (Percentage)		
	2004	2002	2003	2002	2003	2004
Abu Dhabi	35	..	..	1.8	3.3	8.0
Amman	192	75.1	110.2	18.9	23.8	29.0
Bahrain	45	98.7	100.5	2.7	2.7	3.4
Beirut	16	8.0	8.4	8.2	8.7	8.5
Cairo and Alexandria	792	32.2	41.2	24.5	15.6	17.9
Doha	30	53.6	130.8	8.4	12.1	15.7
Dubai	18	..	..	7.3	7.2	39.1
Kuwait	125	98.4	140.9	63.0	91.9	70.4
Muscat	123	25.9	33.6	11.0	18.4	21.3
Saudi Arabia	73	39.8	74.0	41.4	101.1	154.4

Sources: Compiled by ESCWA, based on Arab Monetary Fund, *Quarterly Bulletin, statistical annex, fourth quarter 2002, 2003, 2004*; and Bahrain Monetary Agency, *Quarterly Statistical Bulletin* (December 2004), table 35.

Notes: Two dots (..) indicate that data are not available or are not separately reported.

a/ The turnover ratio is the value of traded securities as a percentage of market capitalization.

The aggregate market capitalization of the stock exchanges in ESCWA members more than quadrupled over the past three years, amounting to \$592.5 billion at the end of 2004, compared to \$141 billion at the end of 2001.<sup>160</sup> However, it should be noted that this increase in the market size can be largely attributed to the increase in the prices of securities, rather than in the total number of listed companies. On the aggregate level, the total number of listed companies fell heavily from 1,610 to only 1,449 over the period 2001-2004.<sup>161</sup> This decrease was most evident in the Egyptian capital market, where the number of listed companies fell by 29 per cent in line with the strict implementation of delisting regulations. Moreover, this substantial decrease outweighed the various increases in the number of listed companies in other ESCWA members.

On the other hand, the local indices for share prices in the respective Arab countries at the end of 2004 showed an increase ranging between 23.78 per cent in the Securities Market of Muscat to 172.23 per cent in the Dubai Financial Market (DFM) in the United Arab Emirates. In Egypt, where the number of listed companies actually dropped, the price index increased by 52.04 per cent. In fact, the Arab Monetary Fund (AMF) composite index for share prices showed a 52.02 per cent increase in 2004, compared to 24.2 per cent in the International Finance Corporation Global Index (IFCG) for emerging markets, 7.61 per cent in Nikkei, 7.4 per cent in CAC 40 and 8.99 per cent in Standard & Poor's Ratings Services (S&P) 500.<sup>162</sup>

Another important factor in terms of assessing market depth is the relative share of new issues to total market capitalization. During the past three years, the AMF data base for Arab stock exchanges showed some value for new issues in only two countries, namely, Egypt and Jordan.<sup>163</sup> The value of new issues on the Amman Stock Exchange represented a modest 0.8 per cent of total market capitalization in 2003 and 1.1 per cent in 2004. In Egypt, the ratio amounted to 11 per cent and 8.9 per cent in 2003 and 2004, respectively. While the capital market is supposed to be the source of long-term finance, new issues of

<sup>160</sup> Arab Monetary Fund, *Quarterly Bulletin, statistical annex, fourth quarter 2002, 2003, 2004*.

<sup>161</sup> Ibid.

<sup>162</sup> Arab Monetary Fund, *Quarterly Bulletin, fourth quarter 2004*, p. 76.

<sup>163</sup> Ibid., pp. 10 and 39.

stocks and bonds covered only 17.2 per cent of Egypt's total fixed capital in 2002, and 16.6 per cent in 2004.<sup>164</sup> The capacity of the markets to attract domestic and foreign savings can also be assessed by the ratio of value traded/GDP. Available data reveal that in 2003 this ratio was as low as 6 per cent in both Egypt and Oman, amounted to 16 per cent in Qatar, 26 per cent in Jordan and reached a maximum of 75 per cent in Saudi Arabia.<sup>165</sup>

Foreign participation in total traded value varied from one stock exchange to another in the ESCWA region. In 2004, foreign participation represented some 27 per cent of total traded value on the Cairo and Alexandria Stock Exchanges, representing a rise from 16 per cent in 2001.<sup>166</sup> This increase reflects the revitalization of the privatization programme in joint venture banks and the cement industry. On the Amman Stock Exchange, foreign participation represented a modest 10 per cent of total value traded in 2004, with Arab investors accounting for 83 per cent of that participation.<sup>167</sup> In Bahrain, foreign participants represented approximately 33 per cent of the total value of traded shares in 2003, compared to 28 per cent in 2002. The majority of foreign participants were from countries of the GCC and accounted for 20 and 28 per cent of the total value traded in 2002 and 2003, respectively.<sup>168</sup>

In their pursuit to attract Arab savings, some ESCWA members have opted for Arab stock exchange networking. Cross-listing agreements exist between Egypt, Kuwait and Lebanon; between Bahrain, Jordan and Oman; and between Jordan and Kuwait.<sup>169</sup>

(b) *Market liquidity*

The different indicators of active trading assess the liquidity of a given capital market. High turnovers were evident in the stock exchanges of only two ESCWA member countries, namely: Saudi Arabia, at 101.1 per cent in 2003 and 154.4 per cent in 2004; and Kuwait, at 91.9 per cent in 2003 and 70.4 per cent in 2004. In all the other stock exchanges in the ESCWA region, average turnovers were humble, falling to some 3 per cent in Bahrain; at approximately 8 per cent in Lebanon and Abu Dhabi in the United Arab Emirates; in the range of 15-18 per cent in Qatar and Egypt; amounting to 21 per cent in Oman; and at 29 per cent in Jordan. Other than Saudi Arabia and Kuwait, the highest turnover ratio in 2004 was recorded in Dubai in the United Arab Emirates, at 39 per cent compared to a modest 7 per cent over the previous two years. The low liquidity level of regional stock exchanges can be largely attributed to the following reasons:

(a) The prevalence of closed, family-owned firms and the tendency to resist public listing. A clear example is the case of Egypt, which accounted for some 55 per cent of total listed companies on the stock exchanges in the ESCWA region in 2004. Despite the steady decrease of their relative share, closed companies still represent 38 per cent of total listed companies.<sup>170</sup> In Bahrain, three joint-stock closed companies were listed in the stock exchange in 2003;<sup>171</sup>

(b) The tendency of privatization programmes to depend on anchor or strategic investors. Privatization is supposed to increase the supply of securities in the market and stimulate trading, when carried out through public offerings. However, when divestiture is carried out through sales to anchor investors, the acquisition process often results in the removal of the privatized company's shares from the

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<sup>164</sup> Ministry of Foreign Trade and Industry in Egypt, *Monthly Economic Bulletin, January 2005*, pp. 4 and 64.

<sup>165</sup> The ratios are based on national accounts provided by IMF, *International Financial Statistics* (February 2005); and by Arab Monetary Fund, *Quarterly Bulletin, fourth quarter 2004*.

<sup>166</sup> Cairo and Alexandria Stock Exchanges (CASE), *Annual Report 2004*, p. 6.

<sup>167</sup> Arab Monetary Fund, *Quarterly Bulletin, fourth quarter 2004*, p. 8.

<sup>168</sup> Bahrain Monetary Agency, *Annual Report 2003*, p. 32; and *Annual Report 2002*, p. 37.

<sup>169</sup> ESCWA, "Responding to globalization: stock market networking for regional integration in the ESCWA region" (2003), p. 8.

<sup>170</sup> Cairo and Alexandria Stock Exchanges (CASE), *Annual Report 2004*, p. 6.

<sup>171</sup> Bahrain Monetary Agency, *Annual Report 2003*, p. 29.

trading circle. In Egypt, for example, there has been some reluctance by majority or anchor investors to make available for trading part of their equity shares;

(c) The modest share of corporate and Government listed bonds. From the perspective of the ordinary investor, stocks represent a higher risk compared to bonds that have predefined maturities and returns. On average, bonds represent some 70 per cent of total value traded on international capital markets. In the ESCWA region, bonds constitute a very modest percentage of listed and traded securities. In Egypt, for example, bonds constituted a mere 12 per cent of total value traded in 2003, and dropped to 7 per cent in 2004. In the same year, the value of listed bonds amounted to some 20.2 billion Egyptian pounds, compared to a market capitalization of 234 billion Egyptian pounds.<sup>172</sup> More importantly, Government bonds represent more than 73 per cent of that amount, which are mainly subscribed at and kept in the “held to maturity” investment portfolios of Egyptian banks. In order to establish and vitalize a secondary market for Government bonds, a primary dealers system was introduced and activated in 2004.<sup>173</sup>

Bahrain presents another example. The value of listed bonds and Islamic certificates, or *sukuk*, amounted to 505.7 billion Bahrain dinars at the end of 2003, compared to a market capitalization of some 3657.6 billion Bahrain dinars.<sup>174</sup> Corporate bonds constituted a modest 19.4 per cent of total listed bonds, compared to the official Islamic *sukuk* of approximately 35.8 per cent.<sup>175</sup>

(c) *Market concentration*

At a regional level, active trading on the stock exchanges is generally concentrated in a few large financial and service companies. During the period 2001-2004, such financial institutions as banks, insurance companies and investment companies constituted more than 52 per cent of total traded securities value in Kuwait; was in the range of 60-70 per cent in Bahrain; and amounted to some 55 per cent in Abu Dhabi and 40 per cent in Dubai, in the United Arab Emirates. The service sector came next, representing an average of 20 per cent in Kuwait; 25 per cent in Saudi Arabia; 30 per cent in Bahrain; 30 per cent in Abu Dhabi and more than 60 per cent in Dubai, in the United Arab Emirates.

In addition to the limited number of listed public companies, this concentration of trading activity in a few economic sectors increases the risk of price volatility. Annual volatility for the Cairo and Alexandria Stock Exchanges amounted to 8.7 per cent in 2003, compared to 4.2 per cent in 2002 and 2.2 per cent in 2001.<sup>176</sup> In fact, even if political and economic stability were to be attained, the capacity of the domestic capital markets to mobilize domestic savings or repatriate Arab investments abroad could still be impeded by the lack of a wide range of investment opportunities, the high price volatility of traded assets, and the lack of detailed and credible information on the value and the earning power of the listed companies.

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<sup>172</sup> Central Bank of Egypt, *Monthly Statistical Bulletin* (January 2005), p. 41.

<sup>173</sup> Ministry of Foreign Trade and Industry in Egypt, *Quarterly Economic Digest, October-December 2004*, p. 100.

<sup>174</sup> *Sukuk*, which is the Arabic name for a certificate, complies with shariah.

<sup>175</sup> Bahrain Monetary Agency, *Annual Report 2003*, pp. 32 and 42.

<sup>176</sup> Annual volatility measures the standard deviation of monthly returns. Ministry of Foreign Trade and Industry in Egypt, *Quarterly Economic Digest, October-December 2004*, p. 89.

#### IV. RECENT PROGRESS MADE BY ESCWA MEMBER COUNTRIES IN PROMOTING TRADE AS AN ENGINE FOR DEVELOPMENT

ESCWA member countries have experienced several developments in their trade policies during the past decade. Most of the developments undertaken have been characterized by shifting towards more liberalization. The reasons for embarking on such liberalization measures include implementing commitments within the framework of the Uruguay Round, the accession requirements for WTO, or in line with regional trade agreements (RTAs).

The Monterrey Conference on Financing for Development stated clearly that trade needed to be the engine for growth and development. Chiefly, the Conference called on the support of the multilateral system, and urged developed countries to help developing and least-developed countries become fully engaged in the global trading system. The outcome of the Conference was seen differently by commentators and analysts. For example, from the perspective of the World Bank, the Conference represents an important landmark in the partnership on global development.<sup>177</sup> By contrast, some think tanks believe that the outcomes are non-binding and vague.<sup>178</sup> Some studies have pinpointed the importance of coordinating macroeconomic policies for trade in order to act successfully as an engine for growth, which is an issue that is still absent from the agenda of Arab countries, including those in the ESCWA region.<sup>179</sup>

Other studies have underscored the need for intense trade promotion and integration among ESCWA members, which needs to go beyond the newly-established Global System of Trade Preferences (GSTP). This System, which provides exchange trade preferences with respect to customs duties to more than 40 developing countries, needs to be “strengthened and extended, both in terms of the number of countries and in scope so as to include investment, production and marketing”.<sup>180</sup>

##### A. IMPLEMENTING OBLIGATIONS UNDER WTO RULES

The ESCWA region can be divided into four categories for the purpose of analysing national trade policies, namely: (a) the signatories of the General Agreement on Tariffs and Trade (GATT), which joined WTO automatically; (b) countries that joined WTO after its establishment in 1995, which are sometimes referred to as the newly acceded members; (c) countries that are in an advanced accession phase for joining WTO, albeit not full members; and (d) countries that are still in the early stages of accession or that have not applied for membership. Table 13 shows the classification of ESCWA members according to this categorization scheme, while identifying the dates of joining GATT/WTO or applying for full membership.

TABLE 13. CATEGORIES OF ESCWA MEMBERS IN RELATION WITH THE WORLD TRADE ORGANIZATION (WTO)

A. Signatories of the General Agreement on Tariffs and Trade (GATT)	B. Countries that joined WTO after its establishment in 1995	C. Countries in an advanced accession phase for joining WTO	D. Countries or territories still in the early stages of accession or that have not applied for membership
<ul style="list-style-type: none"> <li>• Bahrain (1993)</li> <li>• Egypt (1970)</li> <li>• Kuwait (1963)</li> <li>• Qatar (1994)</li> <li>• United Arab Emirates (1994)</li> </ul>	<ul style="list-style-type: none"> <li>• Jordan(2000)</li> <li>• Oman (2000)</li> </ul>	<ul style="list-style-type: none"> <li>• Lebanon</li> <li>• Saudi Arabia</li> <li>• Yemen</li> </ul>	<ul style="list-style-type: none"> <li>• Iraq</li> <li>• Palestine</li> <li>• Syrian Arab Republic</li> </ul>

*Source:* World Trade Organization (WTO), “Understanding the WTO”, which is available at: [www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/org6\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm).

<sup>177</sup> The World Bank and IMF, “Financing for development: implementing the Monterrey Consensus” (11 April 2002).

<sup>178</sup> German Development Institute (GDI), “The Monterrey Consensus: the Conference on Financing for Development” (2002).

<sup>179</sup> ESCWA, “Macroeconomic policy analysis for regional cooperation in the ESCWA region: the effect of real exchange rate variability on intraregional trade” (2003).

<sup>180</sup> ESCWA, “Exploring potential of south-south agreements including Global System of Trade Preferences (GSTP)” (4 June 2004).

Table 14 shows the bound and applied tariff rates for those ESCWA member countries in the first category. Bound tariff rates are the tariff rates that countries are committed to in their schedules of tariff commitments in WTO. In general, applied tariff rates, which are applied by Governments, can be equal to or lower than bound tariff rates. The difference between bound and applied tariff rates is called “water in the tariff”. If a given country has applied tariff rates that are higher than bound tariff rates, this implies that the country in question is not abiding by its WTO commitments, which can subsequently be challenged by other WTO members.

TABLE 14. BOUND AND APPLIED TARIFF RATES FOR SELECTED ESCWA MEMBER COUNTRIES

	Bahrain	Egypt	Jordan	Kuwait	Lebanon	Oman	Qatar	Syrian Arab Republic
Bound tariff rate (year) <sup>a/</sup>								
<i>Simple average of ad-valorem duties</i>								
All goods	35.5	37.2	16.3	100.0	n.a.	13.8	16.0	n.a.
Agricultural goods (AOA)	37.5	95.3	23.7	100.0	n.a.	28.0	25.7	n.a.
Non-agricultural goods	35.1	28.3	15.2	100.0	n.a.	11.6	14.5	n.a.
Applied tariff rate (year)	2001	2002	2003	2002	2002	2001	2002	2002
<i>Simple average of ad-valorem duties</i>								
All goods	7.8	19.9	13.1	3.6	5.4	5.7	4.2	19.6
Agricultural goods (AOA)	9.0	22.8	19.8	1.7	14.7	10.2	4.9	21.3
Non-agricultural goods	7.6	19.4	12.1	3.9	4.0	5.0	4.1	19.4

Source: World Trade Organization (WTO), database on country profiles (2005).

Notes: <sup>a/</sup> According to the source used, no exact date has been identified, just final bound. However, in all the countries the bound tariff rates refer to the commitments undertaken by members in the Uruguay Round, with the exception of Jordan and Oman which joined WTO in 2000.

Entries marked n.a. indicate that data are not applicable.

Two issues are evident from table 14, which applies to almost all ESCWA members, namely: (a) that the applied tariff rate is much lower in the countries of the GCC; and (b) that countries in the first category have been able to bind their bound rates at levels much higher than those in the second category, which received significant pressure from developed countries, including those in the EU and the United States, to bind tariff rates at a lower rate, particularly for non-agricultural goods.

Data on the bound tariff rates are not applicable for those countries that belong to the third and fourth categories. However, as the data indicate, countries of the GCC have lower applied rates compared to countries outside the Gulf sub-region. Moreover, countries that belong to the second category, including, for example, Jordan, have low bound rates compared to countries that belong to the first category, including, for example, Egypt and Kuwait.

In general, lower tariffs help countries implement export-oriented strategies, while lower tariffs are not helpful for countries that adopt import-substitution strategies. Given that the majority of countries across the world, including those in the ESCWA region, have adopted export-oriented strategies, adopting low tariff rates is a positive aspect in implementing such strategies. The fact that the manufacturing activity is still in its early phases in ESCWA member countries implies that most of the intermediate goods used in manufacturing are imported and, consequently, enjoy lower tariff rates that enhance exports. Moreover, the system of manufacturing prevailing in the world has shifted towards global value chains and international production sharing schemes whereby each country specializes in a part of the product, rather than the whole product.

Lower tariff rates therefore help ESCWA member countries to be better integrated in the global value chain system and international production sharing schemes. However, lower tariff rates can result in lower Government revenues, which is an aspect that needs particular attention in those countries where tariff revenues comprise a major part of such revenues, including, for example, Lebanon. The significant

difference between bound tariff rates and applied tariff rates has its advantages and disadvantages. While, this difference provides ESCWA member countries in WTO room for negotiating and eases the pace of required domestic reforms, it can result in backsliding on reforms. Moreover it increases the policy uncertainty as changing policies of a given Government or changing Governments can result in raising the applied tariff rates sharply, which in turn negatively affects the allocation of resources.

From a developmental perspective, a stable committed trade policy is of paramount importance. Consequently, it is important to fix bound tariff rates close to applied tariff rates, thereby anchoring reforms and ensuring certainty. Furthermore, given the new global value chain system, high tariff rates are likely to have a negative impact on development. By contrast, lower tariff rates that are harmonized and have few tariff peaks and less tariff dispersion are likely to be comparatively more pro-development.

Other elements of trade policy include such issues as, among others, specific tariffs, quotas, enactment of laws on intellectual property rights (IPRs). Table 15 shows some indicators related to the trade policies of ESCWA members.

TABLE 15. INDICATORS RELATED TO THE TRADE POLICIES OF ESCWA MEMBERS

Country or territory	Year	Share of tariff lines with international tariff peaks	Share of tariff lines with specific rates	Ad valorem equivalent of non tariff barriers	Laws on intellectual property rights (IPRs) in line with TRIPS
<b>First category</b>					
Bahrain	..	..	..	..	Yes
Egypt	1995 2002	53.5 44.6	0.6 10.0	.. 0.1	Yes
Kuwait	..	..	..	..	While laws on trademarks and patents exist, a law on copyrights is being amended to be in line with TRIPS
Qatar	..	..	..	..	Yes
United Arab Emirates	..	..	..	..	Yes
<b>Second category</b>					
Jordan	2000 2002	63.7 43.9	0.4 0.1	.. 10.2	Yes
Oman	1992 2002	0.8 0.2	0.0 2.3	.. 0.9	Yes
<b>Third category</b>					
Lebanon	1999 2002	31.2 9.8	0.1 0.0	.. 3.7	Yes
Saudi Arabia	1994 2000	9.6 8.6	0.1 3.5	.. 0.9	Yes (copyright law was amended in 2004)
Yemen	..	..	..	..	Not complete and not enforced (only parts of it are complete)
<b>Fourth category</b>					
Iraq	..	..	..	..	No
Palestine	..	..	..	..	No
Syrian Arab Republic	..	..	..	..	Yes

Sources: The World Bank, *World Development Indicators 2004*; and the website of the World Intellectual Property Organization (WIPO), which is available at: [www.wipo.int/directory/en/](http://www.wipo.int/directory/en/).

Note: Two dots (..) indicate that data are not available or are not separately reported.

Table 15 illustrates that countries in the first and second categories have fulfilled all their requirements under WTO. By stark contrast, while some countries in the third and fourth categories have adopted a unilateral liberal trade policy, including, for example, Lebanon, others still maintain a more restrictive and/or non-transparent trade policy, such as the Syrian Arab Republic.

Another important dimension in the area of liberalization of trade policy in the multilateral context is the liberalization of trade in services. Owing to the nature of trade in services, it is not possible to limit comparisons to the countries in the first and second categories. As evident from table 16, the number of commitments undertaken by countries that belong to the second category, namely, Jordan and Oman, is much higher than those undertaken by countries that belong to the first category. This stems largely from pressure faced by these two countries when they acceded to WTO.

From a developmental perspective, liberalization of trade in services is more likely to yield positive effects than the case of liberalization of trade in goods. Liberalization of trade in services is not expected to have negative impacts on employment compared to liberalization of trade in goods. The reason for this is clear. Liberalization of trade in goods implies replacing inefficient, domestically produced goods with more efficient, imported goods, which can entail closing domestic factories and labour dismissal. In the case of services, on the other hand, liberalization usually takes place through the movement of producers to be near consumers. In this case, the replacement of inefficient, domestically produced services by more efficient imported services tends to make use of domestic labour, thereby mitigating adverse effects on domestic labour. Moreover, liberalization of trade in services leads to fewer transaction costs, which in turn often results in more competitive exported goods.

ESCWA member countries enjoy comparative advantage in a wide array of services, including tourism and business, which can help them compete in the world. In other words, liberalization of trade in services is likely to have positive effects on development with fewer costs compared to liberalization of trade in goods.

TABLE 16. NUMBER OF COMMITMENTS UNDER THE GENERAL AGREEMENT ON TRADE AND SERVICES (GATS)

Bahrain	22
Egypt	45
Jordan	111
Kuwait	61
Oman	94
Qatar	46
United Arab Emirates	n.a.

*Source:* World Trade Organization (WTO), database on country profiles (2005).

*Note:* Entries marked n.a. indicate that data are not applicable.

It is clear from the tables above that countries in the first and second categories have relatively more liberal trade policies than their counterparts in the third and fourth categories. Table 17 shows that countries in the third category have experienced positive developments with regard to liberalization, with applied tariff rates at lower levels compared to non-GCC countries in the first category or when traced over time. Such varying degrees of trade liberalization must not deter ESCWA members from undertaking joint positions in WTO, particularly on issues related to WTO rules where national interests are likely to be common, in contrast to sectoral issues where these interests can differ.

TABLE 17. AVERAGE APPLIED IMPORT TARIFF RATES ON NON-AGRICULTURAL AND NON-FUEL PRODUCTS

Country or territory	Year	Simple average rate of total non-agricultural and non-fuel products	Weighted average rate of total non-agricultural and non-fuel products
<b>First category</b>			
Bahrain	..	..	..
Egypt	1998	21.7	17.2
	2002	19.9	..
Kuwait	..	..	..
Qatar	..	..	..
United Arab Emirates	..	..	..
<b>Second category</b>			
Jordan	2000	21.8	19.8
	2002	14.1	..
Oman	1997	4.9	4.9
	2002	7.1	..
<b>Third category</b>			
Lebanon	1999	9.8	12.6
	2002	4.1	..
Saudi Arabia	1999	12.1	11.5
	2000	12.1	11.4
Yemen	..	..	..
	..	..	..
<b>Fourth category</b>			
Iraq	..	..	..
	..	..	..
Palestine	..	..	..
	..	..	..
Syrian Arab Republic	2002	19.8	..

Sources: United Nations Conference on Trade and Development (UNCTAD), *UNCTAD Handbook of Statistics 2003 (2004)*; and the World Bank, *World Development Indicators 2004*.

Note: Two dots (..) indicate that data are not available or are not separately reported.

#### B. BILATERAL TRADE NEGOTIATIONS UNDER THE EURO-MEDITERRANEAN PARTNERSHIPS AND THE MIDDLE EAST FREE TRADE AREA INITIATIVE

The proliferation of regional trade agreements (RTAs) is a dominant feature of the current global trading system. Nearly all the members of WTO are equally members of some form of RTA. Within that context, ESCWA members are engaged in several RTAs both with developed and developing countries.

Historically, some ESCWA members, particularly those based in the Mediterranean basin, have enjoyed comparatively strong ties with Europe. The relationship between the EU and those ESCWA members dates back to the 1970s following the signing of several cooperation agreements between the Union and Egypt, Jordan and Lebanon. A new type of relationship was initiated in 1995 under the umbrella of the Barcelona Declaration, involving a total of 27 countries, namely, 15 EU countries and 12 non-EU countries

in the southern Mediterranean.<sup>181</sup> Among the latter are four ESCWA members, namely, Egypt, Jordan, Lebanon and Syrian Arab Republic.

This partnership process is aimed at developing the following: political and security issues; economic and financial sectors; and social, cultural and human affairs. Moreover, the Barcelona Declaration aims to establish a large free trade area by 2010 that encompasses the EU together with the non-EU Mediterranean countries.<sup>182</sup>

Additionally, the EU has recently announced its adoption of the new European Neighbourhood Policy (ENP). While some analysts who have assessed ENP believe it can strengthen the relationship between ESCWA members in the Mediterranean basin, others perceive it as a threat to the Barcelona Declaration. ENP is aimed at establishing an area of prosperity and good neighbourhood based on the values of the EU.<sup>183</sup> However, ENP is still in the formulation stage and, consequently, its effects on ESCWA members cannot be adequately evaluated. Nevertheless, ENP is set to adopt a flexible approach whereby partners in the Neighbourhood can harmonize some of their national policies and regulations according to EU norms and based on country-specific action plans.

In 1989, the European Community and the GCC concluded a cooperation agreement under which the respective foreign ministers met annually to facilitate trade relations between the two blocs and to work towards strengthening stability in a strategic part of the world. Working groups have subsequently been established in the fields of industrial cooperation, energy and environment. In 1996, decentralized cooperation among universities, and business and media corporations was added to the agenda. In 2004, the Policy Agenda for the EU Strategic Partnership with the Mediterranean and the Middle East countries was developed through consultation with the countries concerned and in the course of two meetings, namely: the Euro-Mediterranean Mid-Term Meeting of Ministers of Foreign Affairs (Dublin, 5-6 May 2004); and a ministerial meeting between the EU and the GCC in May 2004.

The Policy Agenda defined the objectives of the EU towards the countries in the Mediterranean and the Middle East in several domains related to the economic and social spheres. Specifically, the Agenda underscores the following objectives:<sup>184</sup>

(a) Within the framework of the Euro-Mediterranean Partnership: (i) to continue trade liberalization under that Partnership by liberalizing further agriculture and services and by fully incorporating regional accumulation of origin; (ii) to support the Euro-Mediterranean regional economic dialogue; (iii) to promote the approximation of the regulatory frameworks with those of the EU, particularly through ENP; (iv) to foster south-south regional integration while seeking to ensure an inclusive approach, particularly such initiatives as the Agadir Agreement and the Arab Maghreb Union (AMU) that are supported by the EU;

(b) With regard to countries of the GCC: (i) to conclude and implement the FTA between the EU and the GCC; (ii) to promote cooperation on such specific issues for the GCC as the creation of a single currency, a common trade policy and a single market; (iii) to assess the feasibility of technical assistance programmes for restructuring administrative frameworks in the GCC;

(c) With regard to countries in the Mediterranean and the Middle East: (i) to promote WTO membership in those countries, thereby modernizing regulatory environments and liberalizing foreign trade

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<sup>181</sup> The Barcelona Agreement was signed in 1995 when the European Union comprised 15 member countries. The Union was expanded to 25 countries on 1 May 2004.

<sup>182</sup> European Commission, "Europe and the Mediterranean: towards a closer partnership – an overview of the Barcelona Process in 2002" (2003).

<sup>183</sup> European Commission, "Communication from the Commission: European Neighborhood Policy – Strategy paper" (2004).

<sup>184</sup> FORNET, "Draft – final report on an EU strategic partnership with the Mediterranean and the Middle East", which is available at: [www.fornet.info/documents/coreper%20rap.%20st10246.en04.pdf](http://www.fornet.info/documents/coreper%20rap.%20st10246.en04.pdf).

regimes; (ii) to promote the progressive establishment of regional FTAs, including the linking of the Euro-Mediterranean and EU-GCC free trade agreements.

By contrast, the interest of the United States in regional integration is new relative to the EU. The Government of the United States has proposed the Middle East Free Trade Area Initiative (MEFTA) aimed at offering a vision of openness, trade integration and economic development for the region. Moreover, the United States announced that it will actively support WTO membership for those peaceful countries in the region that seek it in the following ways: (a) by expanding the Generalized System of Preferences (GSP) programme to increase trade linkages with the Middle East; (b) by offering to negotiate trade and investment framework agreements (TIFAs) that establish frameworks for expanding and resolving outstanding disputes; (c) by offering to negotiate bilateral investment treaties (BITs) with interested countries; (d) by negotiating comprehensive FTAs; and (e) by providing trade capacity-building aid to help countries realize fully the benefits of open markets.<sup>185</sup>

A free trade agreement was concluded between the United States and Jordan, prior to announcement of MEFTA. Among ESCWA members, Bahrain recently signed an FTA with the United States, while Egypt has attempted to start negotiations for more than five years. Most ESCWA members have signed TIFAs with the United States, which enhance trade and FDI among signatories, following fair trade rules set by the United States that include protection of property rights. In many cases, such TIFAs are seen as a step towards signing a free trade area after a set time period, during which signatory countries undertake the needed reform measures in preparation for the FTAs with the United States.

In general, RTAs between the south, including ESCWA members, and the north, including the United States and the EU, have proliferated since the mid-1980s following the North American Free Trade Agreement (NAFTA) that encompasses Canada, Mexico and the United States. The north-south RTAs can result in gains for the southern partners as well as losses.

There are, in general, two aspects of north-south RTAs that distinguish them from south-south RTAs, namely: (a) north-south RTAs tend to be accompanied with technical and financial assistance, thereby assisting the developmental process in the southern partners; and (b) north-south RTAs often entail elements of “deep” integration, which does not necessarily result in positive implications for the southern partners and to their developmental process. In some cases, for example in terms of adopting laws that are difficult to formulate domestically, deep integration can help partners in the south to implement rules and regulations that help them in the developmental process. However in other cases, for example in terms of stringent environmental and labour standards, harmonization according to regulations set by the north can be anti-developmental if it does not suit the developmental status of the partners in the south.

In the area of trade, ESCWA members are highly dependent on partners in the EU and the United States (see table 18). However, the nature of trade is confined to so-called inter-industry whereby ESCWA member countries export raw materials and low value-added goods, and import high value-added manufactured goods. For example, the high value of fuel product exports outside the region reduces the share of intraregional exports to total exports. Studies focusing on countries in the southern Mediterranean and on their relationships with the EU have identified the failure to enhance integration through intra-industry trade (IIT), as opposed to inter-industry. Moreover, this failure can be largely attributed the low level of competitiveness of exports from those countries in the southern Mediterranean.<sup>186</sup> In fact, a high level of IIT trading in the same group of products is characteristic of a higher degree of development. The reason for this is that IIT depends on a higher level of specialization and arises from economies of scale that exhibit imperfect competition that are likely to prevail in economies with a higher degree of development. This is in contrast to inter-industry trade, which is trading in different groups of products that depend on the conventional comparative advantage.

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<sup>185</sup> United States Department of State, “Middle East initiatives and activities related to trade and investment” (2005), which is available at: [www.state.gov/e/eb/cba/c9636.htm](http://www.state.gov/e/eb/cba/c9636.htm).

<sup>186</sup> O. Havrylyshyn and P. Kunzel, “Intra-industry trade of Arab countries: an indicator of potential competitiveness”, IMF Working Paper No. WP/97/47 (April 1997).

TABLE 18. TRADE BETWEEN ESCWA MEMBERS AND THE EU AND THE UNITED STATES  
AS A SHARE OF TOTAL TRADE IN THE ESCWA REGION, 2001, 2002 AND 2003  
(Percentage)

Country or territory	Flow	2001		2002		2003	
		European Union	United States	European Union	United States	European Union	United States
Bahrain	Export	14	15	13	16	12	15
	Import	37	18	37	17	38	18
Egypt	Export	50	17	45	22	47	16
	Import	35	22	37	18	40	16
Iraq	Export	26	32	26	51	20	57
	Import	32	1	30	1	25	8
Jordan	Export	8	17	9	27	7	36
	Import	41	9	41	9	38	9
Kuwait	Export	13	13	10	13	11	14
	Import	38	12	39	13	38	15
Lebanon	Export	19	10	20	7	20	9
	Import	54	7	55	6	61	5
Oman	Export	2	5	5	5	3	7
	Import	35	8	37	10	36	8
Palestine	Export	15	26	22	29	27	6
	Import	32	3	39	0	32	0
Qatar	Export	1	5	3	5	3	3
	Import	42	10	53	9	53	9
Saudi Arabia	Export	16	20	16	21	16	23
	Import	36	17	38	13	40	12
Syrian Arab Republic	Export	62	3	58	2	54	5
	Import	39	5	38	5	42	4
United Arab Emirates	Export	7	4	8	3	9	3
	Import	34	7	33	9	35	7
Yemen	Export	2	8	5	12	2	2
	Import	2	1	2	1	2	0

Source: World Integrated Trade Solution (WITS) database, which was jointly developed by UNCTAD and the World Bank.

ESCWA members have been trying to enhance their trade relations with both the EU and the United States. The political aspect of such relations, particularly given concomitant financial and technical assistance, has been the major driving force behind the enthusiasm among ESCWA members. In many cases, the implementation of commitments of ESCWA members in such RTAs is much stronger than the implementation of south-south RTAs and WTO commitments. In some cases, RTAs with the EU and the United States have been the major driving forces for trade reforms and liberalization moves. Within that context, examples include the FTA between Jordan and the United States, and the Euro-Mediterranean Partnership Agreement between Lebanon and the EU.

### C. FACILITATING REGIONAL INTEGRATION

Early attempts at regional integration, which first began in the 1950s, failed partly as a result of major weakness in the adopted methodology. Specifically, while these attempts were more ambitious in terms of objectives, they remained unrealistic in terms of implementation. Subsequently, the level of intraregional trade among Arab countries has been largely modest, particularly when compared to other regions in the world, including, for example, the EU, NAFTA and the Association of Southeast Asian Nations (ASEAN).<sup>187</sup>

<sup>187</sup> ESCWA, *Survey of Economic and Social Developments in the ESCWA Region, 2004* (E/ESCWA/EAD/2004/3).

The percentage of Arab intraregional trade has ranged from a conservative 7 per cent to a high of 11 per cent. There remains some debate as to the significance of this low level of intraregional trade. While some analysts view such a low percentage in the light of the inherent potential of Arab countries,<sup>188</sup> others perceive a link with the comparatively modest degree of development across the Arab region.<sup>189</sup>

Several studies have analysed the causes for the weak trade integration among Arab countries, and have identified a number of reasons in the economic, political and institutional spheres, as follows:

(a) Economic sphere: (i) a high degree of similarity in the production and exports structure of Arab countries; (ii) mismatch between exports and imports; (iii) dominating ideology of import substitution; (iv) large size of public sector; and (v) comparatively high tariff protection;

(b) Political sphere: (i) absence of sincere political leadership and willingness for integration; and (ii) lack of credibility and feasibility among some Arab countries to undertake the integration process, thereby creating an atmosphere of mistrust among Arabs concerning RTAs;

(c) Institutional sphere: (i) lack of adequate transport roads; and (ii) vagueness of rules and regulations governing border trade.

Additionally, studies have underscored the low IIT Index in Arab countries, thereby implying a modest industrial base.<sup>190</sup> While Arab countries are experiencing higher growth rates of IIT, current levels of IIT for the Arab region are less than those in NAFTA and Asia Pacific Economic Cooperation (APEC). Specifically, NAFTA and the EU had IIT Index values of 53.4 and 56.3 per cent, respectively. By contrast, IIT values were below 15 per cent in Jordan, Qatar, Saudi Arabia and Yemen. The highest IIT Index was recorded in Kuwait at 34.3 per cent; and the Index for the remaining ESCWA members was in the range of 15-30 per cent.<sup>191</sup>

Another body of literature has argued that the perspectives for Arab integration are more promising than reflected by conventional trade statistics. For example, since the late 1980s, there has been a trend of increasing trade intensity among countries in the Mashreq, in addition to exports from this Arab sub-region to countries in the Maghreb.<sup>192</sup> Moreover, there is higher concentration of non-traditional exports, including processed agricultural products and basic manufactures in non-oil goods traded regionally, than in exports directed to the EU and the rest of the world. Trade among Arab countries demonstrates significant levels of complementarities and competitiveness compared to trade with the EU.<sup>193</sup> A comparative analysis of dynamic exports showed that in most Arab countries the number of dynamic products is higher for intraregional trade than for Arab exports to the EU, thereby suggesting that opportunities for intraregional trade in processing activities have expanded.<sup>194</sup> The dynamic Arab products maintain differentiated export

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<sup>188</sup> O. Havrylyshyn and P. Kunzel, "Intra-industry trade of Arab countries: an indicator of potential competitiveness", IMF Working Paper No. WP/97/47 (April 1997).

<sup>189</sup> H. al-Atrash and T. Yousef, "Intra-Arab trade: is it too little?", IMF Working Paper No. 00/10 (2000), which is available at: [www.erf.org/html/btrade10.pdf](http://www.erf.org/html/btrade10.pdf).

<sup>190</sup> O. Havrylyshyn and P. Kunzel, "Intra-industry trade of Arab countries: an indicator of potential competitiveness", IMF Working Paper No. WP/97/47 (April 1997).

<sup>191</sup> A. Yeats and F. Ng, "Beyond the year 2000: implications of the Middle East's recent trade performance" in *Catching Up with the Competition: Trade Opportunities and Challenges for Arab Countries*, Hoekman, B. and Zarrouk J. eds. (University of Michigan Press, 2000).

<sup>192</sup> J. Devlin and J. Page, "Testing the waters: Arab integration, competitiveness, and the Euro-Med Agreements" in *Towards Arab and Euro-Med Regional Integration*, Dessus, S., Devlin J. and Safadi R. eds, (OECD, Economic Research Forum (ERF) and the World Bank, 2001).

<sup>193</sup> Exceptions to this trend include Morocco and Tunisia, which demonstrate higher levels of competitiveness in exports directed to the European Union than in intra-Arab trade.

<sup>194</sup> J. Zarrouk, "The Greater Arab Free Trade Area: limits and possibilities" in *Catching Up with the Competition: Trade Opportunities and Challenges for Arab Countries*, Hoekman, B. and Zarrouk J. eds. (University of Michigan Press, 2000).

niches in intraregional trade, which implies a real potential for developing export capacity and enhancing the success of RTAs.

The majority of obstacles hindering intraregional trade are caused not by economic failure, rather by the absence of the adequate institutions. A field survey undertaken by LAS in 2004 on the major impediments faced by the Arab business community pointed out challenges in three main areas, namely: abuse of technical barriers to trade (TBT) and sanitary and phytosanitary (SPS) measures; vague rules and regulations, particularly in terms of authenticating origin of goods; and customs procedures. Such issues are institutional in nature, rather than economic or political, and are due to the absence of clear standards.<sup>195</sup>

Moreover, a significant number of Arab countries, including those within GAFTA and the four ESCWA members in the Euro-Mediterranean Partnership, are still not members of WTO. This is a major drawback given that any violation by or against those countries is referred to a bilateral dispute settlement mechanism, which, in many cases, is either inefficient or absent, thereby impacting negatively on trade relations and leading to possible retaliations. Such conflicts, which can only be solved by political intervention, create uncertainty and harass potential exporters. Additionally, Arab countries are not fully engaged in international production-sharing schemes, as reflected by their low percentage of exports in parts and components.<sup>196</sup> The GAFTA members need therefore to develop their efforts aimed at enhancing their exports in this subset of products.

The prospects for regional integration in trade in services are more promising than the prospects for merchandise trade.<sup>197</sup> Some analysts have argued that Arab countries do not appear on the list of the most important developing countries traders in commercial services, with the exception of Egypt as an exporter and of Saudi Arabia as an importer, and are therefore weak in terms of services trade.<sup>198</sup> However, the data show that there are some prospects for different initiatives of liberalizing trade in services owing to the comparative advantage enjoyed by Arab countries, including ESCWA members (see table 19). Comparative advantage is measured by the Revealed Comparative Advantage Index (RCA). The RCA of a certain commodity of a given country is a measure that indicates the potential opportunities for expanded trade in that specific commodity, and the potential for that country to specialize in exporting that commodity. It can take any number between 0 and infinity. A result less than 1 implies that the country has a revealed comparative disadvantage in that commodity; and greater than 1 implies that the country has a comparative advantage in that commodity.

TABLE 19. REVEALED COMPARATIVE ADVANTAGE OF SERVICES EXPORTS  
IN SELECTED ESCWA MEMBER COUNTRIES, 2003

	Transport	Travel	Communications	Construction	Computer and Information Technology	Insurance	Financial services	Other business services	Recreational and social services
Egypt	1.7	1.5	1.3	1.0	0.1	0.1	0.1	0.2	0.8
Bahrain	1.3	2.5	..	..	..	..	..	0.3	..
Saudi Arabia	1.1	2.0	..	..	..	..	..	1.0	..
Yemen	0.9	1.6	6.4	..	..	..	..	0.1	..

Source: United Nations Conference on Trade and Development (UNCTAD), *UNCTAD Handbook of Statistics 2003* (2004).

Note: Two dots (..) indicate that data are not available or are not separately reported.

<sup>195</sup> B. Fuleihan, "Trade liberalization in the Arab world: multilateralism v/s regionalism" (2004).

<sup>196</sup> A. Yeats and F. Ng, "Beyond the year 2000: implications of the Middle East's recent trade performance" in *Catching Up with the Competition: Trade Opportunities and Challenges for Arab Countries*, Hoekman, B. and Jamel Z. eds. (University of Michigan Press, 2000).

<sup>197</sup> ESCWA, *ESCWA Annual Report 2003* (E/ESCWA/OES/2004/3).

<sup>198</sup> J. Zarrouk, "The Greater Arab Free Trade Area: limits and possibilities" in *Catching Up with the Competition: Trade Opportunities and Challenges for Arab Countries*, Hoekman, B. and Zarrouk J. eds. (University of Michigan Press, 2000).

In 2001, Arab countries initiated a separate agreement on liberalizing trade in services on a regional basis, with a proviso relating to GATS commitments for those Arab countries that were already members of WTO. In 2004, the first round of negotiations based on a request/offer approach was initiated and while Arab countries have shown enthusiasm in liberalizing trade, it is too early to assess the outcomes of this round of negotiations.

Other studies have emphasized that labour migrations are the most evident phenomenon of regional integration across the Arab region.<sup>199</sup> However, the political and social challenges posed by such migrations could limit the potential of increased integration. On the other hand, it is evident that less trade frictions are likely to arise from liberalizing services on a regional basis compared to agricultural and manufactured trade.<sup>200</sup> The reasons for this optimistic view arise from the nature of liberalizing trade in services, which mitigate adverse effects on domestic labour compared to liberalizing trade in goods, and which do not provoke lost tariff revenues that often accompany liberalizing trade in goods.<sup>201</sup> Moreover, there is a strong belief that inefficient services owing to the lack of competition from non-liberalization negatively affect the competitiveness of merchandise exports.

### 1. *The Greater Arab Free Trade Area (GAFTA)*

The majority of ESCWA members, which have joined GAFTA by virtue of their membership of LAS, have striven to make the regional free trade area a success. GAFTA represents a new approach of RTAs, based on a more realistic attitude towards integration compared to earlier attempts. In general, as a vehicle for regional integration among Arab countries, GAFTA seems to be functioning according to expectations. However, GAFTA suffers from a weak institutional setup that is unable to resolve disputes among members and to harmonize such standards as are needed to facilitate intraregional trade.

Moreover, complementarities between Arab countries and different production systems of services are likely to increase the chances of success of this agreement, and have positive impacts on intraregional trade in goods. However, there are some inconsistencies between bilateral preferential trade agreements, which were signed by some members, and with GAFTA, which came into force in 2005. Such bilateral agreements should have been abolished given that GAFTA supersedes them in terms of coverage and is free of negative lists that are characteristic of bilateral agreements. In reality, such agreements still exist and while they can appear confusing and conflicting with GAFTA, experts have identified two areas where the bilateral agreements can prove beneficial, namely: (a) the existence of bilateral committees that meet on a regular basis to solve any trade disputes is an important mechanism that is still not fully established in GAFTA; and (b) bilateral agreements do not cause problems in terms of implementation for customs officials, given that exporters choose the agreement for their exports and are treated accordingly with no overlap between bilateral agreements and GAFTA.

Consequently, the existence of bilateral agreements among Arab countries does not represent a genuine conflict with GAFTA. Overcoming the abovementioned impediments can help to accelerate the regional integration among GAFTA members. The enhanced regional integration, including services, among GAFTA members can in turn expand developmental prospects, particularly the migration of labour to provide services. In fact, a successful Arab free trade area can help to cure the ills of ESCWA members related to skewed distribution of labour, particularly those that suffer from both over and under population.

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<sup>199</sup> Ibid.; and S. Fischer, "Prospects for regional integration in the Middle East", in *New Dimensions in Regional Integration*, de Melo, J. and Panagariya A. eds. (Centre for Economic Policy Research and Cambridge University Press, 1993).

<sup>200</sup> This is owing to the large number of sensitive products in agriculture, and to issues related to rules of origin in the manufacturing sector.

<sup>201</sup> A.F. Ghoneim, "Helping to identify the potential and mode for liberalization of trade in services in the southern Mediterranean countries: the case of Egypt" (Economic Research Forum (ERF), 2003), which was presented at the University of European Union Annual Meeting (Florence, Italy, 19-24 March 2003).

TABLE 20. THE STATE OF GAFTA IMPLEMENTATION BY ARAB COUNTRIES

Country or territory	Informing customs stations (authorities)	Tariff structure submission	Implementing rules of origin	Farmer's Almanac (Agricultural Products Group)	Exceptions	Decision taken by official entity
Algeria <sup>a/</sup>						
Bahrain	10 February 1998	*	*	*	*	*
Comoros <sup>a/</sup>						
Djibouti <sup>a/</sup>						
Egypt	11 February 1998	*	*	*	*	*
Iraq	4 March 1998	*	*	*	*	*
Jordan	9 March 1998	*	*	*	*	*
Kuwait	1 January 1998	*	*	None	None	*
Lebanon	1 December 1998	*	*	*	*	*
Libyan Arab Jamahiriya	1 December 1998	*	*	*	*	*
Mauritania <sup>a/</sup>						
Morocco	13 January 1998	*	*	*	*	*
Oman	9 May 1998	*	*	*	None	*
Palestine <sup>b/</sup>				*		
Qatar	1 July 1998	*	*	None	None	*
Saudi Arabia	2 March 1998	*	*	*	None	*
Somalia <sup>a/</sup>						
Sudan <sup>b/</sup>		*	*	*	*	*
Syrian Arab Republic	1 September 1998	*	*	*	*	*
Tunisia	6 February 1998	*	*	*	*	*
United Arab Emirates	14 March 1998	*	*	None	None	*
Yemen <sup>b/</sup>				*		

Source: Arab Monetary Fund, *Joint Arab Economic Report 2002* (in Arabic).

Notes: a/ Algeria, Comoros, Djibouti, Mauritania and Somalia are not members of GAFTA given that they have not ratified the Agreement to Facilitate and Develop Trade Among Arab States.

b/ Palestine, Sudan and Yemen have not applied some of the gradual reduction 10 per cent on tariff and customs duties and taxes of similar effect.

An asterisk (\*) indicates that the measures were implemented.

## 2. Agadir, the GCC and the Arab Maghreb Union (AMU)

Agadir, the GCC and the Arab Maghreb Union (AMU) represent other models of sub-RTAs that have adopted different approaches. All three are efforts aimed at promoting trade and economic cooperation among Arab countries as one bloc within the framework of LAS.

The GCC was established in 1981 in the eastern part of the Arab region; and the AMU was founded in 1987 in its western part, comprising Algeria, Libyan Arab Jamahiriya, Mauritania, Morocco and Tunisia. A third group, namely, the Arab Cooperation Council, was established in the 1980s and included Egypt, Iraq, Jordan and Yemen. However, this initiative was terminated owing to political problems experienced by Iraq. AMU has suffered from similar political challenges, which have hindered the achievement of development

and economic goals. Ultimately, the GCC has been assessed as the most successful model among sub-RTAs in achieving regional trade among Arab countries.<sup>202</sup>

The Agadir Agreement between Egypt, Jordan, Morocco and Tunisia initially faced comparable obstacles. Specifically, the Agreement is aimed at establishing a free trade area among the four countries and requires the adoption of a standard system of rules of origin. Within that context, Egypt and Jordan had a system of rules of origin with the EU that followed the Pan European model. Consequently, the decision was taken to adopt the rules of origin system under the Euro-Mediterranean Agreements, which was highly similar to the Pan European model. However, the system of rules of origin adopted between Morocco, Tunisia and the EU was different. Morocco and Tunisia were therefore reluctant to adjust their rules of origin to a new system to allow for the accumulation, particularly given that the cost of changing those rules was estimated to be higher than the benefits from changing the system. After a long period of negotiations, which addressed some other conflicts relating to agricultural coverage and location of the secretariat, and under pressure from the EU the four countries signed the Agreement in 2004.

Trade data shows that the members of Agadir trade the least with each other, even within the nine Arab countries of the southern Mediterranean; and ongoing developments do not show any significant signs of increasing trade. In the case of Egypt, imports from the other three member countries of Agadir remained at approximately 8 per cent of total intraregional non-oil imports, with a declining share from Tunisia and an increasing one from Jordan.

Jordan, which is more integrated than Egypt, has experienced a rise in the percentage of non-oil imports from the other three member countries, increasing from some 17 per cent of total non-oil intraregional imports in 1995 to approximately 24 per cent in 2003, with the bulk of imports coming from Egypt. That percentage in Morocco climbed from some 18 per cent in 1995 to 37 per cent in 2003, with the main surge of imports coming from Tunisia and Egypt. In Tunisia, that percentage declined from approximately 30 per cent in 1995 to some 24 per cent in 2003, with most of the drop coming from Morocco. Consequently, Egypt appears to be the least integrated in terms of imports, and the most integrated in terms of exports; and Jordan is the least integrated in terms of exports. In general, there seems to be a positive trend of increase in trade among the members of Agadir with respect to intraregional trade.

The expected benefits and costs of the Agadir Agreement are likely to be as follows:

(a) The Agreement can result in stronger regional integration among the four countries owing to the presence of more apparent provisions compared to GAFTA with regard to dispute settlement, and the allowance of mutual recognition agreements. In addition, the involvement of the EU in the process is likely to add an anchoring effect to the Agreement and prevent backsliding;

(b) The Agreement is undertaken among a set of relatively similar countries in terms of export diversification and industrial base. Moreover, the differences in tariff rates are not substantial compared to, for example, the countries of the Gulf sub-region. This is expected to facilitate future agreements, particularly given that the four member countries have undertaken major reforms and are adopting export-oriented policies;

(c) The Agreement is primarily aimed at accelerating the establishment of a free trade area among the four countries. However, given that GAFTA was fully concluded before the entry into force of Agadir, this could dilute the positive effect of Agadir in terms of enhancing regional integration among the four countries. Such dilution could equally arise from RTAs with other countries, including, for example, the free trade area agreements signed separately by Jordan and Morocco with the United States;

(d) The position of the Agreement with regard to GAFTA and other existing bilateral trade agreements between the members of Agadir is not clear, thereby resulting in some confusion and ambiguity in trade transactions among Government officials and the business community;

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<sup>202</sup> B. Fuleihan, "Trade liberalization in the Arab world: multilateralism v/s regionalism" (2004).

(e) The high geographical concentration of trade with the EU currently enjoyed by Morocco and Tunisia is not likely to be easily reoriented towards Egypt and Jordan;

(f) The Agreement does not add any deeper features regarding the migration of labour or the liberalization of services under GATS.

The GCC represents another model of sub-regional integration. While Yemen has been seeking to join the GCC, its membership is still pending. Given that the GCC cannot impose trade policies upon its member States, each is free to pass and enforce its own trade laws. However, there has been growing cooperation among countries of the GCC on such issues as customs duties, intellectual property protection, standards-setting and intra-GCC investments. Within the framework of the plan for greater economic integration, the six countries of the GCC implemented the GCC Customs Union in January 2003, thereby unifying tariffs across the sub-region. In theory, the GCC Customs Union implies adopted unified customs laws and procedures, single point-of-entry with internally free movement of goods, and treatment of goods as national origin within the GCC. However, the practical details of various issues have yet to be resolved, including, among others, tariff exemptions; revenue distribution; and harmonizing standards, particularly given that conflicting standards continue to hamper trade.

Table 21 shows trade performance indicators for ESCWA member countries, including trade openness, rate of growth of merchandise exports, ratio of commercial services exports to merchandise exports, and growth in real trade less growth in real GDP.

TABLE 21. TRADE PERFORMANCE INDICATORS IN ESCWA MEMBER COUNTRIES

Country or territory	Trade openness (trade in goods as percentage of GDP)		Ratio of commercial service exports to merchandise exports <sup>a/</sup>		Growth in real trade less growth in real GDP (percentage points)	Rate of growth of merchandise exports (average annual percentage growth)
	1990	2002	1990	2002	1990-2002	1990-2001
<b>First category</b>						
Bahrain	..	..	..	..	..	..
Egypt	36.8	18.8	138.4	208.3	-2.3	3.7
Kuwait	59.8	68.9	..	..	..	16.3
Qatar	..	..	15.0	18.9	..	..
United Arab Emirates	101.8	..	..	..	..	4.0
<b>Second category</b>						
Jordan	91.1	82.8	134.4	53.7	-2.6	6.7
Oman	77.7	84.6	1.2	3.1	..	14.8
<b>Third category</b>						
Lebanon	106.5	43.3	..	..	-2.5	4.1
Saudi Arabia	58.6	56.4	6.8	7.0	..	3.5
Yemen	46.9	58.4	11.8	4.0	3.1	..
<b>Fourth category</b>						
Iraq	41.2	..	..	..	..	29.4
Syrian Arab Republic	53.7	51.8	17.6	26.7	3.6	0.8
Palestine	..	..	..	..	..	..

Source: The World Bank, *World Development Indicators 2004*.

Notes: <sup>a/</sup> The ratio of commercial service exports to merchandise exports represents total service exports minus exports of Government services.

Two dots (..) indicate that data are not available or are not separately reported.

The indicators presented in the above table must be interpreted carefully owing to the dominance of oil exports among some ESCWA members, which affect the data. Consequently, these indicators need to be perceived as highlighting development over time for the different countries, and for the purpose of pinpointing whether adopted liberal trade policies have resulted in positive outcomes in terms of trade performance. In that light, it is very difficult to arrive at definite conclusions regarding trade policy outcomes for ESCWA members. For example, in the first category, while Egypt experienced negative developments, Kuwait experienced positive developments. In the second category, trade openness in Jordan decreased despite more liberal trade policies, thereby resulting in comparatively lower rates of growth for its exports, compared to an increase in Oman, with its less liberal trade policies. The indicators for countries in the third and fourth categories were equally mixed.

In addition to the domination of oil exports, which skews those indicators, the weak results of some ESCWA member countries can be attributed to “deep” aspects of trade reform, including, among others, customs procedures, trade facilitation, availability of finance for exports and port efficiencies. Moreover, the absence of a clear vision with regard to liberal trade policies can lead to negative results.

Table 22 includes a set of indicators for the exports performance of ESCWA member countries using mainly the number of exported commodities, diversification index and concentration index.

TABLE 22. NUMBER OF EXPORTED COMMODITIES, DIVERSIFICATION INDEX AND CONCENTRATION INDEX IN ESCWA MEMBER COUNTRIES, 1990 AND 2001

Country or territory	Number of exported commodities		Diversification index <sup>a/</sup>		Concentration index <sup>b/</sup>	
	1990	2001	1990	2001	1990	2001
<b>First category</b>						
Bahrain	..	67	..	0.877	..	0.66
Egypt	149	165	0.701	0.681	0.244	0.287
Kuwait	..	..	..	..	..	..
Qatar	28	40	0.741	0.731	0.779	0.626
United Arab Emirates	..	..	..	..	..	..
<b>Second category</b>						
Jordan	105	134	0.740	0.668	0.368	0.191
Oman	117	151	0.835	0.772	0.884	0.681
<b>Third category</b>						
Lebanon	..	167	..	0.659	..	0.107
Saudi Arabia	122	183	0.845	0.885	0.747	0.894
Yemen	..	..	..	..	..	..
<b>Fourth category</b>						
Iraq	..	..	..	..	..	..
Syrian Arab Republic	..	..	..	..	..	..
Palestine	..	..	..	..	..	..

Source: United Nations Conference on Trade and Development (UNCTAD), *UNCTAD Handbook of Statistics 2003* (2004).

Notes: a/ The diversification index reflects the absolute deviation of the country share from world structure.

b/ The trade concentration index is normalized to obtain a numeric range of 0 to 1, whereby 1 represents maximum concentration.

Two dots (..) indicate that data are not available or are not separately reported.

ESCWA member countries differ significantly in terms of their diversification and concentration indexes. For example, Egypt, Jordan and Lebanon score high in the diversification and concentration ratios compared to Saudi Arabia. Moreover, countries of the GCC have lower numbers of exported commodities compared to non-GCC countries, which can be attributed to the dominance of oil.<sup>203</sup> However, over time, the countries in the second category have experienced positive developments compared to their counterparts in the third category. While countries in the first category have also experienced positive developments, these have been more modest than those in the second category.

<sup>203</sup> ESCWA, *Survey of Economic and Social Developments in the ESCWA Region, 2004* (E/ESCWA/EAD/2004/3).

## V. CONCLUSIONS AND RECOMMENDATIONS

### A. CONCLUSIONS

While significant progress has been made by ESCWA member countries in implementing the Monterrey Consensus, some countries have made greater strides than others. Bottlenecks continue to exist in crucial areas of their economies. Given the interrelated nature of the six actions of the Monterrey Consensus, a lack of efficiency in one sector can adversely affect other sectors.

In terms of mobilizing savings, ESCWA member countries have largely focused on privatizing public sector entities, reforming the bank sector and promoting capital markets. In particular, regional stock markets have enjoyed spectacular growth over the past few years. This ongoing trend can be attributed to a number of factors, including the following: (a) comparatively high global oil prices and revenues; (b) strong earnings and dividends of listed companies; (c) low regional interest rates; (d) declines in non-performing loans at banks; and (e) excess liquidity arising from worker remittances and repatriated Arab capital in the wake of the terrorist attacks of 11 September 2001 on the United States of America.

The Saudi Stock Market (SSM) remains the regional giant in terms of market capitalization; and Egypt had the highest number of listed companies, which reflects the diversified nature of its economy.

However, despite a recent flurry of activity by ESCWA members aimed at stimulating domestic capital markets, these continue to face a range of challenges, including as follows: (a) the modest size of capital markets relative to national economies; (b) low trading volumes; (c) inadequate financial disclosure by listed companies; (d) inadequate legal and institutional frameworks; (e) lengthy clearance and settlement delays; (f) a lack of investor protection; (g) systematic, albeit reduced, barriers to foreign and intraregional investors; and (h) limited links to global financial markets.

Bank reforms and capital market promotion have largely focused on adopting international accounting and disclosure standards; enhancing prudential regulations; combating money-laundering; enhancing the legal and regulatory framework; strengthening supervision and corporate governance; automating trading, settlement, clearing and money-transfer systems; and improving contestability and the entry of foreign financial institutions. The steady increase in international oil prices during the past three years has translated into a large increase in bank deposits and stock exchange capitalization and turnover. However, the performance of banking systems and capital markets in the ESCWA region still indicates little success in terms of repatriating Arab savings placed abroad. Wide and increasing spreads interest rates, in addition to comparatively high levels of non-performing loans, indicate the inefficiency of financial intermediation in a number of banking systems in ESCWA member countries. Furthermore, the capital market still plays a marginal role as a source of long-term finance and is highly vulnerable to the risk of price volatility, owing to the limited number of listed financial instruments and to the high concentration of trading activity. If current trends of rising oil prices and revenues do not translate into an increase of direct “real” investments that are supported by an efficient system for financial intermediation, then the excess liquidity will simply find its way to international financial markets without contributing to financing for development in the ESCWA region.

Many factors have contributed to low inflows of FDI into the ESCWA region, including ongoing regional conflicts, slow economic reforms, weak governmental institutions, administrative barriers, and underdeveloped infrastructure and financial sectors. In the past decade, ESCWA member countries have increased their efforts aimed at attracting FDI and at repatriating Arab capital invested outside the region. Repatriating even a portion of Arab capital can boost the financial resources available for economic development and poverty alleviation in the ESCWA region. Moreover, FDI provides recipient countries with funds for development, and exposes firms in developing countries to new technologies and improved managerial skills that raise productivity and competitiveness of domestic industries, cut production costs and, ultimately, help to develop a comparative advantage of local products in international markets.

Consequently, integration into world financial markets is crucial for attracting FDI. In the ESCWA region, regulatory and legislative reforms are necessary to attract international and intraregional investment.

These reforms must aim at modernizing existing investment laws and establishing autonomous investment promotion agencies.

In order to promote exports as an engine for growth, ESCWA member countries have moved steadily to adopt trade liberalization policies in line with the globalization and regional integration policies in other developing regions. These policies encompass a number of fronts, namely: regional integration; interregional bilateral agreements; and membership in WTO.

Several studies have analysed the causes for the weak trade integration among Arab countries, and have identified a number of reasons in the economic, political and institutional spheres, including as follows: (a) a high degree of similarity in the production and exports structure of Arab countries; (b) mismatch between exports and imports; (c) the dominating ideology of import substitution; (d) large size of public sector; (e) comparatively high tariff protection; (f) lack of adequate transport roads; and (g) vagueness of rules and regulations governing border trade.

Despite these negative factors, GAFTA was successfully revived in 2001, with a current membership of 17 out of the 22 member countries of LAS. GAFTA members eliminated intra-Arab tariffs effective January 2005.

Additionally, the six member countries of the GCC were successful at establishing the GCC Customs Union in January 2003 by setting a common external tariff of 5 per cent and by eliminating intra-GCC tariffs. However, liberalization of trade in services is more likely to yield positive effects on development in the ESCWA region than the liberalization of trade in goods.

The absence of adequate institutions is a main impediment to intraregional trade. The resulting challenges are concentrated in the following areas: abuse of technical barriers to trade and sanitary and phytosanitary measures; vague rules and regulations, particularly in terms of authenticating origin of goods and customs procedures. Moreover, a mechanism to solve trade disputes is essential for the success of GAFTA. The neglect of trade facilitation and lengthy customs and bureaucratic procedures by ESCWA members are the main culprits behind weak outcomes for regional trade liberalization, in addition to the absence of a clear vision of the aims of trade liberalization. Such issues have resulted in a significant lack of transparency and uncertainty in the business environment. ESCWA member countries need to make use of existing opportunities for trade reform and learn from past mistakes. There is a need to emulate the approach adopted in GAFTA, which is characterized by realistic timeframes, and the approaches adopted in both the GCC and Agadir, which are characterized by a smaller initial membership.

Furthermore, there is a continuing need for international cooperation aimed at developing the ESCWA region, particularly in the cases of Iraq and Palestine to assist reconstruction efforts; in Yemen, which represents the only least-developed country in the ESCWA region; and the debt-burdened ESCWA member countries. Financial and technical cooperation with the ESCWA members is facilitated through a diverse assortment of international organizations, regional institutions and individual countries in the form of loans, grants and technical expertise for both long- and short-term Arab development projects. However, international aid has traditionally been project-linked or politically motivated and needs to take better account of the development needs of the region. Globally, ODA was approximately \$50 billion in 2001, prior to the International Conference on Financing for Development. It is estimated that this amount needs to be doubled in order to meet the financing requirements of MDGs. Regional donors have been an important component of aid for ESCWA member countries. Over the period 1970-2002, the capital surplus of countries of the GCC, led by Saudi Arabia, Kuwait, and the United Arab Emirates, provided more than \$110 billion in international development aid. Saudi Arabia and Kuwait provided international development aid equivalent to 1.4 per cent and 1 per cent of their respective national incomes in 2002.

There is an ongoing debt crisis in the ESCWA region, particularly for the economies of Egypt, Iraq, Jordan, Lebanon, Syrian Arab Republic and Yemen. The need for financing in those countries is three-fold and can be summarized as follows: (a) there is a general underdeveloped physical infrastructure, including inadequate transportation systems, electricity grids, water and sanitation facilities; (b) there are chronic shortages of such social services as health care and primary education relative to the needs of the population,

which are further exacerbated by poverty and unemployment in the region; and (c) the private sectors in the ESCWA region, including banks, are underdeveloped and lack the resources necessary to finance large development projects, and the region receives a disproportionately small share of global FDI.

The debt crisis in the ESCWA region arises from the use of budget deficits to provide a minimum level of public services and to finance large development projects, given that Governments have limited tax revenues. Commitments by ESCWA member countries under multilateral and regional trade agreements place additional burdens on these Governments to replace lost tariff revenues through borrowing. Debt management requires both fiscal responsibility and access to sufficient Government revenues and private investment funds in order to finance social and economic development goals.

The successful mobilization of international financial resources is linked to stable, flexible and transparent domestic monetary and financial systems. Owing to advances in communications, transport technology, and the liberalization of trade and investment policies, economies have become interlinked and can more easily be pulled into financial crisis originating in other countries. Excessive volatility in the global financial markets can have a negative effect on flows of financial resources to developing countries. Consequently, a stable global economy can be enhanced through the adoption of international standards and the coordination of monetary, financial and trade policies, thereby providing better opportunities for developing countries in terms of obtaining financial resources for development. Recent improvements in coherence and consistency of fiscal, monetary and trade policies in the ESCWA region have occurred primarily in the Gulf sub-region, with other ESCWA member countries lagging behind in coherence and consistency of macroeconomic, trade and investment policies.

The six oil-exporting countries of the GCC have successfully formed the GCC Customs Union and continue to adopt new measures and procedures aimed at establishing a monetary union by 2005 and a single currency by 2007. The criteria for fiscal and monetary integration have been agreed upon, namely, budget deficits, ratio of public debt to GDP, inflation rates, interest rates and exchange rate pegs to the United States dollar. Work continues on the legal and institutional framework necessary to establish a central bank for the GCC. Moreover, countries of the GCC are negotiating a bilateral Euro-Mediterranean Partnership agreement as a bloc, rather than as individual countries, which provides the member countries with more bargaining power during negotiations with the larger EU.

## B. RECOMMENDATIONS

Governments in the ESCWA region must continue their efforts aimed at the following: (a) reforming their macroeconomic policies by, among others, adopting coherent fiscal and monetary policies that support the development of their financial markets; (b) reforming their tax systems by reducing tax evasion and by increasing the tax base through the introduction of new tax schemes, particularly direct progressive taxes that are more pro-poor compared to consumption taxes; (c) eliminating Government waste in spending by making better use of domestic resources available for financing for development; (d) reforming their banking regulations and the supervision of financial markets, thereby meeting international standards; (e) implementing Basel standards in order to ensure competitiveness and security of the banking sectors in an increasingly globalized economy; and (f) privatizing State-owned banks through regional stock markets, thereby supporting their growth and development.

Moreover, members of WTO are encouraged to implement their commitments under GATS by liberalizing their financial services sectors. The goal of financial and macroeconomic policy reforms is to create a business climate that promotes development of the whole financial sector, encompassing banks, capital markets, insurance markets and bond markets. Increasing the availability and diversity of financial instruments for local entrepreneurs and savers improves domestic financial resources. A healthy banking sector is essential for the purposes of providing financial services that support other sectors of the economy and that promote economic growth and development. Equally, it is important to issue laws that secure the rights of savers and investors, thereby creating trust.

The private sector has an important role to play in developing the financial markets of the ESCWA region. Private companies must adopt good corporate governance as a requirement of doing business. Within

that context, good corporate governance implies transparency, full financial disclosure, better access to financial records through Internet sites for investors, and adoption of international accounting standards. Institutional investors are advised to give priority to investment opportunities within the region, rather than sending large amounts of regional savings outside the Arab region.

The high prevalence of family-owned enterprises in the Arab region and their traditional aversion to equity financing limit the investment opportunities for regional capital. Consequently, family-owned enterprises need to learn about equity financing and begin offering shares on regional stock markets, thereby reducing their traditional dependence on bank financing and family assets. Equally, Arab investors, particularly those in the capital surplus oil-exporting countries, are called upon to consider the repatriation of their capital from markets outside the region whenever viable investment opportunities arise within the region. This Arab capital abroad represents a significant amount of lost financing for development for the region, and regional investors are the best informed with regard to local conditions and viable domestic projects. Furthermore, fully-functioning capital markets can open opportunities for female investors and entrepreneurs, particularly female-owned SMEs, which often lack the necessary resources or face cultural barriers that prevent them from obtaining traditional financing from banks.

Significant debt relief and increases in ODA to the ESCWA region are needed to help fill the financial gap if MDGs relating to poverty alleviation are to be met by 2015. While each developing country needs to identify its own development strategy that fosters economic and social growth, such efforts cannot succeed without an enabling environment from the international community. Within that context, developed countries must play a pivotal role in providing financial and technical resources; and developing countries need to adopt proactive policies aimed at engaging the international community on those development goals.

ESCWA member countries outside the Gulf sub-region need to look at the example provided by the GCC in terms of the established GCC Customs Union and ongoing efforts aimed at forming a common market and monetary union. This high-level cooperation was achieved by synchronizing macroeconomic policies that influence investment and economic development. Financial resources for development, both domestic and foreign, favour regions of the world that possess the competitive advantage of good governance and that are consistent with internationally recognized business practices.

Specific recommendations for ESCWA members aimed at meeting their obligations under the six activities of the Monterrey Consensus on Financing for Development are summarized below.

#### *1. Mobilizing domestic financial resources for development*

ESCWA member countries need to accelerate the rate of reforms in their banking sectors and capital markets. Moreover, the privatization of State-owned assets can be accelerated, particularly in the banking sector. Standardized financial terminology, rules and regulations within domestic agencies and across countries improve regional financial markets. Governments are advised to introduce deposit insurance schemes in order to encourage domestic savers and to raise the regional savings rate. Additionally, Governments are encouraged to promote an internationally competitive insurance industry by opening their markets to foreign suppliers of insurance. Governments can promote development by encouraging the private financial sector to adopt IT, management information systems and e-commerce through incentives schemes. Private sector companies, particularly family-owned enterprises, can be encouraged to make better use of equity financing through Government-sponsored training programmes and media campaigns.

The salient recommendations for promoting savings mobilization and financial reform in the ESCWA region include the following:

- (a) To reform tax systems aimed at increasing the weight of income tax relative to consumption taxes, enhancing collection efficiency and ensuring an equitable tax system;
- (b) To strengthen social insurance systems by improving the management of their resources and by ensuring the transparency of Government use of those funds;

- (c) To encourage the development of a competitive and sound insurance industry that can provide life insurance, annuity products and various forms of property insurance;
- (d) To enhance further the disclosure, auditing, corporate governance and supervision of the financial sector;
- (e) To strengthen the capital base and provisions of banks, and stipulate a minimum loan loss coverage ratio at 70 per cent;
- (f) To enhance bank consolidation by enforcing compulsory mergers of ailing banks and by introducing suitable incentives to encourage voluntary mergers;
- (g) To introduce and/or enhance bankruptcy and arbitration systems aimed at establishing market exit rules for ailing companies, including banks;
- (h) To enhance in-house risk management systems and expertise;
- (i) To enhance further the IT and management information systems of banks;
- (j) To establish credit bureaux and information centres for SMEs;
- (k) To promote non-bank financial institutions, particularly in the field of asset management, investment funds, leasing and venture capital;
- (l) To establish rating companies as a prerequisite for the expansion of corporate bond issues;
- (m) To encourage the establishment of joint stock public companies and the introduction of suitable incentives and regulatory frameworks aimed at promoting the transfer of closed listed companies into the public domain;
- (n) To introduce tradable Government debt instruments and to transfer part of the outstanding Government bonds into listed and tradeable securities;
- (o) To introduce market making functions in order to ensure prompt interventions in cases of severe price fluctuations;
- (p) To expand loans securitization and to introduce asset-backed securities;
- (q) To design the acquisition process of listed companies in a way that stipulates a minimum stake of 30 per cent in total shares to be free and available for trading.

## *2. Mobilizing international resources for development: FDI*

Governments are advised to draft new laws and regulations and revise existing laws aimed at promoting an investor-friendly environment. Specifically, these laws must achieve the following: (a) protect private and intellectual property rights; (b) support efficiency and competitiveness of both foreign and domestic firms; (c) encourage the liberalization of trade and capital markets; (d) eliminate double taxation; and (e) incorporate measures that facilitate the repatriation of profits and capital.

Regional capital markets can be opened to foreign investors, particularly venture capitalists, and can be linked by electronic and cross-border transactions. Efforts aimed at repatriating Arab capital invested in Europe and North America are advised, such as requiring legislation that safeguards the rights of investors and that promotes good corporate governance from regional firms, including the adoption of international accounting standards and full-disclosure. FDI is not a substitute for domestic investment; rather, strategies that promote FDI equally support domestic investors. Furthermore, exchange rate and interest rate policies need to complement rather than conflict with policies aimed at attracting investment.

### *3. International trade as an engine for development*

Governments are encouraged to lobby for common positions in WTO, which can be undertaken by joining existing lobbies or by forming coalitions with countries sharing common interests. Regional stakeholders can work together to identify and eliminate non-tariff barriers that reduce gains from trade liberalization policies. ESCWA members are advised to deepen regional integration, particularly in services trade, which can facilitate the migration of intra-Arab labour in the services sectors. Governments are advised not to backslide on their obligations under their existing regional and international trade agreements; and are encouraged to adopt a clear vision of the development goals expected from trade liberalization in order to support their trading agreements with the necessary institutions and measures.

Recommendations for promoting international trade in the ESCWA region include the following:

(a) To adopt a consistent trade policy that is pro development, and to maintain a clear vision of the aims of trade liberalization by achieving development through adequate institutions, sound trade facilitation measures and available finance for exports;

(b) To lobby for and emphasize issues relating to development and to financing for development under the auspices of WTO, particularly given that liberalization of trade helps to enhance growth only if developmental aspects are taken in consideration;

(c) To lobby for common positions in WTO in order to strengthen negotiating power, particularly on issues related to WTO rules where national interests are likely to be common, in contrast to sectoral issues where these interests can differ;

(d) To initiate capacity-building programmes with ESCWA aimed at formulating and fostering “behind the border” policies that support trade liberalization policies;

(e) To make use of various RTAs, particularly when these can anchor trade reforms by using the financial and technical assistance from partners in developed countries; while ensuring that “conditionalities” are pro-development;

(f) To pay more attention to standards and rules that govern trade, particularly within the context of GAFTA and the GCC;

(g) To set up adequate institutions that govern trade relations, thereby establishing effective dispute settlement mechanisms, and ensuring transparency and effectiveness of trade agreements;

(h) To deepen south-south RTAs, including GAFTA and the GCC, by incorporating such elements as migration of labour and liberalization of trade in services;

(i) To undertake the necessary measures aimed at sustaining trade reforms by enhancing transparency and raising public awareness of those reforms.

### *4. Increasing international financial and technical cooperation for development*

In order to meet the MDGs by the target date of 2015, the signatory countries of the Monterrey Consensus, in addition to the private sector, NGOs, and international and regional institutions, need to remain actively engaged in the follow-up and implementation of this agreement. ESCWA member countries are encouraged to continue to petition developed countries to honour their ODA commitments under the Monterrey Consensus. If donor countries honour their commitments by providing 0.7 per cent of their national incomes, rather than the current 0.25 per cent, financing for development will increase significantly. Furthermore, Governments in the ESCWA region are encouraged to adopt policies that facilitate the use of worker remittances as a source of financing for development, rather than limiting remittances to consumptive uses.

### *5. External debt relief and debt management*

International and regional donors are encouraged to increase debt relief and debt forgiveness for debt-burdened ESCWA member countries, particularly those suffering negative economic impacts from regional conflicts. Moreover, countries that increase the transparency of medium- to long-term debt management strategies reduce risk to investors, thereby encouraging private investors to hold public debt and relieving pressure on the Arab banking sector, which holds unreasonably large shares of the public debt.

Consequently, ESCWA member countries are advised to exert more efforts aimed at reforming their fiscal systems to better match revenues with expenditures; and to continue their efforts to privatize inefficient State-owned enterprises, thereby reducing the burden on Government revenues and using the proceeds to pay down the debt principle. Furthermore, Government officials can improve their technical capabilities for collecting and analysing debt statistics, which supports policymakers in sustainable debt management.

### *6. Enhancing the coherence and consistency of the international monetary, financial and trading systems*

ESCWA member countries need to ensure the efficient use of financing for development by coordinating development efforts between ministries and by eliminating duplication. Additionally, there is a strong need for coherent macroeconomic policies aimed at supporting overall development goals. Governments can institute tax reforms that raise collection efficiency and broaden the tax base. Furthermore, Governments are encouraged to promote open monetary, fiscal and trading systems that are rule-based, predictable and non-discriminatory.