ARAB ECONOMIC JOURNAL

Published by the Arab Society for Economic Research

No. 39, Summer 2007

Editor-In-Chief

Mohammed Samir Moustafa

Editorial Advisory Board

Ibrahim Hassan El-Issawy
Ismail Siraj El-Din
El-Shazli Al-Ayari
Galal A. Amin
Goud Abd-El Chalek
Kheir El-Din Hasseeb
Samir Al-Makdisi
Samir Amin
Taher Kanaan
Abbas Al-Nasrawi
Abdel Razak Al-Fares
Abdallah Al-Kowaz
Abdallah Al-Nibary
Ali K. Kawary
Ali Atiqah
Fadel Al-Galabi
Fathallah Walaalo
Karima Korayem
Maged Al Maneef
Mohammed El-Imam
Mohayya Zeitoun
Moatasim Soliman
Nabil Hashad
Yusuf Al Abrahim

And members of the board of directors

All Correspondence to be addressed to

Arab Society for Economic Research

17 Emarat Al-Uboor, Salah Salem St.
Nasr City P.O. Box: 88 Panorama October
Postal Code: 11811, Cairo - Egypt
Tel: 2621737 - Telefax: 2631715
E-mail: asferegypt@yahoo.com

Centre for Arab Unity Studies

«Beit Al-Nahda» Bldg. - Basra Street - P.O. Box: 113-6001
Hamra - Beirut 2034 2407 - Lebanon
Tel: (+9611) 750084 - 750085 - 750086 - 750087 - Cable: «MARARABI» - Beirut
Fax: (+9611) 750088
E-mail: info@caus.org.lb
Website: http://www.caus.org.lb

Financial Governance and Crisis,
Arab Financial Markets and the Basel II Accord

Simon Neaime

Associate Professor and Chairperson,
Department of Economics, American University of Beirut.

1. Introduction and Related Literature

It is well known that the 1997 East Asia financial crisis led to severe declines in the currencies, stock markets, and other asset prices of many Asian countries, threatening these countries' financial systems. In addition to its severe consequences on East Asian financial markets, the crisis spilled over into other emerging markets, contributing to fast declines in their stock markets, and GDP growth rates. According to Stiglitz and Furman(1) one of the reasons the crisis escalated so drastically, stems from weaknesses in the Asian financial systems, as well as the speed of short term capital outflows. A combination of poor financial governance, and the maintenance of pegged exchange rate regimes, induced financial institutions and commercial banks to borrow large amounts of short-term unhedged international capital. In addition, the crisis was accentuated by lack of transparency in corporate and fiscal accounting(2).

While the finance literature is rich in studies dealing with the East Asian financial crisis, the literature on the Arab region is still very limited and sketchy(3). The Arab financial sector appears to have the same characteristics and weaknesses as those observed in East Asia. It is therefore imperative to present an in-depth analysis of Arab financial markets' latest financial developments, especially after the introduction of the new Basel II Accord, with the objective to identify major trends and weaknesses and present policy makers with policy recommendations to avert a similar financial crisis in the Arab region. While many emerging markets suffered backlashes from South East Asia, Arab countries were among the few where the repercussions were minimal(4).

The Asian crisis occurred despite several decades of outstanding growth performance. Similar recent GDP growth rate performances have been observed in the Arab region, owing mainly to record increases in oil prices and revenues, despite

(1) J. E. Stiglitz and J. Furman, «Economic Crises: Evidence and Insights from East Asia,» *Brookings Papers on Economic Activity*, no. 2 (1998), pp. 1-114.

(2) M. Brownbridge and C. Kirkpatrick, «Financial Sector Regulation: The Lessons of the Asian Crisis,» *Development Policy Review*, vol. 17, no. 3 (1999), pp. 243-266; M. C. Chiuri, G. Ferri and G. Majnoni, «The Macroeconomic Impact of Bank Capital Requirements in Emerging Economies: Past Evidence to Assess the Future,» *Journal of Banking and Finance,* vol. 26, no. 5 (2002), pp. 881-904, and S. Kaji, «What Can Countries Do to Avoid a Financial Crisis?,» *World Economy*, vol. 24, no. 4 (2001), pp. 567-589.

(3) Simon Neaime: «Portfolio Diversification and Correlations in Returns and Volatilities in Emerging MENA Stock Markets,» *Thunderbird International Business Review*, vol. 48, no. 4 (2006), pp. 455-484, and «Portfolio Management and Financial Market Integration of Emerging MENA Stock Markets,» in: Sima Motamen-Samadian, ed., *Global Stock Markets and Portfolio Management*, Centre for the Study of Emerging Countries Series (New York: Palgrave Macmillan, 2006), pp. 37-54.

(4) Simon Neaime and S. Hakim: «Price Linkages and Integration of MENA Stock Markets,» *International Review of Comparative Public Policy*, vol. 13 (2002), pp. 63-86, and «Mean-Reversion Across MENA Stock Markets: Implications for Derivative Pricing,» *International Journal of Business*, vol. 8, no. 3 (September 2003), pp. 348-358.

the unstable macroeconomic environment, and the recent political and military turmoil that continue to plague the region. However, a deteriorating macroeconomic performance and outlook, coupled with political tensions, and the on-going Israeli-Palestinian conflict, have all been contributing factors affecting negatively the region's growth performance during the 1980's and early 1990's. In spite of the deteriorating macroeconomic outlook, significant increases in oil prices, and strong world demand for oil, coupled with spectacular increases in stock market capitalization, constituted contributing factors to the recent improvement in the GDP growth rates of the Arab economies in general.

Financial market liberalization is not always accompanied by better growth performances. For example, countries like Kuwait and Bahrain succeeded in achieving high growth rates while maintaining, until relatively recently, substantial government controls on their financial systems. Other Arab countries like Egypt and Jordan for example, achieved higher growth rates with significantly liberalized financial systems.

Financial market developments in the Arab region did not always translate into economic growth, and the development of appropriate frameworks to regulate financial markets has lagged behind government policies promoting domestic and external liberalization, especially in Jordan, Lebanon, and Egypt. This lag - which adds to an economy's «systemic risk» - can make some Arab economies very vulnerable to external financial shocks, such as large inflows of capital, fluctuations in oil prices and revenues, foreign interest and exchange rates, and international foreign reserves, precluding their ability to sustain growth, as has been demonstrated by the recent East Asian crisis. Thus, quantifying the Arab economies' underlying systemic risks is particularly important to avert a similar financial crisis from occurring.

After an overview of the recent banking and stock market developments, this study examines the potential impact of the Basel II Accord on the Arab financial markets. This examination, it is hoped, will contribute to a better understanding of the functioning of Arab financial markets. This study contributes to the limited existing finance literature on the Arab region, by tackling, and perhaps for the first time, the issue of the implications of Basel II on the region's banking system. It will also present policy makers in the Arab region with the essential policy recommendation to better cope with Basel II, and its implications on Arab commercial banking systems.

This paper also studies the dynamic transmission of external and internal financial shocks within the economies of the Arab region. It constitutes the first attempt at examining the impact of financial linkages and fluctuations in the Arab region. After the financial crisis in East Asia and its damaging impact on other emerging markets worldwide, it is of paramount importance to study the financial linkages in the Arab region, with as objective to explore, assess, and identify the financial weaknesses that might have a negative impact on the region. Once these

shocks are identified, policy makers can formulate appropriate financial strategies to better cope with various financial shocks, dampening at the same time their propagation and impacts within the region.

The rest of the paper is divided as follows. The next section takes a close look at the latest banking developments in the Arab region. The Basel II Accord and its implications on Arab banking systems are highlighted in Section 3. Section 4 studies Arab stock markets and their recent trends. Section 5 analyses systemic risks and financial governance, and evaluates the risks of a financial crisis. It also includes recommendations for the development of the regulatory framework of the respective Arab financial market. The last section concludes the paper with some policy implications.

2. Measures of Arab Banking Developments: 1994-2005

Financial markets in the emerging Arab economies are in general dominated by the banking system. Arab stock markets are in most cases new or being developed to serve as a channel to capital from savings to investments. It is therefore imperative to consider first the major developments in the banking systems of Arab countries, and analyze whether they have been able to channel capital to productive investments. Table 1 presents measures of banking developments for the period 1994-2005. These include first a measure of financial depth (MFD), proxied by the banking system's liquid liabilities to GDP. As financial services increase, so will financial depth, and hence economic growth. King and Levine(5) introduce another measure of the importance of specific financial institutions. This variable (DM) is constructed as the ratio of deposit money bank deposits relative to the sum of deposit money bank deposits and central bank deposits. The larger is the DM variable, the better will be the financial transparency, and the provision of financial services. A third variable which is used in the finance literature is CNF, proxied by the ratio of claims on the non-financial private sector relative to total domestic credit. A similar measure is NFP, proxied by the ratio of total claims on the non-financial private sector relative to GDP. The larger CNF and NFP are, the more likely the financial system is to provide certain services, such as financial market transparency.

The Arab countries' banking system is relatively large and account on average for about 70 percent of the stock market capitalization in these countries. The largest bank share in stock market capitalization belongs to Oman followed by Jordan. However, the levels of banking developments in the Arab region are significantly lower than averages in East Asia and some developing economies, and somehow close to averages pertaining to Latin America. It is clear from Table 1 column 5, that Lebanon has the highest average level of banking developments followed by

(5) Robert G. King and Ross Levine, «Finance and Growth: Schumpeter Might Be Right,» *Quarterly Journal of Economics*, vol. 108, no. 3 (August 1993), pp. 717-737.

Jordan, Kuwait, Qatar and Bahrain respectively. Although the Arab banking system plays an important and major role in channeling funds to various sectors of the economy, it is still not providing the kind of services and transparency that are needed to further sustain growth. The Arab banking system still needs to introduce better financial governance to better stimulate investment. Informational efficiency is still relatively weak in the Arab region. Also, informational efficiencies of credit markets in the Arab region is much lower than averages in Latin America and East Asia. This factor is also hindering the expansion of credit markets in the region, and financial capital is not channeled to the most productive investment.

Table (1)
Measures of Arab Banking Developments: 1994-2005

	(1) MFD	(2) DM	(3) CNF	(4) NFP	AVERAGE (1 to 4)
Kuwait	0.39	0.492	0.998	0.351	0.55
Saudi Arabia	0.252	0.136	0.297	0.271	0.23
Bahrain	0.326	0.436	0.491	0.575	0.45
Oman	0.152	0.389	0.313	0.312	0.29
Qatar	0.356	0.462	0.985	0.396	0.54
Egypt	0.392	0.486	0.336	0.412	0.40
Jordan	0.389	0.461	0.862	0.663	0.59
Lebanon	0.412	0.52	0.963	0.655	0.63
Average ARAB	0.33	0.42	0.65	0.45	0.46
Latin America	0.279	0.623	0.719	0.252	0.468
East Asia	0.551	0.805	0.955	0.562	0.714
Developed Countries					
Canada	0.503	0.958	0.878	0.511	0.718
United States	0.634	0.908	0.827	0.665	0.759
Average	0.568	0.933	0.848	0.587	0.734

Source: Author's Estimates.

3. Basel II: Implications on Arab Commercial Banks

Introduced in January 2001, the Basel II Capital Accord has set a new Capital Adequacy Framework to replace the existing 1988 Basel Accord. The latter Accord established minimum levels of capital and helped strengthen the stability of the banking system worldwide. Under its old existing framework, the Basel Accord imposes on banks in industrialized countries maintaining a certain level of capital equal to at least 8 percent of a basket of assets[6].

(6) G. Ferri, L.-G. Liu and G. Majnoni, «The Role of Rating Agency Assessments in Less Developed Countries: Impact of the Proposed Basel Guidelines,» *Journal of Banking and Finance*, vol. 25, no. 1 (2001), pp. 115-148.

There are three pillars to the New Basel Capital Accords: (1) Minimum Capital Requirements; (2) Supervisory Review Process; and (3) Market Discipline (Disclosure Rules). The goal of the Basel II accords is to give banks a new risk sensitive framework to measure credit and operational risk designed to better address the financial innovations that have been introduced in recent years. Member countries are expected to implement the new accord by the end of 2007.

3.1 Historical Overview

The Basel I Accord was based on the concept of a capital ratio where the numerator represents the amount of capital a bank has available, and the denominator is a measure of the risks faced by the bank and is referred to as risk-weighted assets. This resulting capital ratio must be no lower than 8 percent. Capital ratios of internally active banks have increased substantially since the implementation of the Basel I Accord, reinforcing the soundness of the international banking system. The common adoption of the accord in many countries had also led to enhancing competition in their banking sectors. However, with the evolution of the financial system, coupled with the fact that global banking has witnessed a dramatic expansion in the array of financial services and products available to investors, in particular, the growth of derivative instruments, a bank's capital ratio may not always be a good indicator of its level of risk and soundness. The 1988 Basel I Accord provided a major step forward in capital regulation, however its simplicity is regarded as inadequate to deal with the risks that many large and complex financial institutions face nowadays.

The Basel II was introduced to reflect improved risk measurement and management techniques. It streamlines the minimum capital held against credit risk, and assigns capital against operational risk for the first time, mitigating even further the credit and operational banking risks.

3.2 Objectives and Targets of the New Basel Accord

One main objective of the new Basel Accord is to promote the banking systems' safety and soundness, and reduce as much as possible the risk of bank defaults and potential bankruptcies. Capital regulation must be developed to include not only minimum capital requirements, but also foster bank risk management. This is to be achieved by closely aligning banks' capital requirements with prevailing modern risk management techniques. The Accord also ensures that at least the current overall level of capital in the banking system is maintained, and enhanced risk management polices are being adhered to. While the focus should be on internationally active banks, the overall principles should be suitable for application to banks in developing and emerging economies.

3.3 Implications on the Arab Banking System

In the United States (US), a small number of banks are expected to adhere

with the Basel II requirements in 2007, and most banks will continue operating under Basel I. Arab commercial banks are in need of a transition period to become ready to adhere to the New Capital Accord. They will have to review their risk management practices, and upgrade their Information Technology systems. However, by adhering to the Basel II accord, Arab banks may experience better coordination between minimum capital requirements and the profit margins, and better internal asset management practices.

A major source of concern for the Arab region's banking systems remains in the fact that changes to the existing Basel I accord were put forward by large banks from industrialised countries. In addition, these key alterations and standards proposed in the new framework may not apply, and may even clash with Arab banking procedures and methodologies already in place. Another concern stems from the fact that the adoption of the New Accord may change the lending pattern of major Arab commercial banks, leading to a reduction in loans, with devastating consequences on investment and the rate of growth of GDP.

Even the Bank for International Settlements (BIS) has recognized major shortcomings in the new Accord. In particular, during booms, ratings may improve encouraging banks to lend more, whereas, during busts, ratings may be lower, potentially leading to a sharp withdrawal in funds or even a credit crunch[(7)]. This amplifying effect will be especially difficult to adjust to in Arab countries increasing their vulnerability to currency crises.

Another concerns advanced by Arab bank managers remains in whether banks in the region can handle the level of regulatory complexity put forth in the Basel II Accord. Implementing the new accord requires Arab banks to provide bank managers with additional information, incurring additional high costs for gathering financial information. Whether these high informational costs would outweigh the expected benefits from them is yet to be seen. That is why Arab bank managers believe that these requirements appear more appropriate for highly sophisticated financial markets in the more developed economies. The Arab banking system still suffers from the absence of reliable data, since banks have only recently started to build their databases, making them less able to meet the strict requirements of the new Basel Accord. Industry observers also claim that regulators in Arab countries neither have the skills nor the knowledge to implement and enforce the new proposals. Therefore, banks operating in the Arab region, whether small or large, will find it much more difficult to implement the new Basel requirements then their counterparts operating in the more developed economies.

(7) «Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework,» (Document, Bank for International Settlements, 2004).

4. Recent Arab Stock Market Developments and Trends: 1994-2005

Equity markets in the Arab region have played a secondary role in terms of channeling financial capital from savers to investors. A fairly developed commercial banking system has taken the lead in redirecting capital to productive investments. With the possible exception of Kuwait and Jordan (Amman), Arab equity markets have only developed and matured during the mid 1990s. Despite their small market capitalization, during the past five years, the Arab equity markets have exhibited performance characteristics parallel to other emerging markets in similar stages of development. Rising oil prices and revenues have all been contributing factors.

In Table 2, we include three quantitative measures of stock market development: the number of companies listed on domestic stock markets, stock market capitalization, and the number of shares traded. In general, a fairly developed stock market contributes positively to economic development.

Stock markets have two general functions. First, they allow corporations to raise funds externally to finance new investments projects. The second major function of stock markets is their liquidity. The number of traded shares is used as indicator of liquidity in the stock market. It is shown that as liquidity increases, the cost of entering and exiting the stock market (transaction costs) falls, thus stimulating further investments. Stock market capitalization is also used to capture these effects. The number of companies listed provides a measure of the number of firms that have met the standards of the market in terms of recertification and evaluation of investment projects and financial managers.

Table (2)
Measures of Arab Stock Market Developments: 1994-2005

	Date of Operation	Number of Companies Listed 1994	Number of Companies Listed 2005	Stock Market Capitalization (US $ Billion) 1994	Stock Market Capitalization (US $ Billion) 2005	Growth 1994-05 (%)	Shares Traded (Million of shares) 1994	Shares Traded (Million of shares) 2005
Egypt	1950	700	1230	4.25	45.31	966	27.27	1002
Kuwait	1952	48	99	10.96	44.12	302	2519.16	55698
Saudi Arabia	1935	62	74	38.69	90.23	133	152.10	1956
Bahrain	1957	34	49	5.12	8.63	68	257.10	456
Oman	1989	68	154	1.856	6.15	231	42.10	211
Jordan	1978	95	163	4.62	8.16	76	133.82	563
Qatar	1996	-	33	-	12.47	-	-	95
Lebanon	1920	-	14	2.39*	2.19	-1.2	0.84*	35

Source: Author's Estimates.

Notes: *: 1994.

1- Number of companies listed: Year-end totals, excluding listed investment funds where possible.

2- Stock market capitalization: Year-end total value traded of listed domestic company shares.

3- Volume traded: Year-end total market values of listed domestic companies.

Table 2 indicates that Arab capital markets are showing positive performances in recent years particularly in terms of growth, liquidity and transparency. More investment is being attracted to the region, and these markets are heading towards more openness. However, much more can still be done to reach full liberalization especially in the oil producing Arab countries. Among the GCC countries, only Bahrain's financial market is fully accessible by foreigners; others allow non-residents to own shares only through mutual funds. The more diversified Arab economies do not have any restrictions regarding the access of foreign investors.

Egypt experienced a considerable growth improvement of 966 percent in market capitalization in between 1994-2005, with the number of listed companies increasing by 75 percent and the number of traded shares reaching 1002 millions. This can be explained by the introduction of Egypt's economic policy reforms, the market's responsiveness to the government's accelerated privatization program, the increasing interest of foreign institutions in the Egyptian market, and the enhanced performance of Egyptian companies reflected in increased profits.

The number of listed companies on the Kuwait's stock exchange reached 99 in 2005, nearly double the number of listed companies in 1994. Market capitalization improved from US $ 10.96 in 1994, to 44.12 billions in 2005, reflecting a 302 percent growth rate and the number of traded shares showed a significant increase from 2519 in 1994, to 55669 millions in 2005. The Kuwaiti market is fully open to all GCC nationals, however; restrictions on foreigners are still relatively high. Saudi Arabia's stock market activity managed to record a growth of 133 percent between 1994 and 2005, with the number of traded shares rising to 1956 millions in 2005. While market capitalization marked a noticeable enhancement, the number of listed companies hardly increased from a mere 62 companies in 1994, to 74 companies in 2005. Bahrain's capital market performance is improving; nevertheless, it is still not yet developed. Market capitalization witnessed a growth of 68 percent during the period under study and the number of traded shares increased by 199 millions. The number of listed companies on the Omani stock exchange rose from 68 in 1994, to 154 in 2005. Market capitalization jumped from US $ 1.8 in 1994, to 6.5 billions in 2005, recording a 231 percent growth rate, and the number of traded shares more than doubled, attaining 211 millions in 2005. The Jordanian market performance is similar to the Bahraini stock market. After expanding by 76 percent relative to 1994, market capitalization stood at US $ 8.16 billions in 2005. The number of listed companies increased by 72 percent, and traded shares jumped from 133.82 millions in 1994, to 563 millions in 2005. Despite the fact that Qatar's stock exchange was established in 1996, its market capitalization managed to reach in 2005 a value of US $ 12.47 billions, with 33 listed companies and 95 millions of traded

shares in 2005. Lebanon is however the only Arab country that witnessed negative growth in market capitalization between 1994 and 2005. Stock market performance is expected to remain unchanged in the coming few years due to the recent political turmoil. Market activity can be a source of investment attraction to the country especially that markets are fully accessible by foreigners and foreign companies are allowed to be listed on the stock exchange if they abide by some specific rules and regulations.

Most Arab financial markets are still partially or fully not accessible to foreign investors. The ease with which capital flew into South East Asia is absent in the Arab region. This might not be a negative factor after all, as some financial researchers have argued. The limited share of foreign participation has been a boon for the Arab stock markets during the crisis of South East Asia in October 1997. The small reliance on foreign capital helped insulate Arab markets from the severe repercussions felt in other emerging markets more dependent on foreign capital.

Many analysts believe that the rapid and substantial growth in East Asia was due to the fast liberalisation of these financial markets, a factor which contributed to the fast transmission of the crisis from one company to another, and from one financial system to another. Although growth rates in the Arab region appear to be much lower than their emerging markets counter-parts. This has contributed to their isolation from foreign financial shocks. While financial liberalisation might be important for sustained growth, fast liberalisation however might become destructive to growth. However, regional stock market integration is essential for attracting foreign capital and stimulating growth in the Arab region.

The opening of emerging markets may induce the participation of foreign investors whose entry makes markets more competitive and reduce the noise associated with the transmission of information about company earnings and market fundamentals. At the same time, increased foreign participation may increase the volume of traded shares and the number of listed companies. All these factors will enhance market liquidity and help reduce, not raise, market volatility.

5. Systemic Risks and Financial Crisis

This section discusses the impact of qualitative factors in some Arab economies, especially relating to the financial sector, on financial market development. Taking into account both quantitative and qualitative factors offers a better understanding of the process and sustainability of financial market development and financial governance.

Table 3 lists 15 variables summarizing the economic and financial features of the Arab economies over the period 1994-2005. The rankings in the table are relative to averages observed in East Asia. The Table provides also indices relating to the transparency of the financial sector, the efficiency of available information, and the accounting system used and developed in each respective country. Arab countries are devoting genuine efforts to develop their accounting systems for better transparency and information disclosure. Egypt has the highest level of development in its accounting system followed by Kuwait and Bahrain. Saudi Arabia and Jordan still need to further develop their accounting systems by introducing new accounting measures. The qualitative measures of the speed of financial liberalization of the domestic financial and of the external sectors - the current and capital accounts, are also presented. With the exception of Egypt, most Arab countries in our sample have yet to liberalize their capital account to attain higher growth rates in the future. Also, and with the exclusion of oil exports, most Arab countries have import-oriented economies, due to their low export levels relative to East Asia. Measures of how actively each government pursues industrial policies, of the closeness of the government and the private sector, and also of the relationship between banks and private corporations are also included. Table 3 indicates that there is still a lot to be done to dissociate the close ties that still exists between most Arab governments and their respective private sectors.

Domestic deposit growth is important for understanding the vulnerability of the financial sector to outflows of short-term capital, one of the major reasons behind the East Asian financial crisis. This qualitative variable refer to the period 1994-2005. The variable is a good indicator of the shortfall of domestic savings in stimulating growth. For all the Arab economies net external liabilities of the financial sector is indicated as medium or low. This is due to high restrictions on capital flows to the region. This contrasts with the economies of East Asia, where the net external liabilities of the financial sector were medium or high. The relaxation of restrictions on capital flows in most of these economies was among the factors contributing to the large and rising capital outflows during the East Asian financial crisis. Those countries with relatively fixed exchange rates and large capital inflows also experienced significant credit expansion during the crisis. With the exception of Egypt (having a managed float), all exchange rate systems in the Arab region are either fixed to the dollar or to a basket of currencies. This would constitute a problem if the capital account was liberalized at a fast pace. If that was the case, then short-term capital would flow in and out very swiftly, causing currency depreciations, a disruption of the financial system, and a loss of foreign currency reserves.

Inadequate accounting procedure in East Asia led to poor credit analysis and

investments in real estate and equity markets produced asset inflation in those markets. This is not the case for Arab countries.

Table (3)
Summary of Country Profiles of Arab Countries: 1994-2005

Item/Country	Egypt	Kuwait	Saudi Arabia	Bahrain	Jordan
Exchange Rate Regime	Managed Float	Pegged to a basket of currencies	Pegged to the dollar	Pegged to the dollar	Pegged to a basket of currencies
Openness relative to East Asia	Low	Low	Low	Low	Low
Trade orientation	Import oriented	Import oriented	Import oriented	Import oriented	Import oriented
Degree of capital account liberalization	High	Low	Low	Low	Medium
Degree of domestic financial market liberalization	High	Low	Low	Low	Low
Level of bank share in financial sector	Low	Medium	Medium	Low	High
Market concentration in banking	Low	Medium	High	Low	High
Rate of domestic deposit growth (1994-2005)	High	Low	Medium	Low	Medium
Net external liabilities of financial sector	Medium	Low	Low	Low	Low
Level of government-directed lending	Medium	High	High	High	Medium
Closeness of government-business relationship	Medium	High	High	High	High
Closeness of bank-private corporation relationship	Medium	High	High	High	Medium
Level of financial sector's transparency	Medium	Low	Low	Low	Medium
Adequacy of financial sector's disclosure rules	Medium	Low	Low	Low	Medium
Level of development of accounting system	High	Medium	Low	Medium	Low

Source: Author's Estimates.

6. Conclusions and Policy Implications

This study highlighted the main financial trends in both the banking systems and stock markets of some selected Arab countries. It has also highlighted the New Basel II Accord and its implications on Arab banking systems. It was shown that although the Arab banking system plays an important and major role in

channeling funds to various sectors of the respective economies, it is still not providing the kind of financial services that are needed to further sustain growth and development in the region. The Arab banking system still needs to introduce new financial products such as derivative securities to better develop its credit markets. Risk management and information processing is still relatively poor in the region. Also, informational efficiencies of credit markets in the Arab region are much lower than averages in East Asia. This factor is also hindering the expansion of credit markets in the region. The banking system is also suffering from the lack of proper evaluation of investment projects and bank managers. In most instances, funds are not channeled to the most productive projects, and the costs of financing these projects are often higher than those present in more developed economies.

This study has shown that a lot of preparation is warranted on behalf of Arab banks before they can fully enjoy the benefits of the New Base II Accord. Banks will have to review their current credit management polices and upgrade their Information Technology systems. These may prove to be rather costly and some bank managers worry about whether the cost of imposing this new capital regime will outweigh any potential benefits. Another concern was expressed, emphasizing whether banks in the region can handle the level of regulatory complexity set forth in the New Basel Accord. Implementing the new accord requires banks to provide bank managers with additional costly information. That is why it is believed that these requirements appear more appropriate for highly sophisticated financial markets in the more developed economies.

It was also argued that Arab financial markets still need to be more transparent. The disclosure of financial information is still weak and sometime totally absent. This is one of the reasons why until relatively recently, Arab stock markets have not yet been able to properly and fully channel funds to productive investments, and have not been able to be used for capital raising purposes within the region. The Arab banking system is still the major source of funds for the majority of Arab projects undertaken.

Arab countries are devoting genuine efforts to develop their accounting systems for better transparency and information disclosure. For all the Arab economies, it was shown that net external liabilities of the financial sector are relatively low. This is due to high restrictions on capital flows to the region. This contrasts with the economies of East Asia, where net external liabilities of the financial sector were medium or high before the crisis. The relaxation of restrictions on capital flows in most of these economies was among the factors contributing to the large and rising capital outflows during the crisis. With the exception of Egypt (having a managed float), all exchange rate systems in the Arab region are either fixed to the dollar or to a basket of currencies. This would be problematic if the capital ac-

counts were liberalized swiftly. If that was the case, then short-term capital would flow in and out, causing currency depreciations, a disruption of the financial system and a loss of foreign currency reserves.

Financial reforms are indeed taking place, although at a slow pace in the Arab region. However, since the capital account is still protected with a variety of barriers to the free flow of capital, financial reform can take place without a financial crisis looming in the horizon. Removing barriers to capital flows should be slow, and should move in conjunction with financial reforms. Fortunately, this has been the case in the Arab region, although at a relatively slow pace. The Arab region is now expected to move fast on those financial reforms, which will enable it to open up to foreign capital, an essential element for sustained growth. This at a time when the emerging Arab region is expected to take the lead in attracting foreign international capital which took various hits after the financial crisis in East Asia, Japan, Russia, Argentina, Mexico, and the events of September 11th 2001 in the US.

Acknowledgements

Financial Support from the University Research board of the American University of Beirut is greatly acknowledged. The author is also grateful to Rima El-Kadi for superb research assistance.