FINAL DRAFT

Occasional Paper 4

ISLAMIC DEVELOPMENT BANK

ECONOMIC POLICY AND STRATEGIC PLANNING DEPARTMENT

THE ROLE OF FINANCIAL MARKETS IN PRIVATE SECTOR DEVELOPMENT IN IDB MEMBER COUNTRIES

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بسم الله الرحمن الرحيم

FOREWORD

The Board of Executive Directors Sub-Committee on the Annual Report, in its meeting of Shawwal 1420H, suggested that IDB prepare a paper for 1421H on the topic “The Role of Financial Markets in Private Sector Development.” At the request of the Chairman of the sub-committee, the Economic Policy & Strategic Planning Department (EPSP) of the Islamic Development Bank took in hand the task of co-ordinating the preparation of the paper. Following internal review, the task was entrusted to Arshad Zaman Associates (Pvt.) Ltd., a consulting firm specialising in economics and finance, based in Karachi, Pakistan.

From the start, the exercise has been co-ordinated by Dr. Siddig Abdelmajeed Salih of the EPSP Department. At the request of IDB, Mr. Wafik Grais of the World Bank kindly consented to be the designated external reviewer of the paper. The paper itself has been prepared by Dr. Arshad Zaman, as an external expert, provided by Arshad Zaman Associates.

This is the 4th Occasional Paper produced by the Islamic Development Bank. The present paper reviews the state of the private sector and the financial sector in all member countries for which data is available from international sources. The latest statistics on these aspects are presented in an extensive statistical annex to the paper, which Governors may find useful. Based on an examination of the state of these sectors, the paper goes on to examine policy options in financial sector development for least developed member countries, and in financial reform for higher income member countries of the Bank. Finally, the paper draws some operational conclusions, on the basis of its analysis, for the IDB Group, focussing mainly on IDB itself and the newly created ICD.

The views expressed in the paper do not necessarily reflect those of the IDB, its Board of Governors, its Board of Executive Directors, or its member countries.

31 Aug 2000

ABBREVIATIONS AND ACRONYMS

AAOIFI	Accounting and Auditing Organisation of Islamic Financial Institutions
ADB	Asian Development Bank
AfDB	African development Bank
BCBS	Basle Committee on Banking Supervision
BCEAO	Banque Centrale des Etats de l'Afrique de l'Ouest [Dakar] [West African Central Bank]
BEAC	Banque des Etats de l'Afrique Centrale [Central African Central Bank]
BIS	Bank for International Settlements
CAEMC	Central African Economic and Monetary Union
CAMEL	Capital adequacy, management, earnings, liquidity
CAMELS	Capital adequacy, management, earnings, liquidity, sensitivity to risk
CARICOM	Caribbean Common Market
CDC	Commonwealth Development Corporation
CPs	Core Principles [of effective banking supervision, issued by the BCBS]
EBRD	European Bank for Reconstruction and Development
ECOWAS	Economic Community of West African States
FASB	[US] Financial Accounting Standards Board
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
ICD	Islamic Corporation for the Development of Private Sector
IDB	Islamic Development Bank
IFC	International Finance Corporation
IFIs	International Financial Institutions
IFU	Industrial Fund for Developing Countries (Denmark)
IMF	International Monetary Fund
IØ	Investment Fund for Central and Eastern Europe (Denmark)
IOSCO	International Organisation of Securities Commissions
LDMC	Least Developed Member Country [of IDB]
OIC	Organisation of the Islamic Conference
OICIS	OIC Information System [OICIS-NET = OICIS Network]
UEMOA	See WAEMU
UK	United Kingdom
UK GAAP	UK Generally Accepted Accounting Practice
US	United States (of America)
US GAAP	UK Generally Accepted Accounting Principles
WAEMU	West African Economic and Monetary Union [Union Économique et Monétaire Ouest Africaine, UEMOA]
WB	World Bank

PREFACE

Following earlier discussions, in June 2000, Arshad Zaman Associates were invited by the Islamic Development Bank, as external experts, to prepare an Occasional Paper on “The Role of Financial Markets in Private Sector Development in IDB Member Countries,” according to terms of reference and an outline provided by the Bank. The paper was prepared under IDB’s sponsorship, with IDB retaining ownership rights of the final report. Dr. Siddig A. Salih of the IDB was designated as the co-ordinator of the exercise, and Dr. Wafik Grais of the World Bank, as the external reviewer.

A paper of this scope could not have been prepared without the help of a large number of persons. The Islamic Development Bank was kind enough to arrange a trip to Washington, DC from June 18-24, 2000. En route, a stopover in London also proved fruitful.

In Washington, DC, Wafik Grais at the World Bank and Mohsin Khan at the International Monetary Fund were most gracious not only in their hospitality, but in sharing their wisdom and providing much needed guidance. Guy Pfefferman at the International Finance Corporation provided invaluable insights, and helped in gaining access to IFC data on the private sector and capital markets in member countries.

At the International Monetary Fund, Zubair Iqbal, David Marston, and Ghiath Shabsigh were kind enough to discuss country and conceptual issues relevant to the paper.

At the World Bank, helpful discussions were held with Victor Agius, Paul Collier, Robert Cull, Deane Jordan, Gregory Kisunko, Asli Demirgüç-Kunt, Ijaz Nabi, Dimitri Vittas, and Shahid Yusuf. Victoria Duncan and her colleagues in Wafik Grais’ office provided excellent research support. Courtney Vaughan assisted ably in the collection of hard to access materials. The resources of the Joint Bank-Fund Library were invaluable in providing ready access to articles, handbooks and other research materials.

In London, Martin Raiser, Clemens Grafe, and Bong-Ik Kim of the European Bank for Reconstruction and Development were able to shed light on Albania and the Commonwealth of Independent States. Debbie Pascoe of Pricewaterhouse Coopers provided useful data on accounting standards in several IDB member countries.

A draft of the Occasional Paper, responding as fully as possible to the terms of reference provided, was submitted to IDB in late July 2000. This draft was discussed in Jeddah, in two meetings and individually, with concerned IDB officials during August 5-9, 2000. Helpful comments were received, among others, from Muhammad Ahmed, Mabid Ali Al-Jarhi, Abdul Aziz Al-Othman, Al-Waleed Fareed Atabani, Muhammad M. Awwad, Syed Jaafar Aznan, Mamadou Cellou Bah, Yusuf Balci, Sidi Ould Bebaha, Abdul Lateef Bello, Mubarak El-Tayeb El-Amin, Bashir Omar Fadlallah, Hissam Kamal Hassan, Munawar Iqbal, Hamza Kunna, Faiz Mohammad, Muhammad Currim Oozeer, Zafar Saleem, Siddig Abdelmajeed Salih, Marwan Seifeddine, Wasim Ahmed Abdul Wahab, and Mohammad Ahmed Zubair.

The draft was also circulated to the external reviewer and other concerned experts at the same time. Based on this review of the draft, the Bank provided their comments and suggestions in writing on August 23, 2000. Helpful comments were also received from Zubair Iqbal at the IMF, and Stephanie Gober, Wafik Grais, and Dimitri Vittas at the World Bank. This Final Draft of the paper has benefited from all these comments and suggestions.

In Karachi, Kamran Lakhani prepared the statistical annex to the paper, and otherwise provided excellent research assistance.

It is a pleasure to acknowledge a debt of gratitude to all these friends, colleagues and well-wishers. Naturally, any and all errors in the paper are exclusively the responsibility of the authors.

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EXECUTIVE SUMMARY

This paper examines institutional requirements for the development of financial markets, to strengthen the private sector in member countries of the Islamic Development Bank (IDB). While a great deal has been written on this subject, there is a need to adapt the lessons learned to the special needs of IDB member countries. These needs arise from four sources: (i) an aspiration to conformity with Islamic law (*shari`ah*); (ii) the preponderance of small, low-income economies, on which much less has been written; (iii) controversies surrounding financial liberalisation and other financial sector development issues; (iv) operational concerns of the IDB Group, and especially its newly-created affiliate, the Islamic Corporation for the development of the private sector (ICD).

The paper is based largely on a selective review of readily available information and data, primarily from international financial institutions. Of the 53 members of IDB, virtually no data are available for Afghanistan, Somalia, the State of Palestine, and the seven member states with a population of less than one million persons (Bahrain, Brunei Darussalam, the Islamic Federal Republic of Comoros, Djibouti, Maldives, Qatar, and Suriname). Consequently, the paper seeks to cover most of the remaining 43 countries on which data can be found, although wherever possible the other countries are also kept in view.

State of the Private Sector

In 1999, the overall size of the private sector in IDB member countries was an estimated US$ 940 billion. Turkey and Saudi Arabia, in order, are estimated to have the largest private sectors among IDB members. Iran, Indonesia and Egypt are the next largest. With another eight countries – Pakistan, Malaysia, Bangladesh, Algeria, Morocco, Lebanon, Kuwait, and Tunisia – the share of thirteen countries rises to 85% of the total size of the private sector in all member countries. While investment rates are low, most member countries have registered high growth of investment since the 1980s. Investment in Guinea Bissau, Mauritania, and Sierra Leone, however, along with Bahrain, has declined by over 5% per year. Moderate declines – averaging under 2.5% per year – have been registered also in Burkina Faso, Niger, Algeria and Indonesia. In most cases, country-specific factors account for the shortfall from average performance of IDB members.

The principal constraints to private entrepreneurial activity in member countries are poor law and order conditions, corruption and high taxes, paucity of infrastructure, and lack of incentives to take risk and invest. Surprisingly, surveys of businessmen in IDB member countries reveal that lack of finance is not among the top three constraints to doing business in any

country – other than in three of the four African countries that have seen a major upturn in growth rates: Mali, Mozambique and Uganda. In Benin, despite a turnaround in growth in the 1990s, businessmen ranked lack of finance seventh among obstacles to doing business. While data on private investment are scarce, those on private saving simply don't exist (in international sources). We have therefore compiled our own estimates, which suggest that private domestic saving in member countries may be both higher and rising faster than investment. This suggests a net capital outflow from the private sector, which would be consistent with rising fiscal deficits, induced by rising debt burdens, but data limitations preclude further exploration of this issue.

State of the Financial Sector

There is great diversity in the state of financial markets in member countries. African members have seen greater macroeconomic stability in the 1990s than in the past. Nevertheless, due to structural and historical reasons, the financial sector in most of the least developed member countries remains underdeveloped. Macroeconomic conditions in Arab and Asian member countries of the Bank have been stable, but little is known publicly about the state of their financial sectors. In Albania and among the Commonwealth of Independent States (CIS) members of IDB, both macroeconomic conditions and the state of the financial sector remain a cause of concern. Much depends on the pace of bank restructuring and privatisation, both of which are proceeding slowly.

The social, economic, and business environment remains worrisome for most IDB member countries. Many of the higher income and more populous member countries have adopted the international accounting standards that have been promulgated. Nevertheless, practice often lags, and there are questions about the appropriateness of these standards for Islamic business instruments and practices. Efforts so far have addressed technical issues, not conceptual ones. There is a need for the IDB Group, along with other concerned institutions and scholars, to take a lead in undertaking fundamental research in Islamic accounting. Corruption is a pervasive problem, along with high taxation. The legal framework constrains the creation of trust necessary to do business. While property rights are clear, contract enforcement is a problem and the judicial process is slow and often subject to corruption.

There is no unique objective measure of the level of financial development in a country. One index – financial depth, or the ratio of currency in circulation plus demand deposits to domestic income – suggests that Jordan, Kuwait, Lebanon, and Malaysia may be among the more financially developed member countries. Of these, by all indicators, Malaysia has the most developed financial sector among all member countries. A consideration of other indicators would add Tunisia and Turkey to this list. Another nine member countries – Albania, Algeria, Egypt, Indonesia, Iran, Morocco, Pakistan, Saudi Arabia, and the United Arab Emirates – also have developed financial sectors. The financial sector in the economies of the remaining thirty-eight members is thought to be much less developed.

An analysis of statistics on banking in 26 member countries reveals very high concentration ratios in all countries. With the exception of Uganda, the top three banks hold 90-100% of the assets of the banking sector in the six other African member countries on which there is data, and in Kazakhstan. Among Arab members, the same is true for Algeria, Bahrain, Jordan, Qatar, and Yemen, while the lowest concentration ratios are found in Saudi Arabia and Tunisia (51-52%). Among Asian members, these ratios range from 44-57% – with Bangladesh and Pakistan showing the highest concentration. Foreign banks continue to account for a large share of the market – over 50% of the number of banks, in Bahrain, Indonesia, Pakistan and Uganda; and over 40% of assets, in Bahrain, Indonesia, Pakistan, and Sierra Leone. The government holds over 40% of banking sector assets in Bangladesh, Egypt, Indonesia, Pakistan, and Turkey. Egypt, Kuwait and Saudi Arabia have the most efficient banking systems – with overhead costs under 1.5% of assets, and interest margin, under 2%. Algeria, Qatar and Malaysia also have comparable overhead costs, but have slightly higher interest margins.

In terms of market capitalisation, Malaysia and Turkey had by far the largest stock markets among IDB members, followed by Indonesia, Saudi Arabia, and Egypt. In terms of value traded, however, Pakistan, Oman, Saudi Arabia and Indonesia feature in the second tier, behind Malaysia and Turkey. Market capitalisation has registered the highest growth in Egypt, Morocco and Indonesia over the 1990s. The turnover ratio has grown fastest in Pakistan – at 50% per year over the 1990s – with the result that in 1999 it had by far the highest turnover (345%), followed by Turkey (103%), Indonesia (47%) and Malaysia (40%). In addition to secondary markets, US$ 36 billion of equities were issued in primary markets in Malaysia and Indonesia, in equal parts, during 1980-95. Turkey and Tunisia also had significant activity in this market over the same period, as did Jordan and Pakistan, although to a much lesser extent. Little is known about insurance and pension funds.

Financial Sector Development

In financial sector interventions, it is useful to distinguish development from reform. In most of the least developed countries, where very few financial institutions exist and financial dealings are small in relation to the level of economic activity, policy attention should be directed to the development of financial institutions and instruments. By contrast where financial structure

– institutions and instruments – has emerged, policy reform should address improvements not only in the capacity but also in the efficiency of the system. Where this structure has yet to emerge, most of the international discussion of financial reform – interest rate liberalisation, dismantling of directed credit arrangements, reduction of taxation of financial intermediation, liberalisation of the capital account of the balance of payments, etc. – may well be largely irrelevant.

Both development and reform are normative concepts. IDB member countries need therefore to define an ideal state of affairs, and a path towards it, in the light of their own cultural values. Such an ideal may be called an Islamic Financial Architecture. While important steps have been taken in adapting financial instruments to the requirements of Islamic law (the *shari`ah*), a grand design of the ideal Islamic financial system has not been attempted. IDB may wish to consider whether it would be opportune to constitute a committee of distinguished scholars, supported by a special group in IDB, to work on an Islamic Financial Architecture to guide national efforts at financial development and reform.

In the interim, efforts at financial development in member countries should proceed pragmatically. As a general policy guideline it seems reasonable that financial development should be in response to market demand for financial services, rather than in imitation of the course of developments elsewhere. Secondly, policy should consider both the scale at which financial institutions become viable, and the size of the market in which competition can be a source of efficiency. In perhaps a dozen IDB least-developed member countries there are no cities of 1 million persons or over, nor is one expected to arise by the year 2015, on the basis of current demographic projections. In these countries, financial development should be designed not from international blueprints, but from a specific assessment of market demand and country conditions. In countries where such urban agglomerations exist, more conventional paths of development can be pursued, but again with a special effort to adapt international patterns to domestic requirements.

In many least developed countries, the possibility of promoting the establishment of Islamic micro-finance institutions may be worth investigating. Finally, where there are many benefits from a regional central bank in West Africa, it may well be time to begin a discussion on the benefits and costs of this arrangement.

Financial Sector Reform

There is now fairly conclusive evidence that over the last twenty years experiments at financial liberalisation and reform have led frequently to financial distress in the experimenting countries. Critics of the reforms claim that this is due to fundamental flaws in design; apologists, either (i) that institutional pre-conditions – legal framework, accounting standards, prudential regulation and supervision of banks, etc. – were not met, or (ii) that sequencing – macroeconomic stability, before financial liberalisation – was wrong, or (iii) that some "creative destruction" is necessary to increase welfare and efficiency. All agree, however, that development of social and financial infrastructure – laws, accounting standards, etc. – and macroeconomic stability are essential pre-conditions for successful financial reform.

In most cases, budget deficits are the root cause of macroeconomic problems. While low taxation and weak expenditure controls may have been the source of rising pressures on public finances in the past, leading to increasing indebtedness, today it is the burden of debt that is the main impediment to the sustainability of macroeconomic policies. The restoration of macroeconomic stability therefore requires an effective debt management policy on the part of member countries. At the same time, there is a need to put in place effective public expenditure control mechanisms.

The principal lesson of the financial sector reform experience of the last two decades may be a simple one: in policy-making, market-friendly approaches will work, *dirigiste* ones may work, but the dogmatic pursuit of a policy design – even if based on sound theoretical principles – will quite likely lead to disaster. Among IDB member countries who pursued these policy reforms, financial crises erupted in Turkey (1982-85, 1991, 1994), Jordan (1989-90), Egypt (1981-83, 1990-91), Indonesia (1992-98), Malaysia (1985-88), Mali (1987-89), Togo (1993-95), and Uganda (1994), among others. On the basis of these mishaps, there is now an extensive literature on bank fragility and insolvency, early warning indicators, and financial crisis avoidance, management and resolution. As this debate is of relevance to no more than half a dozen member countries, it is not pursued further. Instead, a strategy for Islamic financial reform is outlined.

There have been suggestions in the recent literature that market-based systems are superior to bank-based systems. Also, universal (rather than specialised) banking may be more suitable to the circumstances of most member countries. With increasing sophistication, it may well be wise to phase in equity markets at the expense of banks in financially developed countries. At the same time, regulatory design should encourage universal banking. In this a study of the experience of Malaysia should be valuable. This suggests a reform design that emphasises equity market development, especially through promotion of Islamic pension management schemes; the promotion of mutual insurance (*takaful*); promotion of universal banking; and the Islamisation of commercial banking. This would not rule out the role of the central bank in regulation and supervision of banks, but would place the task of financial reform with the security market regulation agency in member countries, rather than the central bank. Equally, member countries should explore the North European experience of integrated financial sector regulation.

Conclusions

The Islamic Development Bank has accomplished a great deal since its establishment 25 years ago. Over this period, the Bank has committed US$ 18 billion to Muslim states, while they have had to transfer only US$ 3 billion in share capital to the Bank. Since 1975, however, the world has changed significantly. The Bank has been aware of these changes, and the 1994 *Strategic Agenda for the Medium-Term* provides a cogent outline of operational priorities and guidelines for IDB. It is within these priorities that some recommendations are advanced in this paper.

While most development research at the IMF/WB and international research centres can be adapted profitably to the problems of member countries, with minimal change, the premises on which financial research in these institutions is based are radically different from those of the *shari`ah*. There is therefore a need to carry out basic research from an Islamic perspective on many of the areas surveyed in this paper. IDB may wish to constitute a special group within the Bank to undertake research, leading among other outputs, to the design of an Islamic Financial Architecture to guide development and reform efforts in member countries.

At the same time, IDB should make systematic efforts to enhance relations with the International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), and the Bank for International Settlements (BIS). This follows naturally from the strategic priorities suggested in this paper, and the need for IDB to assume a higher profile in global discussions of financial policy issues. Another area, of immediate application, is the promotion of Islamic micro-finance institutions and instruments, either on a country by country basis, or on a regional basis. IDB has already formulated guidelines in this area, but much more work needs to be done to formulate operational directives and procedures, in line with global best practice. Finally, both to meet enhance resources and to ensure product development, the IDB Group should continue to attach priority to financial engineering.

As should be clear from this discussion, IDB's 1994 *Strategic Agenda for the Medium-Term* has now been overtaken by events. IDB may well consider the formulation of a new long-term corporate strategy for the IDB Group to guide the group of institutions during the next decade. This should be done with the widest possible consultation among key stakeholders both within the IDB Group and in member countries.

As for ICD, it would seem wise to prepare a corporate strategy document for the institution at an early date. This strategy should be based not only on a strengths-weaknesses-opportunities-trade-off (SWOT) analysis of ICD, but should also benefit from a survey of the markets in which ICD is likely to compete (estimated at over US$ 30 billion, annually). In the absence of such a strategy, only preliminary ideas can be advanced in this paper.

ICD should attach priority in its staffing decisions to building up a special capacity in development of equity markets, pension funds, insurance, and Islamisation of banking. As the institution will have to spend a great deal of resources in the identification of suitable business partners and opportunities in member countries, some thought may also be given, at this early stage, to the creation of a “Project Preparation Facility” to defray costs.

One generic area of activity for ICD, in association with IDB, could be the market for Islamic ways of debt restructuring. Currently, 10 countries, including 6 IDB member countries qualify for debt relief – amounting to US$ 4.3 billion in net present value, or some US$ 8.5 billion in nominal terms – under the IMF/WB HIPC framework – and a number of other member countries will be eligible for enhanced HIPC terms. With some research and development, ICD/IDB should investigate the possibility of securitising some of the debt of the highly-indebted Muslim countries, for marketing in higher income member and non-member countries.

A second area of capital market activity could be in housing finance, on Islamic principles. While leasing and hire-purchase have been the preferred modes in this area, it may be possible to securitise real property, and provide *shari`ah*- compatible financing against such securities. A third area, in which the IDB has already made progress is that of mutual funds. ICD could take this further by focusing on better marketing arrangements so that savers in Muslim countries have an opportunity to place their saving in *shari`ah* permissible instruments.

Another area, of immediate application, is investment in Islamic micro-finance institutions, either on a country by country basis, or on a regional basis. The design for providing micro-finance on an Islamic basis has been worked out. With a project preparation cost of less than US$ 500,000, it should be possible to design a high-impact viable project to promote saving and investment in the CFA-Franc member countries of West Africa. The same design, which is now fully worked out, can be applied at smaller scales to most member countries.

In addition, in keeping with its mandate, ICD should seek to identify a number of regional private sector projects. While this can only be done after careful studies, it may be possible to prepare a commercially viable regional fisheries project in the coastal West African region.

While more difficult, ICD should also explore ways of acting as an intermediary between higher and lower income member countries. In this, services tailored to the requirements of Muslim communities are likely to be most successful. Promoting intra-OIC foreign direct investment is a more difficult proposition, but one well worth the effort.

1. INTRODUCTION

The Islamic Development Bank (IDB) seeks to foster economic development, in accordance with the principles of the *shari`ah*. In addition, the Bank is enjoined to pay due regard to the needs of the least developed member countries (LDMCs) in conducting its operations.[1] Keeping these objectives in view, this paper reviews and translates current lessons in financial sector development and reform into an approach to the operations of IDB, and the newly formed Islamic Corporation for the Development of Private Sector (ICD).

1.1 Objectives of the Study

The main objective of this study is to examine institutional requirements for the development of financial markets, in order to strengthen the role of the private sector, in IDB member countries. Specifically, emphasis is given to the interaction between the structure of financial markets, the regulatory regime, and the development of the private sector. On this basis, lessons are drawn on good policy practices for IDB member countries, and on operational strategy and practices – including the identification of *niches* of activity – for the Bank itself. Based on the review of past experience, the study also identifies structural pre-conditions and sequencing of development of financial markets that best support private sector led economic growth in these countries.

1.2 Approach, Methodology and Data

Clearly, a full analysis of the issues raised is well beyond the scope of a single paper. In particular, the paper cannot provide the degree of specific country detail that is necessary to formulate concrete policies in any one country. At best, therefore, the paper hopes to provide a framework that can serve as a starting point for discussions on strategy and policy formulation both in member countries and in the Bank.

1.2.1 Approach

With the extensive literature that exists on financial development and reform,[2] why should it be necessary to write a special paper for IDB member countries? Given IDB's mandate, there are in effect at least four sources of special concern that warrant such an effort:

(i) There is a need to examine the extent to which the findings and recommendations of the existing literature are relevant for those countries that seek to bring their financial affairs in conformity with Islamic law

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[1] Under Articles (1) and 16(3) of the Bank's Articles of Agreement. Of the 53 IDB member countries, 23 are considered to be least developed. Of these, 14 are classified as African countries: Benin, Burkina Faso, Chad, Comoros, Gambia, Guinea, Guinea-Bissau, Mali, Mozambique, Niger, Senegal, Sierra Leone, Togo and Uganda; 6 as Arab countries: Djibouti, Mauritania, State of Palestine, Somalia, Sudan, and Yemen; and 3 as Asian: Afghanistan, Bangladesh, and Maldives.

[2] Levine (1997) provides a current review of the issues with extensive references to literature.

(*shari`ah*), and if not, to identify what changes would be necessary. This has three important consequences. First, there is a need to develop the framework of what might be called an Islamic Financial Architecture, to guide efforts at financial sector development and reform at the national level. Second, greater attention needs to be paid to lessons from market-based (as opposed to bank-based) financial systems.[3] Third, the merits of integrated provision of financial services (implying universal, rather than specialised banking) need sympathetic consideration.

(ii) There is a need to fill the gap in existing literature, which focuses almost exclusively on large, better-off and more financially developed, economies, in order to provide guidance on policy lessons for much smaller, and especially least developed, member countries of the Bank.[4] (Accordingly, this paper distinguishes between financial sector *reform*, one variant of which can be financial *liberalisation*,[5] on the one hand, and financial sector *development*, on the other.)

(iii) Even in "higher income" member countries,[6] there is a need not only to chart out a middle course through the minefield of controversies surrounding financial sector liberalisation (or reform), but also to address financial sector development issues other than liberalisation.

(iv) There is, finally, the need to translate such insights as emerge into operational implications for the Bank Group, and its newly created affiliate, the Islamic Corporation for the Development of the Private Sector (ICD).

In addressing these concerns, the paper accepts uncritically the dominant paradigm within which its scope is located. This paradigm, which has held sway over the last fifty years or so, may be represented by the following propositions:

(i) Economic development can be pursued independently of cultural, political and social change;

(ii) While the process of economic development is complex, for practical purposes, it is embodied in the sustained – over 30-40 years – growth of per capita national output;[7]

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[3] For a recent comparative review of the two systems see Demirgüç-Kunt and Levine (July 1999).
[4] In this connection, it may be relevant to note that a research proposal on "Financial Sector Policy for Small Countries" was under consideration at the World Bank in June 2000.
[5] Liberalisation refers primarily to elimination of ceilings on interest rates and directed credit arrangements.
[6] The World Bank classifies Brunei, Kuwait, Qatar and the UAE as high income countries, and Bahrain, Gabon, Lebanon, Libya, Malaysia, Oman, Saudi Arabia and Turkey as upper middle income countries. These 12 countries are referred to as "higher income countries" in this paper.
[7] Kuznets (1966).

(iii) In order to increase and maintain rates of economic growth, it is essential to increase and maintain the rate of capital formation (or investment), and its efficiency;

(iv) Since investment is constrained by savings, there is a need both to raise the rate of saving in the economy, and to develop and improve the efficiency of the financial sector, which consists of financial intermediaries that transfer savings to investors; and finally,[8]

(v) Over the last two decades, there has been a marked shift in the conventional wisdom. Earlier, it was held that because markets are imperfect the public sector must spearhead the development effort. Now the view is that governments are inefficient and it is the private sector that must be enabled to spearhead the development effort.

1.2.2 Methodology

The paper is based on a selective review of the literature, and an analysis of country data that is readily available from the key international agencies – International Monetary Fund (IMF), the World Bank (WB), and the International Finance Corporation (IFC). For Albania and the Commonwealth of Independent States, the work of the European Bank for Reconstruction and Development (EBRD) has also been consulted. In both cases – literature and data – the paper is based on published and readily available material, especially on the Internet, that could be accessed in the short time available. In addition, the paper has benefited from a field trip to gather information and hold discussions with knowledgeable persons in the IMF, WB, IFC and EBRD, as well as IDB.

Of the 56 member states of the Organisation of the Islamic Conference (OIC), 53 are members of the Islamic Development Bank (IDB) – see Table 1.1.[9] Of the latter, virtually no data are available for Afghanistan, Somalia, State of Palestine[10] and the seven member states with a population of less than 1 million (Brunei Darussalam, Bahrain, Comoros, Djibouti, Maldives, Qatar and Suriname). As a result, the paper attempts to cover mainly the remaining 43 member countries, although where data are not available on one of these 43 countries, they too are excluded.[11] Equally, wherever possible, the other countries are also kept in view.

1.2.3 Data

Given the time available, the principal source of data for the paper has been the World Bank's *World Development Indictors 2000*, supplemented, wherever necessary, by the *African Development Indicators 2000*, and *Global Development Finance 2000* all of which are available as CD-ROMs. In addition, the paper draws on the key statistical publications of international financial institutions.

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[8] Lewis (1955).
[9] Guyana, Nigeria and Uzbekistan are OIC members, but not IDB members.
[10] Data for "West Bank and Gaza" in international sources is taken in this report as data for State of Palestine.
[11] For example, data on monetary assets (M2) are available for only 40 member countries.

Table 1.1 Classification of Member Countries of the Islamic Development Bank

IDB:	African	Arab	Asian	Albania & CIS
23 Least Developed Member Countries (LDMCs)	**WORLD BANK: LOW INCOME COUNTRIES (1998 GNP/CAPITA < US$760)**			
	SUB-SAHARAN EAST AFRICA Comoros Mozambique Uganda WEST AFRICA Benin Burkina Faso Chad The Gambia Guinea Guinea-Bissau Mali Niger Senegal Sierra Leone Togo	Djibouti [1,2] Mauritania [2] State of Palestine [1] Somalia [2] Sudan [2] Yemen Republic	Afghanistan Bangladesh Maldives [1]	
30 Other Member Countries	Cameroon [2]		Indonesia [3] Pakistan	Azerbaijan Kyrgyz Republic Tajikstan Turkmenistan
	WORLD BANK: LOWER MIDDLE INCOME COUNTRIES (1998 GNP/CAPITA US$ 761-3,030)			
		[Djibouti] [State of Palestine] Algeria [3] Egypt Iraq [3] Jordan Morocco Syria Tunisia	[Maldives] Iran [3]	Albania Kazakstan **Americas** Suriname
	WORLD BANK: UPPER MIDDLE INCOME COUNTRIES (1998 GNP/CAPITA US$ 3,031-9,360)			
	Gabon [2,3]	Bahrain Lebanon Libya [3] Oman [3] Saudi Arabia [3]	Malaysia Turkey	
	WORLD BANK: HIGH INCOME COUNTRIES (1998 GNP/CAPITA > US$ 9,361)			
		Kuwait [3] Qatar [3] United Arab Emirates [3]	Brunei [3]	

Source: IDB (1999) and World Bank (2000). CIS refers to Commonwealth of Independent States.
1 Djibouti, State of Palestine, and Maldives are classified as "Lower Middle Income" by the World Bank.
2 Classified as being in "Sub-Saharan Africa" by the World Bank.
3 Oil-exporting country.

A number of private agencies publish banking and finance data on those IDB member countries that are classified as emerging markets. While frequently there is a (substantial) charge for purchase of this data, it is often possible to find this data in secondary sources available in libraries. Wherever possible, the paper cites such data – copied by hand from publications available in libraries – for some or all of the IDB member countries. In addition to standardised country data from these sources, the paper draws on secondary data cited in empirical papers published in scholarly journals. Even though these data are somewhat dated, they provide useful insights – especially, on non-economic variables.

Finally, information on the state of the private and financial sectors is available from survey (or "micro") data. Over the course of the last two decades, a number of international surveys have been carried out, in pursuit of diverse concerns. There is, however, no central inventory of this data. Frequently, access to the data requires time-consuming release procedures. In some cases, there is a charge for access, or they are proprietary. In the time and resources available, it was only possible to access one major survey of private sector enterprises carried out by the World Bank in 69 member countries.[12] The European Bank for Reconstruction and Development (EBRD) adapted this survey to carry out a Business Enterprise and Performance Survey of over 3,000 enterprises in 20 transition economies. While we were unable to gain access to this data, we have relied on published accounts of the results of this survey.[13] In all cases, the sources of the data are clearly cited in the paper.

1.3 An Overview of the Private Sector in Member Countries

In all countries of the world resources are owned and used by both the public and the private sectors. The relative importance of each is largely a matter of history and politics. The evolution of the modern Muslim state reflects a confluence of four distinct set of influences: custom (*`adah*), adaptation to the *shari`ah*, to European (colonial) influences, and post-colonial developments. By and large, customary local arrangements allowed a large scope to private entrepreneurial activity. The rise of Muslim states did not much alter the scope of freedom to private initiatives. State structures remained minimal, and in principle the *shari`ah* was (and is) private sector friendly.

By contrast, the colonial state evolved from, and served, the commercial interests of the metropolitan powers. As such, despite dif-

Box 1.1 The Colonial Heritage

Between 1876 and 1915 about one-quarter of the globe's land surface was distributed or redistributed as colonies among a half-dozen states. Britain increased its territories by some 4 million square miles, France by some 3.5 millions, Germany acquired more than 1 million, Belgium and Italy just under 1 million each… Portugal's ancient African colonies expanded by about 300,000 square miles; Spain, while a net loser (to the USA), still managed to pick up some stony territory in Morocco and the Western Sahara. Russian imperial growth is more difficult to measure, since all of it was into adjoining territories and continued some centuries of secular territorial expansion of the tsarist state…

– Eric Hobsbawm (1987, 59)

[12] Brunetti, Kisunko and Weder (1998). We are indebted to Gregory Kisunko of the World Bank for access to the data.
[13] EBRD (1999) and Hellman, Jones, Kaufman and Schankerman (1999).

ferences in political, social and economic arrangements at home, all colonial powers sought to centralise control over infrastructure, trade (especially foreign trade), finance, and often production (especially in the form of plantations). This was done mainly by selective changes in the system of laws and the introduction of education in the language of the metropolis. Both had important consequences for governance, and although seldom addressed, are relevant to current discussions of the role of governance in economic development.

> **Box 1.2 When Rulers Trade**
>
> *Commercial activity on the part of the ruler is harmful to his subjects and ruinous to the tax revenue… [it] crowds out competitors [and] dictates prices for materials and products which could lead to the financial ruin of many businesses. When the ruler's attacks on property are extensive and general, affecting all means of making a livelihood, the slackening of business activity too becomes general.*
>
> – ibn Khaldun,
> quoted by Iskander (1995)

Even after independence, state structures in the post-colonial Muslim world continued to retain many of the features of the colonial state. These tendencies were strengthened during the Cold War era (1949-1991) as both the United States of America and the former Union of Soviet Socialist Republics promoted an interventionist state to absorb military assistance, and carry out externally funded development projects and programs. It is only recently, under pressure from external lenders, that highly indebted Muslim states have been forced to create greater space for private initiatives.

This history has shaped the institutional contours of the private sector in Muslim countries today.[14] As a result, the private sector occupies (i) the space that has not been occupied by the state (the "informal" sector[15]), or (ii) the space created – and regulated – by the state for joint public-private initiatives (the "mixed" sector[16]), or (iii) for exclusively private initiatives (the "formal" private sector). Within the formal sector a distinction can also be made between a "state-sponsored" private sector that is not public-owned but is supported by government by a variety of means, and what might be called an "independent" private sector.[17] Finally, from a conceptual standpoint, it is also useful to distinguish between the sub-sectors that sell in markets for traded versus non-traded goods, and between markets in urban versus rural areas. In appreciating the conditions of the private sector, therefore, it is essential to understand the role of the state in each country.

1.3.1 The Overall State of the Private Sector

In 1999, the size of the private sector in IDB member countries was an estimated US$ 940 billion.[18] Turkey had by far the largest private sector in the Muslim world

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[14] Mauro (1995) reports that he failed to find any "significant evidence that a country's economic performance or its institutional efficiency were affected by *which* country colonised it."
[15] Although many definitions exist, the defining feature of the informal sector is its location outside the government registration network.
[16] The defining characteristic of the mixed sector is joint public-private ownership.
[17] It is widely held that the truly independent private sector either does not exist, or is very small, and possibly shrinking.
[18] Data on private investment are published only by IFC (Pfeffermann, Kisunko and Simlunski, 1999). Size is defined as the sum of private consumption and private investment, and is

(US$ 176 billion, or some 19% of the US$ 940 billion), followed by Saudi Arabia (US$ 126 billion, or 13%).[19] Another three countries – in order of size, Iran, Indonesia and Egypt – together accounted for US$ 249 billion, or over 26%. Another eight countries – in order, Pakistan, Malaysia, Bangladesh, Algeria, Morocco, Lebanon, Kuwait, and Tunisia – accounted for US$ 258 billion, or 27%. The size of the private sector in the remaining 40 IDB member countries, together constituting 15% of the total, was estimated to be under US$ 10 billion in each country.

As is well known, the rates of investment in member states is not high. In 1998, the average rate of private investment for the world was 14.3% of GDP – 18.5% in East Asia, 16.2% in Latin America, 13.2% in South Asia, and 10.2% in Sub-Saharan Africa.[20] By comparison, 11 IDB member countries reported 1998 investment rates of less than 10% of GDP.[21] Another 13, between 10-15%;[22] six, between 15-20%; and five, above 20%. By far the highest investment rate was reported by Azerbaijan (33.7%) and the Kyrgyz Republic (27.5%), followed by Lebanon (27.5%), Jordan (22.5%), Malaysia (21.4%), and Turkey (20.3%).

In contrast to the low rates of private investment, the rates of growth of private investment are generally high, albeit variable (Table 1.2).

Among member countries that have experienced negative growth rates of investment there is a need to distinguish between the Sub-Saharan African countries, on the one hand, and Algeria, Indonesia and Bahrain, on the other.[23]

A great deal has been written about Africa's economic performance since Africa was placed on the global development agenda in the late 1980s.[24] In particular, considerable interest has attached to why Africa has grown slowly?[25] While inter-

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estimated from WB's WDI 2000 data. There is no private investment data on 11 countries – Afghanistan, Brunei, Iraq, Libya, Maldives, Oman, Qatar, Saudi Arabia, Somalia, Sudan, and Suriname. For them, this figure is estimated primarily from GDP estimates, on the assumption that on average their investment rates are the same as that of a comparable country or country average. See Statistical Annex, Table 2.1.

[19] The estimate for Saudi Arabia may be subject to a large margin of error.

[20] Based on data for 50 countries. Bouton and Sumlinski (2000).

[21] Primarily African members, Chad (9%), Guinea Bissau (5.2%), Mauritania (7.3%), Niger (4.7%), Sierra Leone (4.3%), Togo (9.7%), and Uganda (9.7%); but also Pakistan (9.6%), and Bahrain (5.4%).

[22] Again, primarily African members, Burkina Faso (14.9%), Comoros (13.8%), The Gambia (12.5%), Guinea (13.4%), Mali (11.7%), Mozambique (11.1%), Senegal (13.8%), but also Egypt (13.1%), Tunisia (12.8%) and Kuwait (13.6%), as well as Albania (11.3%).

[23] In view of this paper's focus, the decline in private investment in Bahrain is not explored. According to WB's *WDI 2000*, gross domestic investment in Bahrain fell from US$ 802 million in 1990 to US$ 332 million in 1997. Over the same period, according to the IMF's *GFS 1999*, capital expenditure by government fell from US$ 48.5 million to US$ 39.0 million (using IMF's *IFS* exchange rates for conversion). Using government capital expenditure as a proxy for public investment, private investment would have fallen from some US$ 753 million to US$ 293 million, or some 12.6% per year.

[24] The first flagship publication, World Bank (1989b) has recently been updated, World Bank (2000).

[25] Collier and Gunning (Summer 1999, and March 1999), on which this section draws for much of its classification, and analysis, but not necessarily its assessments.

national financial institutions found fault with exchange and trade policies (especially in the 1980s), African governments have blamed deteriorating and volatile terms of trade. Of late, some scholars have considered climate and geography as explanatory factors.[26] While this debate is unlikely to be resolved soon, the fact remains that since the 1970s, investment and growth in Africa has declined sharply. In large part, this is because of the substantial *risks* involved in entrepreneurship and investment.[27]

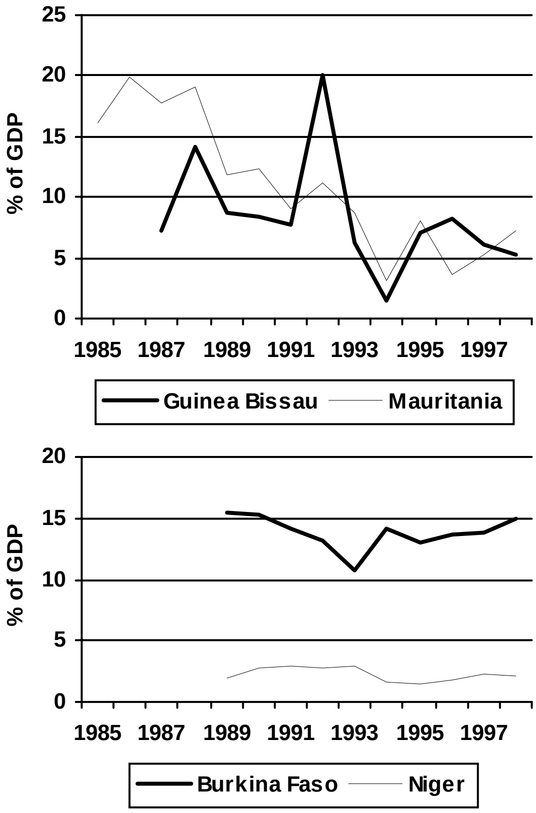
Table 1.2 Private Investment in Selected IDB Member Countries

Rate of Private Investment (% GDP) in 1998	Average Annual Rate of Growth of Private Investment (1980-98)					
	Negative Growth		**Zero Growth**		**Positive Growth**	
	High (< -5%)	**Moderate (- 5.0-2.5%)**	**Low (- 2.5-0%)**	**Low (0-2.5%)**	**Moderate (2.5-5.0%)**	**High (> 5%)**
African Members						
H						
M			Burkina Faso[2]	Cameroon The Gambia[2] Mali[2]		Benin[2] Comoros Guinea[2] Senegal
L	Guinea Bissau[2] Sierra Leone[2]		Niger		Togo	Chad[2] Uganda[2]
Arab Members						
H						Lebanon[2]
M			Algeria	Djibouti[3] Kuwait[2]	Tunisia	Egypt[2] Morocco UAE[2]
L	Bahrain[2] Mauritania[2]					
Asian Members						
H						Malaysia Turkey
M			Indonesia[1]	Iran		Bangladesh
L					Pakistan	
Albania & CIS Members						
H					Azerbaijan[4]	
M					Albania[5]	Kazakhstan[6]
L						

Note: Where data are not available for 1980, earlier years are used, as indicated.
Key: Rates of private investment (as % of GDP): H = Above 20% M = 10-20% L = Less than 10%
[1] From 1981 [2] From 1990 [3] From 1991 [4] From 1994 [5] From 1995
[6] From 1997
Source: Statistical Annex, Table 2.2.

[26] Sachs and Warner (1997).
[27] Collier and Pattillo (2000). On the basis of panel data for Cameroon, Ghana, Kenya and Zimbabwe, Bigsten et. al. (1999) find “very low levels of investment” concurrent with “high profit rates,” and conclude that due to poor macroeconomic performance, capital costs are unduly high – and this is reflected in the unusually high profit rates.

Figure 1.1 Private Investment Rates



These risks arise from the domestic, and external, environment and policy, leading to a four-part explanation of outcomes.[28] In this schema, the first set of constraints relate to poor natural resources – the soils are poor, and do not respond well to fertiliser applications; rainfall is scarce, variable, and possibly diminishing as a long-term trend; leading to hostile conditions for crops and livestock. The second, relate to domestic structures and policies – like other post-colonial nations, the state has been captured by xenophile élite that have been unable to dismantle colonial structures of governance, with the result that most of civil society remains distant, if not hostile, to state initiatives and actions. This has led, among other conditions, to an inappropriate urban-industrial bias to economic strategy and policies that has constrained performance, and has also led to a growing dependence on external finance in the face of difficulties in revenue mobilisation. With dependence on foreign finance, the ability of governments to take independent action in areas where their interests have been at variance with their donors has been limited. Finally, while the external environment has been favourable to aid and access to markets, the terms of trade have fallen over time, and aid may have been a mixed blessing.

Apart from these general factors, the sustained fall in the rate of investment in Guinea Bissau and Sierra Leone reflects law and order conditions, and political instability.[29] Guinea Bissau's long independence war (1963-74) led to the destruction of one-third of the country's agriculture sector.[30] Since then, however, private investment had recovered to about 7-8% of GDP. In Mauritania, by contrast, there

[28] Guillaumont, Jeanneny, and Brun (1999) employ a different schema to argue that "primary" instabilities – climate, terms of trade, and politics – impact "intermediate" instabilities – rate of investment and the real exchange rate – to affect economic policy, which in turn lowers economic growth. See also Gyimah-Brempong and Traynor (1999).

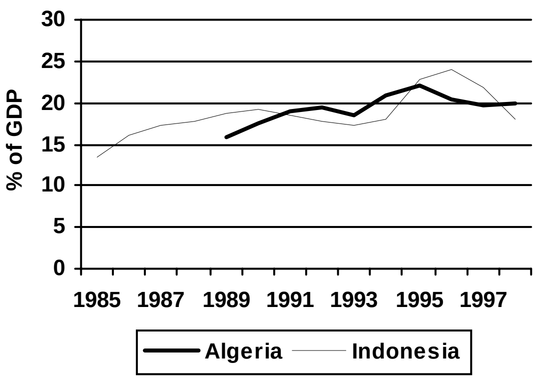
[29] Although the peace agreement signed in Lomé on July 7, 1999, ending the civil war in Sierra Leone, had raised hopes of restoration of normality, fresh disturbances broke out in 2000, which make the economic prospects once again uncertain.

[30] IMF (April 1998).

has been considerable political stability. The principal constraints to private investment growth have been strategy and policy-related. Since the mid-1980s, Mauritania has implemented a number of IMF programmes – and has received debt relief under the IMF/WB's Highly Indebted Poor Countries (HIPC) initiative – but private investment rates have remained low.[31]

In contrast to these countries – Guinea-Bissau, Mauritania, and Sierra Leone, with strongly negative investment growth – four countries, Burkina Faso and Niger, and Algeria and Indonesia, have recorded mildly negative investment growth in the 1980s and 1990s. Burkina Faso, a landlocked country of 10 million, with 84% of the population living in rural areas, has few natural resources and limited rainfall. Although private investment rates have fallen slightly over the longer-term, they have risen since 1993 (Figure 1.2).[32] In Niger, by contrast, they have been low and stagnating.

Figure 1.2 Private Investment Rates



In Algeria, the slightly negative rate of growth reflected in Table 1.2 arises from a relatively high rate of investment in the base year (22% of GDP in 1980). While investment rates have fallen from those levels, they have been rising in recent years (Figure 1.2). This reflects the government's successful efforts in public enterprise reform, and some success in privatising small public sector units by selling them to the workers. Currently, the private sector contributes over 70% of GDP, and employs almost 3 million persons (half the labour force).

In Indonesia, with the rise of oil prices fuelling an economic boom, private investment rose rapidly in the mid-1970s – exceeding 15% of GDP in 1979 – but fell back to its early 1970s level of around 11% of GDP, by the mid to late 1980s.[33] Under the supplementary Memorandum of Economic and Financial Policies (MEFP), dated May 17, 2000, submitted by the government on the occasion of the first review of the January 2000 extended arrangement with the IMF, the govern-

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[31] Mauritania's Enhanced Structural Adjustment Facility Medium-Term Economic and Financial Policy Paper 1999-2002, dated July 12, 2000, is available at the IMF website, and has been consulted.
[32] While rejecting the hypothesis of a general de-industrialisation in the Africa region, Jalilian and Weiss (2000) confirm that this may have happened in Burkina Faso and Sierra Leone (along with Burundi, Ghana, Rwanda and South Africa).
[33] Chhibber and Shafik (May 1990) attribute this, among other factors, to the impact of the 50% devaluation of the rupiah in March 1983. A major reform of the financial sector took place during 1988-91.

ment has taken a number of initiatives that would increase private sector growth further.[34]

Apart from these eight member countries – of which mildly negative growth in three (Bahrain, Algeria, and Indonesia) does not reflect a secular trend – all other member countries for which data on private investment is available report positive, though variable, growth in private investment (see Table 1.2 above).

1.3.2 Constraints to Private Sector Growth

The principal constraints to private sector growth, in order, are: (i) poor law and order conditions, (ii) corrupt tax agencies and high taxes – in relation both to personal incomes and benefits from government expenditure, (iii) lack of infrastructure, and (iv) lack of incentives to take risk and invest.[35] Of these, the last merits further comment. It stands to reason that the risk/return profile of corporate entities, entrepreneurs and individuals in IDB member countries would be quite different from that in industrial countries.[36] As a result, there should be a difference in the pricing of risk between the two groups of countries.

While a broad agreement on the significance of all these factors has emerged over time, the discussion has often been based on anecdotal evidence. Of late, however, efforts are being made to quantify these factors. While the resulting data lack the comprehensiveness and precision of usual macroeconomic data, they are indicative of broad orders of magnitudes. In this section, then, we report on the results of one such data set that has become available through the courtesy of the World Bank.

1.3.3 Is Finance an Obstacle to Private Sector Development?

What are the main constraints to private sector development? In particular, is lack of finance a major obstacle to doing business? An answer to these questions is provided by the results of a major world-wide survey of the private entrepreneurs carried out by the World Bank in preparation for its publication, *World Development Report 1997*. One question in the survey asked entrepreneurs to rank, in terms of their severity, a list of 15 obstacles to doing business. Table 1.3 presents their responses from IDB member countries.[37]

With the exception of Mozambique, Mali, and Uganda, finance was not ranked among the top three obstacles to doing business mentioned by respondents. In the sample of 19 member countries, “tax regulations and/or high taxes” were by far the most frequent top constraints to doing business mentioned by respondents (8/19).

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[34] These initiatives involve state enterprise reform, privatisation, and the resolution of contractual disputes with independent power producers (IPPs). For details see the May 2000 MEFP, at the IMF website.

[35] In many instances, the prevalence of high interest rates on safe government bills and bonds, and high returns on a variety of rent-seeking activities have also hampered genuine investment.

[36] It has been suggested that the spirit of entrepreneurship may also be lacking, especially in CIS member countries. We are indebted to Yusuf Balci for this observation.

[37] The survey did not distinguish between working capital finance and investment finance.

Table 1.3 Is Finance an Obstacle to Doing Business? 1996-97 Survey Results

Scale: 1 ("No") to 6 ("Very Strong")

	Average		Score by Firm Size			Foreign Partici-pation	Expor ters	Bigger Obstacles[1] (See Key)
	Score	Rank	Large	Mid	Small			
Benin	3.7	7	4.0	3.9	3.6	2.7	3.6	ngkhml
Cameroon	4.6	5	3.4	4.4	5.1	3.8	4.3	hn g-m
Chad	3.4	9	6.0	1.8	4.8	3.5	3.8	ngchf i-l m
Guinea	4.2	5	4.0	3.8	4.6	3.9	4.3	nghm
Guinea-	4.6	5	..	5.5	4.1	5.0	4.0	kl m-f
Bissau	4.1	3	3.9	4.4	4.1	4.4	4.4	gn
Mali	4.9	2	4.5	5.2	5.1	4.8	5.2	m
Mozambique	3.3	8	2.5	3.2	4.1	3.4	3.1	gnefhcl
Senegal	3.9	6	3.8	3.4	3.9	3.8	4.2	gkfin
Togo	4.6	3	4.4	4.9	4.5	4.6	4.7	gn
Uganda								
Jordan	3.5	8-9[2]	3.7	3.4	3.3	3.3	3.4	ghinlba
Morocco	3.9	5	2.4	4.3	6.0	2.6	4.3	nhge
Palestine[3]	4.2	4	..	3.8	4.4	2.8	4.4	hci
Malaysia	2.7	11	2.6	2.8	3.0	2.7	2.6	eknaglcjh
Turkey	4.1	6	4.1	4.1	4.0	3.9	4.1	m
								kilgh
Albania	3.9	6	2.0	3.4	4.0	3.9	3.7	hmngo
Azerbaijan	3.9	9	1.0	3.8	3.9	3.7	3.0	ginmlhfk
Kazakhstan	4.4	7	4.2	4.4	4.4	4.6	4.5	gnilmk
Kyrgyzstan	4.1	6	6.0	3.2	4.1	4.0	4.1	gnmil

Note: Respondents were asked: "Please judge on a six point scale [1-2: No, 3-4: Moderate, 5-6: Very Strong] how problematic these different policy areas are for doing business (Please do not select more than 5 obstacles as the very strong (6))." They were given 16 choices (see footnote 1 to this table, just below).

[1] Based on country averages, ranked in order of severity. Key: (a) Regulations for starting business/new operations, (b) Price controls, (c) Regulations on foreign trade (exports, imports), (d) Financing, (e) Labour regulations, (f) Foreign currency regulations, (g) Tax regulations and/or high taxes, (h) Inadequate supply infrastructure, (i) Policy instability, (j) Safety or environmental regulations, (k) Inflation, (l) General uncertainty on costs of regulations, (m) Crime and theft, (n) Corruption, (o) Terrorism, (p) Other." Hyphenated letters represent a tie.

[2] Tied with "Inflation" for 8th position.

[3] West Bank and Gaza Strip

Source: World Bank

This frequency rises to 12/19 if the top two constraints are considered, and to 13/19, if the top three are considered. The second most frequent top constraint cited was "corruption" (4/19). This frequency rose to 10/19 if the top two constraints are considered, and to 13/19, if the top three are considered.[38] Finally, the third most frequent top constraint cited was "inadequate supply infrastructure" (3/19).

[38] It is likely that the high frequency of responses on taxation and corruption may reflect the fact that they are often two sides of the same coin.

This frequency rose to 4/19 if the top two constraints are considered, and to 6/19, if the top three are considered.

Other obstacles that are mentioned among the top three obstacles are: inflation (5/19), policy instability (4/19), crime and theft (4/19), labour regulations (2/19), foreign currency regulations (1/19), and general uncertainty on costs of regulation (1/19). Perhaps surprisingly, in addition to finance, none of the following merited a mention among the top three constraints: regulations for starting business, price controls, safety or environmental regulation, and terrorism. A closer look at the regional and country data sheds some more light on these constraints. First, however, the case of the three countries where finance was cited as a major obstacle to doing business merits a closer look. The question is whether this constitutes a seasonal or country-specific phenomenon, not inconsistent with the finding that finance is of secondary importance, or not?

In Mozambique, only "crime and theft" is cited as a bigger constraint to doing business than finance.[39] Ranked after finance, in order of severity, were inflation, corruption and taxation. Clearly, the top concern reflects the residual effects of the country's 16-year civil war that came to an end in 1992, with the signing of the peace accord. The squeeze on finance reflects the government's stabilisation efforts. The rate of inflation in Mozambique was consistently high from 1987 to 1995, averaging 47%, but it plunged in 1996 to 17% from a peak of 70% in 1994.[40] This was accomplished by a marked tightening of monetary policy since 1995.[41] At the same time, tax rates have risen, as part of the government's fiscal efforts. Partly as a result, corruption is thought to have increased significantly during the years immediately preceding and following the peace accords.

In Mali and Uganda, taxation and corruption were cited as bigger constraints than finance.[42] After finance, in order of severity, infrastructure, crime and regulations were cited as major constraints in Mali; and crime, infrastructure and policy instability, in Uganda. The singling out of finance as a major constraint to business operations in Uganda is understandable in the light of economic developments in the country. Since the National Resistance Movement took power in 1986, Uganda has seen reasonable economic growth, with generally low, stable rates of inflation. While average income remains low, Uganda is currently considered to be a major success story in Sub-Saharan Africa. As a result, private investment has risen steadily from 5.7% of GDP in 1989 to reach 10% in 1995, and beyond. In many ways, Mali is also a success story. With the transition to a democratic form of gov-

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[39] Crime and theft feature prominently in responses from the CIS and African member countries of the Bank, but are not significant in those from Arab and Asian members.
[40] For an analysis of inflation in Mozambique, see IMF (June 1998).
[41] The business class in Mozambique is quite thin. The primary activity is trading and distribution, although this is changing. Distribution systems are nascent. Many Mozambicans engaged in international trade take advantage of personal ties to Portugal, South Africa, Zimbabwe, or India to accomplish their commerce. Until recently, the country has been served by a handful of banks specializing in short-term, trade-related finance and fee-for-service business. The market supported few medium-term loans.
[42] A recent government survey of households found that judiciary and police are among the most corrupt institutions. See Republic of Uganda (1998).

ernment in 1992, and a 50% devaluation of the CFA Franc, in concert with its WAEMU partners, in January 1994, the last decade of economic reforms in Mali appear to be bearing fruit. While private investment, on average, has risen from 9.9% of GDP during 1985-90, to 12.5% during 1990-98, the rate of investment has fallen slightly in recent years, from a peak of 13.9% in 1996. Nevertheless, the expression of demand for finance to promote business is encouraging.

In the seven other African countries in our sample (of 10 African countries), corruption was the most frequent top constraints to doing business mentioned by respondents (3/7). This frequency rises to 5/7 if the top two constraints are considered. The second most frequent top constraint cited was "tax regulations and/or high taxes" (2/7). This frequency rose to 5/7 if the top two constraints are considered, and to 6/7, if the top three are considered. Finally, the third most frequent top constraints cited were "inadequate supply infrastructure" and "inflation" (1/7). For infrastructure this frequency rose to 2/7 if the top two constraints are considered, and to 4/7, if the top three are considered. Inflation was cited as a top constraint only in Guinea Bissau, and as the 3rd most frequently mentioned constraint in Benin.

Box 1.3 Mali: Chronology of Pricing & Trade Policy Reforms

1986
Price controls limited to 58 strategic products.
Elimination of all export monopolies
1988
Elimination of all but two import monopolies
1990
Start of pre-shipment inspection & verification of imports
Price controls reduced to 4 products
Import/export licensing replaced with registration system
All export taxes and restrictions abolished
1991
Price controls limited to petroleum products
1992
Price controls on petroleum products eliminated
Liberalised price system maintained

- IMF (April 1999)

In sum, with the exception of Mozambique, Uganda and Mali, businessmen in all other African member countries in the sample did not consider lack of finance to be a major constraint to doing business.[43]

Among the three Arab member countries covered by the survey, excessive taxation and inadequate infrastructure featured in the top three complaints by entrepreneurs in Jordan and Morocco. In Jordan, policy instability was also cited, while corruption was cited as the main constraint in Morocco. As can be expected, in The State of Palestine, inadequate infrastructure, excessive regulations, and policy instability were cited as the key constraints to private sector growth. Among problems faced by business, lack of finance ranked 5 in Palestine, 6 in Morocco, and was tied for 8th place (with inflation) in Jordan. Once again, these results are not surprising in the light of country background.

[43] This is somewhat at variance with earlier findings. On the basis of panel data for Cameroon, Ghana, Kenya and Zimbabwe, Bigsten et. al. (1999) report that financial constraints was "the most common reason advanced for low levels of investment." Earlier, Marsden (1990) had found that "the development of African private enterprise is being retarded by inadequate access to bank credit." See also Pedersen and McCormick (1999) for a supplementary perspective on impediments to business – arising from institutional segmentation between parastatals, foreign-dominated formal, and indigenous informal, sectors; and from lack of state support

1. INTRODUCTION

Morocco has a vibrant private sector, accounting for 70% of total investment, three-fourths of output, and some three-quarters of urban, and over half of rural, employment. Nevertheless, average annual growth rates have fallen in the 1990s (to 2.2% during 1990-98, compared to 4.8% during 1985-89, and 4.7% during the decade before). This reflects a slowdown in both exports and private investment. The major constraints to private sector growth in Morocco arise from macroeconomic difficulties. Public savings remain low, squeezing public investment – especially in infrastructure, to which the survey results allude – without a compensating rise in private investment. An appreciation in the effective exchange rate in the 1990s, and slow progress in privatisation may also have restrained export growth. In addition to these macroeconomic problems, Morocco also faces the usual institutional constraints – lack of competitive markets, weak regulatory incentives to competition (except in telecommunications), administrative and procedural bottlenecks, and paucity of trained manpower.

Unlike Morocco, economic growth in Jordan jumped from an annual average of 2.5% during the 1980s to 5.4% during 1990-98. The private sector – including a dynamic small and medium enterprise (SME), and a micro-enterprise, sector – contributed to and benefited from this growth. Further development of the private sector will depend on both external and internal factors. Prosperity in Jordan is linked inextricably to war and peace in the region. Developments on this front affect Jordan's prospects for budget support, workers' remittances, and regional export prospects (largely determined by oil prices). Internally, the government faces a large debt burden, and a limited resource base of the economy.[44] It is quite understandable therefore that businesses in Jordan found finance to be extremely low in their list of problems.

Among the two Asian members surveyed, Malaysia and Turkey, lack of finance as a constraint to business operations ranked 6 in Turkey and 11 Malaysia. Businessmen in Malaysia cited labour regulations as the main constraint to doing business, followed by inflation, and corruption.[45] In Turkey, understandably, inflation topped the list, with policy instability, and general uncertainty about the cost of regulations as the second and third most frequent responses.

Among the Albania and CIS member countries also finance was not cited as the key problem. In Albania and Kyrgyzstan it was ranked 6th in frequency of response, while in Kazakhstan it was 7th, and in Azerbaijan, 9th. In Albania, infrastructure, crime, and corruption are cited as the major obstacles to doing business. By contrast, in the three CIS countries sampled, "tax regulations and/or high taxation" ranks as the biggest obstacle, with corruption and policy instability as close seconds. In the Kyrgyz Republic, "crime and theft" ranks ahead of policy instability as a severe obstacle.

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[44] In May 1999, the Paris Club rescheduled about US$ 800 million in debt service obligations, but this was far short of Jordan's request.

[45] Other than Malaysia, only Morocco in our sample of countries cited labour regulations as a constraint (at rank 4). This factor did not appear in the list of constraints for any other country in our sample.

1.3.4 Can the Public Sector Promote Private Sector Development?

The existence of markets and instruments for the mitigation of risks is an essential ingredient of any strategy for private sector development. In IDB member countries, especially those that are least developed, it is thought that these risks are the greatest obstacle to private sector development. Historically, governments have had a large role to play in the creation and regulation of these markets. Even in later stages of development, when the private sector has taken up some or most of the responsibility for self-regulation, governments have continued to exercise an important role in monitoring and ensuring fair play. Not only do governments have a role to play in financial markets, but as is now widely recognised (especially in the light of the East Asian experience), government support is an essential precondition for the development of the private sector.

1.4 Macroeconomic Policies and Savings in the Formal Sector

There is controversy – both theoretical and empirical – on how successful macroeconomic policies have been in mobilising savings in the formal sector.[46] Even so, there is a consensus that the saving rate rises with per capita income, and falls with higher proportion of the elderly and the young, in comparison to persons of working age, in the population (dependency ratio). With only a handful of exceptions, if any, it now seems clear to all that higher interest rates do not lead to higher saving.[47]

More interestingly, it is not clear that a rise in the government deficit leads to an equal, or almost equal, fall in private consumption (and hence, rise in saving).[48] Based on a study on panel data,[49] Edwards (1995) concluded that: “While private savings respond to demographic variables, social security expenditures and the depth of the financial sector, government savings do not. Government savings, on the other hand, are affected by … the degree of political instability of the country in question. However, both private and government savings are affected by real growth and by the current account balance or foreign savings.” Mason, Bayoumi, and Samiei (1998) conclude that “there seems to be a substantial offset of changes in the government fiscal position from private saving, averaging 75 percent, depending on whether those changes are due to changes in government spending or in taxes” – with spending reduction having a larger impact.[50]

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[46] For a recent review of the determinants of private saving at the macroeconomic level see Masson, Bayoumi, and Samiei (1998), on which the discussion here draws. Browning and Lusardi (1996), and earlier, Deaton (1992) and King (1985), provide a survey of the literature on household saving behaviour.
[47] See section 4.4.1 below.
[48] A full offset is referred to as Ricardian Equivalence.
[49] The data covered 36 countries, including 9 IDB members: Cameroon, Iran, Malaysia, Morocco, Pakistan, Sierra Leone, Togo, Tunisia, and Turkey.
[50] Foreign saving are thought to have a similar offsetting impact on private saving. The offset, “though large, is only partial,” according to Masson, Bayoumi, and Samiei (1998).

Also, it has been suggested that an improvement in the terms of trade may lead to an increase in the rate of saving.[51] There is evidence to support this in industrial countries, and perhaps for developing countries, but the results are not robust.

Where data on private investment are scarce, those on private saving, much less broken down by household and corporate saving, simply don't exist.[52] As a result, we rely in this section of some rough estimates prepared for this paper (presented in Statistical Annex, Table 2.4). Based on these estimates, the position of IDB member countries is shown in Table 1.4.

Table 1.4: Rates of Private Domestic Saving (% GDP), 1998

Negative	Zero	Positive Growth			
High (< 0%)	**Very Low (0-5%)**	**Low (0-10%)**	**Moderate (10-20%)**	**High (20-30%)**	**Very High (> 30%)**
African Members					
Comoros Sierra Leone	Chad Mozambique Guinea Bis-sau Gambia Niger	Uganda Togo Benin	Burkina Faso Mali Senegal Cameroon Guinea		
Arab Members					
Palestine Djibouti	Lebanon	Jordan Yemen Mauritania Egypt	Syria Morocco	Tunisia Algeria Kuwait	Saudi Arabia Bahrain
Asian Members					
		Maldives	Iran Pakistan Bangladesh	Turkey Indonesia	Malaysia
Albania & CIS Members					
	Albania		Azerbaijan Kazakhstan Kyrgyzstan		

Note: Based on author's estimates of private saving rates. Briefly, the current budget surplus is used as a proxy for public saving, and private saving is derived residually from domestic saving.
Source: Statistical Annex, Table 2.4.

In the absence of data on the breakdown of private saving by households, businesses and government it is not possible to analyse the state of saving in member countries further. This is because the average saving rate in most developing countries represents an averaging of large saving by the private sector with a large dis-saving by government.

In addition to the national accounts classification of savings, an area that has received considerable policy interest in the last decade has been the area of contrac-

[51] The so-called Harberger-Laursen-Metzler effect. A transitory change in the terms of trade, it is argued, will lead to a transitory change in income, and therefore to a change in saving (not consumption), while a permanent change would have ambiguous effects.
[52] Such data as are available are from sample surveys in individual countries.

tual savings – pension funds and life insurance.[53] Neither are "saving" in the economist's sense of the term – an excess of production over consumption – but rather, they represent reciprocal obligations that do not constitute a net asset of a nation. These obligations, however, can be a source not only of capital market development but also of Islamic financial innovation, and therefore merit policy attention. An example of the latter is the justly acclaimed *Tabung Haji* scheme in Malaysia, which is among the oldest of modern Islamic financial institutions, and merits replication elsewhere.[54] Among conventional schemes in IDB member countries, however, pensions are likely to be far more important than life insurance, because of their greater acceptability under Islamic law (*shari`ah*). In the absence of comparative data, however, it is difficult to discuss the scope for expanded recourse to Islamic forms of contractual saving, beyond generalities.[55]

1.5 Summary

This paper examines institutional requirements for the development of financial markets, to strengthen the private sector in member countries of the Islamic Development Bank (IDB). It is based largely on a selective review of readily available information and data, primarily from international financial institutions. In 1999, the overall size of the private sector in IDB member countries was an estimated US$ 940 billion. While investment rates are low, most member countries have registered high growth of investment since the 1980s. Where investment rates have declined, country-specific factors account for the shortfall from average performance of IDB members.

The principal constraints to private entrepreneurial activity in member countries are poor law and order conditions, corruption and high taxes, paucity of infrastructure, and lack of incentives to take risk and invest. Surprisingly, surveys of businessmen in IDB member countries reveal that lack of finance is not among the top three constraints to doing business in most member countries. In the absence of data, the paper presents original estimates that suggest that private domestic saving in member countries may be both higher and rising faster than private investment.[56]

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[53] For a discussion of policy and regulatory issues relating to contractual saving, see Glaessner and Valdés-Prieto (September 1998), and Vittas (March 1998, and November 1997).
[54] The scheme allows Muslims to contribute to a saving scheme to finance their pilgrimage (*Hajj*). The sponsors of the scheme invest the funds in Islamic ways, and provide education and assistance to pilgrims to enable them to perform *Hajj* in a religiously desirable way.
[55] Note, however, that Turkey has recently announced a major reform of pensions. See IMF (February 2000).
[56] The interesting implication that capital is flowing out of the (formal) private sector would be consistent with rising fiscal deficits, induced by rising debt burdens, as well as with increased capital formation in the informal sector, but data limitations preclude further exploration of these issues.

2. THE STATE OF FINANCIAL MARKETS

The financial sector consists of banks and non-bank financial intermediaries (NBFIs). The banking sector comprises of the central bank, commercial banks, and any other deposit-taking institutions. The defining feature of “non-banks” is that they do not accept deposits. Accordingly, NBFIs may consist of finance companies,[57] development finance institutions (DFIs), stock exchanges, brokerage houses, venture capital companies, insurance companies, investment funds, and pension fund managers, among others. Securities markets include money markets, where short-term instruments like treasury bills, certificates of deposit, and commercial paper are traded, and capital markets, which provide debt and equity finance through longer-term bonds and equities.

2.1 Macroeconomic Policies and Financial Markets

Financial markets are affected by conditions in the real economy – both macroeconomic and structural (supply-side) – which provide the signals to which financial markets respond. Where these conditions create reasonable certainty about real activity – output, employment, prices, etc. – the risk of financial “mistakes” and the likelihood of financial problems are reduced. Macroeconomic stability requires the avoidance of unsustainable debt or financial imbalances, especially by government, whose reversal can lead to sudden large shifts in asset prices and to instability in the real economy. Equally financial markets respond well to signals that create incentives for efficient resource allocation, across sectors and over time.

What constitutes good macroeconomic policy? Essentially, macroeconomic policies should seek a sustainable growth path that avoids sharp upturns and downturns that create market uncertainty and increase real and perceived risks. Second, price and exchange rate stability reduces uncertainty about relative prices, and provides incentives to enter into long-term contracts. Third, sound public finances are essential, with prudent recourse to deficit and debt. Fourth, both public and private saving should be adequate to finance domestic investment, without unsustainable recourse to foreign borrowing. Fifth, exchange and trade policies, as well as policies relating to the capital account, should ensure that the external payments position is sustainable. Finally, macroeconomic policy instruments should not only be adequate, but also must be seen to be consistent with conditions in the real economy, so as to be credible in the market. This requires clear, transparent and internally consistent policy commitments by the government.

Governments should also be sensitive to the impact of macroeconomic policies on the real economy. Tax policies should not only be stable and predictable, but should also ensure that incentives to production and investment are optimal. Equally, it is the task of government to ensure that product and factor markets are efficient, competitive and flexible. In many ways it is real conditions in the economy that determine the scale of investment activity in the economy, and the derived

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[57] Analytically, it has been argued that the more Islamic Islamic banks become, the more they would resemble investment companies. See Errico and Farahbaksh (March 1998). This has important implications for performance assessment, regulation and supervision of Islamic banks (see section 4.4.5).

demand for financial services. Structural – or supply-side – policies should seek to ensure therefore that relative prices are in line with economic fundamentals. Sound structural conditions promote the smooth adjustment of prices and quantities to changing economic conditions, and reduce risks that asset values will be impaired by sudden shifts of relative prices. Finally, structural policies affecting the financial sector need to ensure its efficient operation, stability and robustness.

In addition to conditions in the real economy, financial market performance is dependent on a complex network of institutions and practices, loosely referred to as financial infrastructure. This consists of prudential supervision and regulation of financial institutions, laws and mechanisms of dispute resolution, accounting and other information systems, payment and settlement systems, and arrangements for dissemination of legal, regulatory and financial information.

2.1.1 African Member Countries[58]

In discussing the state of the financial sector in the 16 African member countries of the IDB, it is useful to distinguish between the 11 members of the CFA Franc zone and the 5 Non-CFA members (Table 2.1).[59]

Table 2.1 Participation in Regional Arrangements by African IDB Member Countries

	CFA Franc Zone			
	West African Economic and Monetary Union (WAEMU)	*Central African Economic and Monetary Community (CAEMC)*	*Other*	**Non-Franc Zone**
IDB Members	Benin Burkina Faso Guinea Bissau [1] Mali [2] Niger Senegal Togo	Cameroon Chad Gabon	Comoros	The Gambia Guinea Mozambique Sierra Leone Uganda
Non-IDB Members	Côte d'Ivoire	Central African Republic Republic of Congo Equatorial Guinea		

[1] Guinea Bissau joined in 1997.
[2] Mali withdrew from the Union (then, the West African Monetary Union, WAMU) in 1961 and rejoined in 1984. WAEMU was created in 1994.
Source: Bhatia (1985) and Hernández-Cáta (1998).

The CFA Franc zone consists of the 7 members of the West African Economic and Monetary Union (WAEMU), the 3 members of the Central African Economic and

[58] This section relies mainly on Mehran et. al. (1998), Hernández-Cáta (1998), Bhatia (1985), and Popiel (August 1994). See also World Bank (2000, and 1989b).
[59] CFA stands for the Communauté Financière Africaine in the WAEMU countries and Comoros, and Coopération Financière en Afrique in the CAEMC countries. The WAEMU members are served by the Central Bank of West African States (BCEAO); CAEMC, by the Bank of Central African States (BCEAO).

Monetary Community (CAEMC), and the Islamic Federal Republic of Comoros. The Non-Franc zone consists of three West African countries (The Gambia, Guinea, and Sierra Leone) and Uganda and Mozambique. All African member countries of IDB are also in the World Bank's "Sub-Saharan Africa" (SSA) group.[60]

As is well known, economic growth in Africa suffered a major and extended slow-down in the 1970s that lasted until the mid-1990s. This structural development placed burdens not only on governance in general, but on public finances in particular. As a result, macroeconomic stability was undermined, further exacerbating structural pressures on economic performance. While a substantive discussion of macroeconomic performance in IDB's African member countries is not possible in this paper, key statistics are presented in Table 2.2.

Table 2.2 Key Macroeconomic Indicators for African Members of IDB

	Output Growth (% p.a.)			Inflation (% p.a.)			Fiscal Balances (% GDP)		
	'85-89	'90-98	1999	'85-89	'90-98	1999	'85-89	'90-98	1998
CFA-11									
Comoros	1.3	-0.2	-15.0	3.9	4.4	3.0	11.2	-3.3	-3.0
WAEMU-7									
Benin	1.5	4.5	5.0	..	..	1.0	11.5	-2.1	2.0
Burkina Faso	4.4	3.4	3.7	-0.9	5.7	-1.0	-17.4	-3.3	-2.9
Guinea Bissau	3.1	1.7	8.7	..	43.3	-0.9	-6.1	-12.8	-10.7
Mali	0.1	3.7	5.2	1.3	5.4	-1.1	-5.4	-3.1	-2.4
Niger	4.2	1.7	2.3	..	..	3.0	-4.8	-3.8	-1.9
Senegal	3.5	2.7	5.1	1.7	5.9	0.8	-2.0	-0.9	0.0
Togo	3.4	1.7	2.1	0.7	8.6	-0.1	-3.7	-6.7	-5.1
CAEMC-3									
Cameroon	-0.1	-0.1	4.4	6.4	6.3	0.0	-5.2	-5.0	-1.6
Chad	4.9	4.2	-1.1	..	..	-8.4	-4.2	-5.9	-4.9
Gabon	-1.4	3.3	-5.8	1.0	6.8	2.0	-7.1	-1.2	-4.1
Non-CFA-5									
The Gambia	3.3	2.5	4.2	24.3	4.7	2.5	3.8	-2.6	-2.5
Guinea	4.0	4.8	3.7	30.5	8.3	4.5	-5.4	-3.5	-3.2
Mozambique	6.0	5.0	9.7	68.4	40.1	1.7	-8.1	-3.6	-2.4
Sierra Leone	0.8	-4.4	-8.1	92.4	39.3	29.6	-13.0	-8.4	-10.0
Uganda	3.4	7.1	7.8	158.9	17.4	-0.2	-3.6	-3.3	-0.6

Source: World Bank, *Africa Database*, CD-ROM. 1999 data from IMF *WEO* (May 2000)

In comparison to the second half of the 1980s, a number of countries had resumed stable economic growth in the 1990s, with sustainable fiscal balances. In this category, the turnaround in economic growth in Benin, Mali and Uganda is especially noteworthy, while Mozambique has held on to its high growth path. Except for Mali, where there has been a slight acceleration in the rate of inflation, this growth has been accompanied by price stability, with dramatic success in price stabilisation in Uganda. With the exception of Benin, which appears to have enjoyed a substantial

[60] The World Bank classifies all African countries other than Algeria, Egypt, Libya, Morocco, Tunisia in the North, and Namibia and South Africa in the South, as Sub-Saharan Africa. Also Burkina Faso, Cape Verde, Chad, Gambia, Guinea Bissau, Mali, Mauritania, Niger, and Senegal are referred to as Sahelian Economies. See World Bank (1989b).

budget surplus in the late 1980s, overall fiscal deficits have also been contained in recent years. The other countries, however, have not been so fortunate. Among the worst hit is Sierra Leone, where continuing violence has led to current levels of domestic output that are over 40% below those of 1990, while inflation has soared. Growth rates in Comoros and Sierra Leone have turned negative in the 1990s, while the economy of Cameroon has continued to stagnate in the 1990s.

These prolonged adverse structural and macroeconomic developments have had a profound impact on financial markets. Banking, in most African countries, started with "colonial banks" that served expatriate enterprises engaged in developing the agricultural cash crop, mineral extraction, and local services like oil, retailing, and equipment. Through branch networks they offered saving, money transfers, and limited credit facilities to small businesses, salaried employees and other borrowers. As they did not penetrate the indigenous economy, African governments developed government-owned commercial banks after independence. By aggressive banking, they were able to exploit the segmented nature of the banking services market to make inroads into those sectors of the local economy that were not served by the colonial banks. Where public sector involvement in utilities or manufacturing grew, they were also enlisted in financing state enterprises.[61]

The weak macroeconomic background affected the growth of banking. Not surprisingly, with economic recession, there was little growth in the demand for banking services. As a result many colonial banks were acquired by banks abroad. Those that were not so fortunate found themselves severely weakened, and indigenous banking did not develop. At the same time, national banks found themselves beset with the management problems and the financial consequences of political decisions. Until the 1990s therefore the financial sector in most African countries, including IDB members, remained weak and underdeveloped. Table 2.3 presents key indicators of banking system structure in selected countries.

In these circumstances, informal financial markets have continued to play a major role in providing for the credit needs of the indigenous economy. Although the government, government-sponsored enterprises (parastatals), and larger private firms acquire credit – when liquidity permits – through banks, much of the rest of the economy operates outside the formal financial system. By far the most common are group saving schemes, known by a variety of names in different member countries, that are either rotating or non-rotating. Rotating saving and credit associations (ROSCAs or *tontines*) are a popular way to save for the purchase of indivisible goods. In non-rotating saving associations, savings are pooled in a fund, without distribution at each collection. The fund is then used to provide emergency loans to members, serving as a means of mitigating risk and providing mutual insurance. A variety of other arrangements, that are well known, characterise the informal financial sector in member countries.[62]

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[61] In rare cases, foreign banks were nationalised (Tanzania), or specialised banks were used (Angola, Ethiopia, and Mozambique). In Mozambique a small foreign-owned bank, the Standard Tota, continued to operate, but otherwise the banking system was typical of centrally planned economies. Mehran et. al. (1998), on which this relies.

[62] For a recent review of theory and experience see Aryeetey and Udry (1997).

Table 2.3 Structure of the Banking System in Selected African Member of IDB, 1997

	BCEAO	BEAC	Mozam-bique	Uganda
Number of licensed banks, of which	53	30	8	20
Branches of foreign banks	5	2	1	0
Subsidiaries of foreign banks	22	7	-	11
Total assets (% of GDP)	28.8	15.1	20.7	14.9
Total loans (% of GDP)	19.3	12.8	23.4	5.2
Total deposits (% of GDP), of which	22	12	28.6	7.9
Central government	18.7	1.8	2.4	13.4
Non-interest expenses (% of total income)	49	..	..	51.6
Return on equity (%)	8.3	<0 to 20	..	2.6
Return on assets (%)	2.3	<0 to 3	..	0.2
Major[1] deposit-taking institution	..	Yes[3]	..	no
Major[1] non-bank financial institution	no	No	..	no
Reduction in government control[2]	no[4]	No[5]	yes	yes
Mergers and acquisitions[2]	yes	Yes	yes	no
Non-performing loans (% total)	6.2	6	15	38.2
Provision for loan losses & doubtful debts				
General provisions (% loans & advances)	..	..	2.7	[6]
Specific provisions (% non-performing)	19.6	..	56.2	47.6

[1] With more than 5% of total banking assets
[2] During last five years.
[3] Savings Bank.
[4] But underway
[5] But privatisation planned.
[6] At least one, but not required
Source: Mehran et. al. (1998).

2.1.2 Arab Member Countries

Among the 21 Arab member countries of IDB, six are least developed (Djibouti, Mauritania, State of Palestine, Somalia, Sudan and the Yemen Republic), seven are lower-middle income (Algeria, Morocco, Tunisia, and Egypt, Syria, Iraq, and Jordan), and eight are higher income countries (Bahrain, Libya, Oman and Saudi Arabia being upper middle income, and Kuwait, Qatar, and United Arab Emirates, high income countries). Given the scope of this paper, it would be impossible to do justice to describing the state of the financial sector in all these countries, or even in the three groups described. Somewhat arbitrarily, therefore, in this section, a brief description of the middle group of member countries is given. Basic data and key macroeconomic indicators for these countries are presented in Table 2.4.

The Maghreb countries have experienced a high rate of economic growth with considerable price stability. Nevertheless, unemployment in Algeria and Morocco remains high. There is little public information about the state of the financial sector in these countries. Although foreign banks have been allowed recently, the involvement of the public sector in banking remains high, and the pace of reforms is thought to be slow. By contrast, the banking system in Morocco is thought to be doing well. This is reflected in the rise in financial depth. According to comparative statistics (Chapter 4, Table 4.5), Tunisia is thought to have the most developed financial sector in the Maghreb, but once again there is little public information to assess the state of the sector.

Table 2.4 Macroeconomic indicators for Selected Arab Members of IDB, 1998

	Algeria	Tunisia	Mo-rocco	Egypt	Jordan	Syria
Basic Data						
Population (million)	30	9	28	61	5	15
GNP per capita in US$	1,550	2,060	1,240	1,290	1,150	1,020
Share of industry in GDP (%)	47	28	32	32	26	..
Share of agriculture in GDP (%)	12	12	17	17	3	..
Macroeconomic Indicators						
Real GNP Growth (%)	5.8	5.5	7.0	6.3	3.3	0.2
Inflation (% p.a.)	5.8	3.1	2.9	4.7	4.5	-0.4
Unemployment (%)	28.1[c]	5.7[d]	17.8[b]	11.3[c]	..	6.8[e]
Fiscal balance (% of GDP)	2.9[b]	-3.1[b]	-4.4[c]	-2.0[a]	-3.3[a]	-0.2[a]
Financial depth (M2/GDP %)	42.7	46.6	69.7	75.2	100.6	33.9
Interest Rates						
Lending Rate (one year %)	47.5	9.9[g]	9.0[f]	13.1	12.3[a]	..
Deposit Rate (one year %)	36.9	7.4[g]	8.5[f]	9.4	9.1[a]	..
Spread	10.6	2.5[g]	0.5[f]	3.7	3.2[a]	..

[a] 1997 [b] 1996 [c] 1995 [d] 1994 [e] 1991 [f] 1990 [g] 1988 .. not available
Source:.*WDI 2000*, *WEO May 2000*, *IFS*.

Among the other Arab members for whom data is presented in Table 2.4, Egypt has the highest growth and financial sector development, albeit with substantial unemployment. In comparison to Jordan, Syria's economic performance and financial sector development appears to be lagging.

2.1.3 Asian Member Countries

There are nine Asian member countries of IDB. Three are least developed (Afghanistan, Bangladesh and Maldives), three are low or lower-middle income (Pakistan and Indonesia, being low income, and Iran being lower-middle income), and three are higher income countries (Malaysia and Turkey being upper middle-income, and Brunei Darussalam, high-income countries). As data on Afghanistan, Brunei Darussalam, and the Maldives is not readily available, a brief description of remaining six member countries is given in this section.[63] Basic data and key macroeconomic indicators for these countries is presented in Table 2.5.

Once again, a description of the state of the financial sector in each of these economies is not possible within the scope of this paper. In generic terms, however, the state of the financial sector in Bangladesh and Pakistan is similar, while Iran, Indonesia, Malaysia, and Turkey are more unique in their characteristics. Of the latter group, however, there are some common aspects to the experience of Indonesia and Malaysia, in view of their geographical proximity, and their common experience of the Asian crisis.

[63] In 1998, Afghanistan's population was estimated at 25 million; Brunei Darussalam's at 315 thousand; and Maldives' at 263 thousand. Maldives has a 1998 GNP per capita of US$ 1,130, and GNP growth was 7.1 percent.

Table 2.5 Macroeconomic indicators for Selected Asian Members of IDB, 1998

	Bangladesh	Pakistan	Indonesia	Iran	Malaysia	Turkey
Basic Data						
Population (million)	126	132	204	62	22	63
GNP per capita in US$	350	470	640	1,650	3,670	3,160
Share of industry in GDP (%)	28	..	45	37	44	25
Share of agriculture in GDP (%)	22	..	20	25	13	18
Macroeconomic Indicators						
Real GNP Growth (%)	5.9	3.0	-16.7	1.5	-5.8	3.9
Inflation (% p.a.)	8.3	6.2	57.6	19.4	5.3	84.6
Unemployment (%)	..	5.4	4.0	..	2.5	6.4
Fiscal balance (% of GDP)	..	-6.3	-2.4	0.3	2.9	-8.4
Financial depth (M2/GDP %)	29.2	44.4	48.6	39.4	95.9	30.3
Interest Rates						
Lending Rate (one year %)	8.0	..	32.2	..	10.6	..
Deposit Rate (one year %)	8.4	..	39.1	..	8.5	80.1
Spread	-0.4	..	-6.9	..	2.1	..

Source:.*WDI*, *IFS*, *WDR*. [a] 1995 [b] 1996 [c] 1997 .. not available

In Bangladesh and Pakistan, commercial banks dominate the financial system, accounting for a disproportionately high share of financial sector assets – 97% in Bangladesh. Within the banking sector, there is considerable concentration – in Bangladesh, four nationalised commercial banks have accounted for over 60% of assets since the mid-1990s, while private domestic banks account for about 32%, and foreign banks for the remaining 6-7%. In both countries, the banking sector has been in distress for well over a decade. The key problem has been a premature liberalisation of the financial sector – both in terms of inadequate prior macroeconomic stability, and the establishment of effective arrangements for prudential regulation and supervision. While both governments are making significant efforts to put in place more effective mechanisms, a great deal remains to be done. Equity markets in both countries have been volatile – in Bangladesh, the stock market has yet to recover from the crash of 1996/97, while the market in Pakistan remains affected by macroeconomic and political uncertainties.[64]

Information on the financial sector in Iran is not readily available. As of late 1997, the financial system in Iran consisted of the central bank, six commercial banks, and four specialised banks, all government-owned. The six commercial banks had 11,000 domestic branches (up 20% from six years ago) and 62 foreign branches, while the specialised banks had some 2,000 domestic branches (up 36% from six years ago). In 1997, the first private non-bank financial institution started operations in Iran. In addition, there are insurance companies, pension funds, and investment and leasing companies, most government-owned. Commercial banks accept demand, time and saving deposits; engage mainly in short-term lending, primarily to the private sector and public non-bank financial enterprises; and act as agents of depositors in the investment of funds. The profits (losses) are then distributed to the depositors depending on the amount and duration of the investment.

[64] IMF (May 2000). For greater details see also IMF (March 2000).

Specialised banks lend mainly on a long-term basis (five years or more), and have equity participation in the agricultural, industrial, mineral, housing and export sectors. Their sources of funds are low cost, long-term government deposits and loans, except the housing bank, whose resources are largely private deposits.[65]

In Turkey, "macroeconomic instability – characterised by chronic inflation, wide swings in output, volatile interest rates, and persistent fiscal imbalances – has been the norm…during the last two decades."[66] The banks have also had to finance the government's budget deficit, and meet the credit needs of public and private sector institutions. This has led to high and variable interest rates, with the result that banks have been limited in their ability to transform the maturity of their assets and liabilities. At end-1998, the average maturity of all assets was under four months, and for liabilities, a little over a month. This has led banks toward arbitrage and shorter-term lending, at the expense of traditional banking services. Public sector borrowing has crowded out the private sector, with the result that government securities comprise over 25% of private banks' assets.

At end-1998, there were 4 state-owned commercial banks, 18 foreign banks, 15 investment and development banks (3 state-owned), and 39 private locally-owned deposit money banks. The state owned banks account for some 40% of deposits, and banking system assets. However, they have a quasi-fiscal role in directing subsidised credit, and undertaking treasury functions on behalf of government. By contrast, private banks account for 55% of banking system assets, 70% of net interest income, and 65% of banking system profits.[67] As elsewhere, concentration ratios tend to be high – four banks account for almost half of private bank assets. Also, most large private banks are owned by big industrial conglomerates, while the banks in turn own other financial institutions (leasing and insurance companies, brokerage houses, and even, smaller banks).

2.1.4 Albania & the CIS Member Countries

A decade after the dissolution of the Soviet Union, the so-called Transition economies continue to face major difficulties. Despite the unanticipated severity of the economic shocks, however, some progress has been made in restoring stability and laying the foundations for the resumption of growth. Naturally, this general assessment varies quite considerably from country to country. Indicators of vulnerability are high and rising for most IDB member countries in this region. Basic data and macroeconomic indicators for Albania and the CIS members of IDB are presented in Table 2.6.

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[65] This paragraph is reproduced, with minor editing, from IMF (April 1998).

[66] The rate of inflation averaged 20% during the 1970s, 40% during 1981-87, 65% during 1989-93, 85% during 1993-97, and reached 100% in late 1997, when the government launched its latest dis-inflation programme in 1998.

[67] In view of the high rates of inflation, however, there are serious questions about the accuracy of bank profits reported in Turkey. Average profits for 1997 and 1998, after monetary correction, are reported at 3% of average assets in Turkey, when OECD averages for 1994-96 range from 0.84% (in Hungary) to 1.79% (in the Czech Republic), with the exception of Poland (3.7%). See IMF (February 2000).

Table 2.6 Macroeconomic indicators for Albania and the CIS Members of IDB, 1998

	Albania	Azerbaijan	Kyrgyzstan	Tajikstan	Turkmenistan	Kazakhstan
Basic Data						
Population (million)	3.2	7.6	4.8	6.1	4.8	15.0
GDP per capita in US$	930	540	350	210	420	1,490
Share of industry in GDP (%)	12.2[c]	24.8[c]	15.5[c]	45.7	44.3[c]	22.5
Share of agriculture in GDP (%)	62.6[b]	20.0[c]	43.4[c]	8.8	19.8[c]	8.8
Macroeconomic Indicators						
Real GDP Growth (%)	8.0	10.1	1.8	5.3	4.2	-2.5
Inflation (% p.a.)	20.6	-0.8	12.1	43.2	16.8	7.3
Unemployment (%)	17.7	19.3[c]	3.2[c]	3.1	3.0[a]	3.7
Fiscal balance (% of GDP)	-10.4	-4.2	-9.9	-3.8	-2.7	-8.0
Financial depth (M2/GDP %)	52.0	10.2	15.0	5.9	11.8[c]	8.4
Non-performing loans (% total)	49[b]	20[b]	8[b]	..	14[b]	8[b]
Interest Rates						
Lending Rate (one year %)	35.0	27.7	42.5	73	48.7[c]	18.4
Deposit Rate (one year %)	16.5	10.9	29.5	80	47.2[c]	14.5
Spread	18.5	16.8	11.0	-7	1.5[c]	3.9

Source: EBRD (1999, 1998). [a] 1995 [b] 1996 [c] 1997 .. not available

These macroeconomic difficulties have added to the difficulties in effecting a financial sector transition. The bulk of the effort in recent years has been in putting together a legal framework, within which financial laws, regulations and standards can be located. Efforts to adapt the Basle core principles, and the recommendations of IOSCO, are proceeding on the basis of surveys conducted in 1998. The surveys have shown that while well-developed laws exist, dealing with both banking and securities activities, there are serious problems with enforcement and implementation of these laws. Despite initial setbacks, however, progress has been made in formulating and implementing minimum international standards in the financial sector. Table 2.7 presents key data on the state of the financial sector in Albania and the CIS member countries.

Albania's banking sector remains dominated by two state-owned banks, which together account for 70% of banking sector assets. Both are being privatised. With the advice, and likely participation of EBRD and IFC in the National Commercial Bank, a strategic investor was selected in May 1999. Under an IMF agreement, the government has agreed to privatise the other, Savings Bank, as well. While these two banks are still prohibited to expand net credit, due to their infected portfolios, the central bank is relaxing credit controls imposed in the wake of the 1997 collapse of pyramid schemes. These schemes have all been closed down and liquidation and asset recovery is taking place. Estimates of likely recoveries, which will distributed among depositors, are in the order of 2.5-5.0% of the US$ 1 billion that were deposited in these schemes.

Table 2.7 Financial Institutions in Albania and the CIS Members of IDB, 1997

	Albania	Azerbaijan	Kyrgyzstan	Tajikstan	Turkmenistan	Kazakhstan
Securities Commission	Yes	no	yes	no	no	yes
Insider dealing prohibited	Yes	yes	yes	yes	no	no
Secured transactions law	restricted	restricted	yes	yes	restricted	yes
Deposit insurance	no	no	no	no	no	no
Capital adequacy ratio (%)	6	8	8	10	8	8
Number of banks	9	99	20	24	15	82
of which: Foreign	*3*	*3*	*3*	*0*	*3*	*22*
Asset-share of state-owned banks	89.9	80.9	9.8	..	68.3	45.4
Bad loans (% of total loans)	91.3	19.9	7.5	..	13.9	7.7
Credit to private sector (% of GDP)						
Stock market capitalisation (% GDP)	..	..	2.8	..	..	5.9

Source: EBRD (1998) .. not available

Among the CIS members of IDB, consolidation of the banking sector and privatisation and restructuring of banks is proceeding slowly. Depositor confidence tends to be low; the banking sector, under-capitalised; and in many of the countries, the fragility of the banking sector may well be increasing. While member governments have been making progress in the passage of enabling legislation, with input from international financial institutions, the creation of effective capacity for prudential regulation and supervision of banks by the central banks is taking time. A domestic private sector has been slow to emerge, with the result that bank credit to private sector has not grown. In Kazakhstan, stock market capitalisation has grown to US$ 1.8 billion (9% of GDP), but turnover is low (US$ 43 million, including US$ 39 million on the over-the-counter market), with the result that liquidity remains a problem.

2.2 State of Supporting Environment

Over the last decade, it has been realised increasingly that institutional reform, much more than policy change, is the key to economic development. This is a new area of investigation, and data are only just beginning to be compiled, and refined, on the basis of a theoretical framework supplied by the new institutional economics tradition in economics.[68]

Within the overall social and political environment, the business environment and especially the financial sector infrastructure has a direct bearing on financial market performance. In this section therefore we review the state of accounting standards in member countries, the legal framework, and measures for controlling corruption. A final section on performance aspects concludes this chapter.

[68] Data on governance, defined “broadly as the traditions and institutions by which authority in a country is exercised” are provided in two papers by Kaufmann, Kraay, and Zoido-Lobatón (October 1999). A more recent, seemingly more comprehensive, database has been prepared by Beck et. al. (February 2000), as of late July 2000, it is not yet available on the World bank’s website.

2.2.1 Accounting Standards

Banks, and other financial institutions, not only provide financing, but also assess the returns and risks of business enterprises in the economy. In order to discharge this task, they must have access to accurate accounts. This must be ensured by appropriate laws, and regulations.

Currently, there are three accepted international accounting frameworks: International Accounting Standards (IAS), administered by the IAS Committee; US Generally Accepted Accounting Principles (US GAAP), by the US Financial Accounting Standards Board (FASB); and UK Generally Accepted Accounting Practice (UK GAAP), by the UK Accounting Standards Board (ASB). Most of the higher income members of IDB have moved, and are moving, toward the adoption of the IAS, with such modifications as may be necessary in the light of specific country situations (Box 2.1, on the next page). For the others, it is important that an emphasis on appropriate accounting policies and practices be an early part of programmes to promote the development of the financial sector and private investment.

There is, however, a need for fundamental research and study in devising appropriate accounting standards and practices for quasi-Islamic and Islamic business practices.[69] Of the former, accounting practices related to leasing – especially the distinction between finance and operating lease – are of special interest.[70] The IAS, FASB and ASB are in the process of revising their standards on lease accounting. A discussion paper published in late 1999 proposes to abolish the distinction between finance and operating leases, so as to move to a single approach to all leases.[71] This has important implications for member countries, that they may wish to take up within the IASC.

More fundamentally, modern accounting practices are based on notions of capital and interest in economics that may not be compatible with the *shari`ah*. The Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) in Bahrain has done commendable work in devising *shari`ah*-compatible accounting standards. The IDB, in association with AAOIFI, may wish to constitute a special group consisting of *shari`ah* scholars, economists, and accountants to look at the *shari`ah*-compatibility of the economic foundations of accounting.

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[69] Quasi-Islamic refers to practices evolved in non-Islamic contexts that are, or with minor modifications can be made to be, compatible with the *shari`ah*.

[70] Under an *operating lease* the lessee has use of the asset, against rental payment. By contrast, under a *finance lease*, all risks and rewards associated with ownership, other than legal title to the asset, is transferred to the lessee. Often, there is also a bargain purchase option. Accounting standards have been set for both lessors and lessees. The concepts behind lease classification in US standards are similar to those in IAS and UK GAAP. Unlike US GAAP, which has extensive form-driven requirements, however, IAS and UK GAAP place greater emphasis on underlying substance. See Pricewaterhouse Coopers (February 2000), on which this discussion is based.

[71] "All material leases would give rise to assets and liabilities for lessees, measured with reference to the payments required by the lease and any other financial liability incurred. Lessors would report financial assets (amounts receivable from the lessee) and non-financial assets (residual interests) as separate assets, reflecting the different property rights arising." Pricewaterhouse Coopers (February 2000).

Box 2.1 Compliance with Accounting Standards in Selected Member Countries

Egypt

In 1993, Egypt required listed companies to follow IASs when there were no national standards. Since 1996, national standards have been issued by the Society of Accountants and Auditors, which is a member of the IASC. These standards comply with IASs except for certain minor differences necessary to adapt the standards to the Egyptian environment.

Bahrain

Corporations and companies are required to prepare financial statements and file them with the ministry of commerce. The ministry and the society of accountant and auditors encourages the use of IASs and legal backing for IASs is under consideration. Since 1992, the monetary authority has required banks to comply with IASs. Most public companies and all banks issue IASs financial statements.

Kuwait

IASs have been adopted as national standards, with explanatory material added. The accountancy body is a member of the IASC.

Oman

The law requires all companies to prepare financial statements in accordance with IASs.

Turkey

Public companies, banks and other large companies must follow the accounting standards issued by the capital market board (CMB) and which are generally similar to IASs and which comply with the EU 4^{th} and 7^{th} directives. In the absence of a specific CMB standard, use of either industry practice or IASs is recommended. The accountancy body is a member of the IASC.

United Arab Emirates

IASs have been used as national standards on a voluntary basis for a number of years. A new law requires that all banks and financial institutions prepare IAS financial statements – many have done so for several years.

Pakistan

Accounting requirements are set out in the companies ordinance 1984 which requires listed companies to follow IASs adopted in Pakistan. All current IASs except the revised IAS 12, IAS 22 and IAS 29 have been adopted. Several recent IASs developed as part of the core standards project have not yet been adopted. The two bodies are members of the IASC.

Malaysia

Under the companies act, companies are required to submit audited annual accounts which must be prepared in accordance with approved accounting standards. In 1978, the Malaysian Association of Certified Public Accountants (MACPA) adopted IASs as national standards. From 1987, the Malaysian Institute of Accountants (MIA) took over the primary responsibility for the issuance of national accounting standards. The MIA and MACPA adopted virtually all IASs for use in Malaysia; these IASs were supplemented by a number of national accounting standards (MAS) dealing with accounting issues were of national importance but which had not been addressed by the IASC.

In 1997. The government established the accounting standards board (MASB) which has taken over the sole responsibility for issuing legally binding accounting standards. The MASB has adopted 24 extant standards issued drafts of a further 10 standards, nine of which were based on IASs. While the MASB intends to continue using IASs as national standards, it has departed from current IASs in a number of respects, most notably in allowing the deferral of foreign exchange gains and losses, a practice which the IASC banned with effect from 1995. The MASB has also delayed the implementation of a number of IASs.

Although Malaysian accounting standards are based on, and are often the same as, IASs, no Malaysian companies are believed to refer to compliance with IASs in their annual reports.

Both the MIA and MACPA are members of the IASC and have represented Malaysia on the IASC board since 1995.

Source: Cairns (1999)

2.2.2 Legal Framework

Within the last decade there has been a major shift away from neo-classical explanations of economic development to institutional ones. "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction."[72] These constraints – formal (laws) and informal (norms) – can either be conducive to political, social, and economic change, or be a hindrance. In the economic arena, the existence of clear property rights, and rules to promote competitive investment are thought to be essential. The major burden of the colonial history of IDB member states is the admixture of custom, *shari`ah*, and metropolitan colonial laws that makes the system of laws opaque, contradictory, and unpredictable.

Table 2.8 Shareholder Rights in Selected IDB Member Countries

	English-Origin		French-Origin			
	Malaysia	Pakistan	Egypt	Indonesia	Jordan	Turkey
One Share – One Vote	1	1	0	0	1	0
Proxy by mail allowed	0	0	0	0	0	0
Shares not blocked before meeting	1	1	1	1	1	1
Cumulative voting / Proportional representation	0	1	0	0	0	0
Oppressed minority	1	1	0	0	0	0
Pre-emptive right to new issues	1	1	0	0	0	0
Share Capital % to call Extraordinary Meeting	0.10	0.10	0.10	0.10	0.25	0.10
Anti-director rights	4	5	2	2	1	2
Mandatory dividend	none	none	none	none	none	none

Note: In general, a "1" indicates pro-shareholder right and a "0" not so. Share capital to call an Extraordinary General Meeting gives the company law or commercial code provision (it ranges from 1-33%). Anti-director rights range from 0-6. Mandatory dividend refers to restrictions in the law or code.
Source: La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998)

Economists now realise that "institutions that protect property rights are crucial to economic growth and to investment. Some [analyses] point to effects that rival even those of education… the security of property rights affects not only the magnitude of investment, but the efficiency with which inputs are allocated."[73] Equally, contract law, institutions for speedy dispute resolution, and enforcement mechanisms are essential to the conduct of business transactions. This is especially true in the financial sector, where property is intangible, and often consists simply of rights embodied in contracts.[74]

[72] North (1990, p. 3). Organisations, by contrast, "are groups of individuals bound by some common purpose to achieve objectives" (p. 5). The distinction is technical; in common usage, we often mean organisations when we speak of institutions.
[73] Knack and Keefer (1995, p. 223).
[74] Islamic law does not recognise these rights as property. Under the *shari`ah* property has three attributes: (1) it must have some value, (2) it must be a thing the benefit of which is permitted, and (3) it must be possessed. The Hanafi jurists add a fourth attribute: it must be capable of being held in reserve. In their conventional forms, therefore, many "sophisticated"

A study of legal rules covering protection of corporate shareholders and creditors in 49 countries finds that common law countries provide the strongest investor protection; French civil law countries, the weakest; and German and Scandinavian civil law countries fall in the middle. Also, French-civil-law countries are the weakest in law enforcement, while German and Scandinavian civil-law countries are strongest, with the English common law countries falling in the middle.[75] Data on IDB member countries is presented in Table 2.8.

Legal reform must therefore be accorded the highest priority in agenda of governments in all developing countries, and especially the IDB member countries. In many ways, the promise of de-colonisation and independence cannot be redeemed until a legal framework compatible with the cultural values of society is put in place.

2.3 Summary of Performance Aspects

A distinction can be made between economy-wide performance of the financial sector, and less aggregated measures of performance – by markets, or by institutions.

A variety of indicators have been devised to assess financial sophistication of an economy. Within the 43 IDB member countries for which data are readily available, a simple criterion – the ratio of currency in circulation plus demand deposits (M2), to gross national product (GNP), or "financial depth" – can be used to classify countries according to their level of financial development. The resultant numbers suggest a five-part classification by level of financial development for the 40 member countries that report data on M2:

(i) Very High – Only Lebanon, an "upper middle income" country, with an M2/GNP of 143% in 1998, falls in this category.

(ii) High – Three member countries (Jordan, Kuwait and Malaysia), with an M2/GNP of around 100%.

(iii) Middle – Eleven member countries (3 Asian: Indonesia, Pakistan, Iran; 7 Arab: Egypt, Morocco, Saudi Arabia, United Arab Emirates, Tunisia, Algeria and Yemen; and Albania), with an M2/GNP ranging from 39% to 75%.

(iv) Low – Twenty one member countries (all African members, except Guinea, Niger and Comoros (14); 2 Asian: Turkey and Bangladesh; 3 Arab: Oman, Syria and Mauritania; and 2 CIS: Kyrgyz Republic and Azerbaijan), with an M2/GNP of 11-36%.

(v) Very Low – Four members (Guinea, Niger, Sudan and Kazakhstan), with an M2/GNP ratio of under 9%.

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financial products - insurance policies, bonds, forward contracts, puts, calls, derivatives, and the like – would not be permissible under Islamic law.

[75] La Porta et. al. (1998). The 49 country sample included 6 IDB member countries – Malaysia and Pakistan (English origin), and Egypt, Indonesia, Jordan and Turkey (French origin). There is no recognition in the governance literature of *shari`ah*-based legal systems.

As the discussion below will show, however, this classification does not capture the full complexity of the situation. A summary assessment of some aspects of the performance of financial sector institutions can be carried out on the basis of a new database compiled from various sources at the World Bank – hereafter the BDL database.[76]

2.3.1 Size & Activity of Financial Intermediaries

With the exception of Malaysia, where the financial sector is sizeable (with assets in excess of 150% of GDP in 1997), total financial assets are less than GDP in all IDB member countries (see Statistical Annex, Table 3.3). Data on size of the financial sector in the 10 IDB member countries on which the BDL database includes data on both relative and absolute size, are presented in Table 2.9. Following the BDL database scheme, data presented in Table 2.9 distinguish between three classes of financial institutions – central banks, deposit money banks, and other financial institutions.[77]

Table 2.9 Measures of Financial Sector Size in Selected IDB Member Countries

Size …	… Relative to the Economy (As % of GDP)			… Relative to Each Sub-Sector (As % of Total Financial Assets)			
	Total Financial Assets	**Liquid Liabili-ties**	**Private Credit**	**Central Bank**	**Deposit Money Banks**	**Other Financial Instit'ns**	**Deposit Money Share [1]**
African Member Countries							
Comoros	70.1				22.5	52.7	24.8
Mozambique	92.8	20.7	35.4	14.6	26.6	16.9	3.5
Arab Member Countries							
Egypt	96.0	78.2	42.0	17.4	76.5	6.1	81.5
Iraq	23.3	22.5	6.8	6.4	74.6	19.0	92.1
Jordan	97.9	97.3	74.9	53.2	45.4	1.3	35.5
Morocco	54.6	69.6	29.4	12.2	60.5	27.3	84.3
Tunisia	63.6	48.0	60.9	0.4	78.6	21.0	99.5
Asian Member Countries							
Iran	45.0	38.3	21.3	44.2	41.3	14.6	48.3
Malaysia	153.4	127.0	144.9	0.9	66.3	32.8	98.7
Turkey	29.1	26.7	18.0	6.9	89.3	3.8	92.9

Note: Data for most recent year is reported. For details and explanation, see Statistical Annex, Table 3.3.
[1] Assets of deposit money banks, as a ratio of the sum of assets of the central bank and deposit money banks. This measure has also been used as a measure of financial development.
Source: See Statistical Annex, Table 3.3.

[76] Beck, Demirgüç-Kunt, and Levine (July 1999).
[77] Other financial institutions consist of bank-like institutions (deposit-taking institutions without facilities for deposit transfer – like saving banks, co-operative banks, mortgage banks, and building societies; and finance companies, that raise funds mainly in the form of negotiable bonds), insurance companies, private pension and provident funds, pooled investment schemes (like mutual funds, or real estate investment funds), and development banks. Insurance companies and private pension and provident funds exclude insurance funds that are part of a government social security system.

2.3.2 Commercial Banks: Market Structure and Efficiency

Statistics on market structure and efficiency of the banking sector in 26 IDB member countries is presented in Table 2.10.

Table 2.10 Measures of Market Structure & Efficiency

		Market Structure				Efficiency	
	Year	Concen-tration[a]	Foreign Bank[b] Share: Number	Foreign Bank[b] Share: Assets	Public Share[c] Assets	Over-head Costs[d]	Interest Margin[e]
Benin	1996	100.0	33.3	34.3	0.0	3.5	3.4
Cameroon	1994	90.2	25.0	38.6	0.0	4.7	0.0
Mali	1996	100.0	0.0	0.0	0.0	6.8	5.2
Senegal	1996	90.0	25.0	14.1	0.0	4.7	5.4
Sierra Leone	1996	100.0	33.3	40.4	0.0	10.7	11.0
Togo	1996	100.0	0.0	0.0	0.0	5.0	4.1
Uganda	1997	76.6	50.0	37.2	0.0	7.4	7.8
Algeria	1994	100.0	66.7[f]	62.0[f]	0.0	1.1	2.5
Bahrain	1997	96.0	66.7	89.6	0.0	1.6	2.8
Egypt	1997	70.8	13.3	9.1	59.9	1.5	1.7
Jordan	1997	97.2	0.0	0.0	0.0	2.3	2.7
Kuwait	1997	68.3	16.7	12.0	0.0	1.0	1.7
Lebanon	1997	59.9	46.7	29.6	0.0	3.2	3.5
Morocco	1996	59.6	20.0	8.3	0.0	2.6	3.9
Oman	1997	62.9	0.0	0.0	0.0	2.2	3.4
Qatar	1997	92.8	0.0	0.0	0.0	1.3	2.4
Saudi Arabia	1997	51.3	11.1	4.9	0.0	1.5	0.9
Tunisia	1996	51.6	18.2	22.3	0.0	2.1	2.5
U.A.E	1997	60.7	6.3	0.7	0.0	1.7	3.4
Yemen	1996	88.5	0.0	0.0	0.0	2.9	3.8
Bangladesh	1996	57.2	35.7	28.0	80.7	2.1	1.3
Indonesia	1997	44.0	50.0	46.4	40.5	2.7	4.6
Malaysia	1997	44.2	12.0	5.5	0.0	1.3	2.7
Pakistan	1997	56.0	63.6	41.7	41.0	2.6	2.6
Turkey	1997	44.8	3.1	0.2	50.0	5.1	11.2
Kazakhstan	1997	91.2	16.7	5.3	0.0	12.7	9.4

[a] Ratio of the 3 largest banks' assets to total banking sector assets.
[b] A bank is defined as foreign if at least 50% of the equity is owned by foreigners.
[c] Share of public owned commercial bank assets in total commercial bank assets. A bank is defined as public, if at least 50% of its equity is owned by government or a public institution.
[d] The accounting value of a bank's overhead costs as share of its total assets.
[e] Accounting value of a bank's net interest revenue as a share of its total assets.
[f] As Algeria does not have many foreign banks at present, data for 1994 reported here require re-checking.
Source: Financial Structure and Economic Development Conference Feb 10-11, 2000 World Bank, Washington Database. *www.worldbank.org/research/projects/finstructure*.

As can be expected, market concentration is highest among African member countries. The top 3 banks account for 100% of total banking sector assets in Benin, Mali, Sierra Leone, and Togo. In Cameroon and Senegal, this figure falls to 90%; in Uganda, to 76%. The same is true of Kazakhstan, where a concentration ratio of over 91% is reported. Among Arab members, high concentration ratios are reported for Algeria, Bahrain, Jordan, Qatar, and Yemen, while the lowest concentration ratios are found in Saudi Arabia and Tunisia (51-52%). Among Asian members, these ratios range from 44-57% – with Bangladesh and Pakistan showing the highest concentration.

Interestingly, the share of publicly owned commercial bank assets in total bank assets is significant in only five member countries – Bangladesh (81%), Egypt (60%), Turkey (50%), and Indonesia and Malaysia (each 41%). All other member countries report a zero share of the public sector in commercial bank assets. By contrast, foreign banks have a significant presence in the banking sector (in both shares in numbers and in assets): over 50% of the number of banks, in Bahrain, Indonesia, Pakistan and Uganda; and over 40% of assets, in Bahrain, Indonesia, Pakistan, and Sierra Leone.[78] The government holds over 40% of banking sector assets in Bangladesh, Egypt, Indonesia, Pakistan, and Turkey.

Egypt, Kuwait and Saudi Arabia have the most efficient banking systems – with overhead costs under 1.5% of assets, and interest margin, under 2%. Algeria, Qatar and Malaysia also have comparable overhead costs, but have slightly higher interest margins.

2.3.3 Other Financial Institutions

Although commercial banking is by far the largest sub-sector, a number of non-bank financial institutions (NBFIs) are engaged in significant activities in the financial sector.[79] Of these, the largest usually are development banks (or development finance institutions, DFIs) and life insurance companies, although investment banks[80] are increasingly becoming important in a number of higher income countries. The stock exchange and institutions managing pension funds also play a significant role in the financial sector.[81] Finally, a number of informal financial institutions round up the picture of the financial sector. Unfortunately, other than the banking sector (central bank and commercial banks), very little data exists on any of the components of the financial sector. Such data as exists in the BDL database on IDB member countries is presented in Table 2.11.

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[78] There may be an error in the data for Algeria for 1994, in that foreign banks are not very much present in Algeria. We are indebted to Wafik Grais for pointing this out.
[79] Conceptually, the distinction is that banks (and bank-like institutions) create money – usually, far in excess of the deposits they receive, while non-banks do not.
[80] Called merchant banks in the UK.
[81] Life insurance and pension funds, referred to as "contractual savings," are increasingly viewed as important sources of saving in the economy.

Table 2.11 Size & Activity of Other Financial Institutions

		Size (Assets as % GDP)				Activity (Private Credit as % GDP)			
		Insurance Companies		Devel-opment		Insurance Companies		Dev'p-ment	Private Credit
	Year	Life	Other	Banks	Total	Life	Other	Banks	Total
Egypt	1997		36.3[a]	7.1			1.08[a]	4.92	
Indonesia	1994			5.4	2.1[f]			4.17	
Jordan	1997		2.7[b]	31.2[b]	1.8[e]		0.54[d]	6.46	0.85[e]
Morocco	1997							14.47[a]	
Malaysia	1997	8.0	11.8	4.7[e]	63.5	1.84[e]	2.13[e]		31.37[b]
Pakistan	1995	5.1[e]	5.4[e]	7.8					
Saudi Arabia	1996							35.35	
Tunisia	1997			13.6	8.0			10.38	2.95
Turkey	1997			2.9[b]	0.7[c]			0.84[b]	

Note: Data on pooled investment schemes are available only for Malaysia: 9.9% of GDP in 1992.
[a] 1996 [b] 1995 [c] 1994 [d] 1993 [e] 1992 [f] 1990
Source: World Bank. See http://www.worldbank.org/research/projects/finstructure. Data provided by Asli Demirgüç-Kunt.

While the sample is small and the data are incomplete, it appears that development banks remain an important feature of the NBFIs landscape, both in size and in the credit they extend. This is in keeping with general trends toward the phasing out of development banks in favour of private sector institutions.

Insurance remains a comparatively minor activity in member countries. According to data provided by the Swiss Reinsurance Company, life and non-life insurance premia in IDB member countries amounted to US$ 13,355 million in 1998 (life US$ 3.4 billion, non-life US$ 10.0 billion), a fraction of one percent of the world market share (see Statistical Annex, Table 3.4). By far the biggest insurance markets were in Malaysia and Turkey, although Indonesia and Iran were also significant. The Gulf states exhibit the highest insurance density (Qatar $271.90, UAE $253.40, Bahrain $191.80), followed by Lebanon ($140.40), Malaysia ($133.40), and Kuwait ($97.80).[82]

By contrast, a number of significant stock markets have emerged in member countries (Table 2.12). In terms of 1999 market capitalisation, Malaysia (US$ 145 billion) and Turkey (US$ 113 billion) have by far the biggest stock markets among IDB member countries. Next come Indonesia (US$ 64 billion) and Saudi Arabia (US$ 60 billion), followed by Egypt (US$ 33 billion), Iran (US$ 15 billion), and Morocco (US$ 14 billion). While much smaller in absolute size, in relation to their GDP, market capitalisation is noticeably large in Jordan (79%) and Oman (29%). Egypt and Morocco have been the fastest growing markets over the 1990s, followed by Indonesia, Turkey and Tunisia. Significantly, in Iran the stock market has stagnated over the same period.

[82] Insurance density refers to premia per capita per annum. An alternative measure, insurance penetration, refers to premia as a ratio of GDP (see Statistical Annex, Table 3.4, for figures).

Table 2.12 Major Stock Markets in IDB Member Countries

	Market Capitalisation			Value Traded		Turnover Ratio		Listed
	Share	Value	Growth	Value	Growth	Value	Growth	Cos.
	% GDP 1998	$ mln 1999	% p.a. 1990-99	$ mln 1999	% p.a. 1990-99	$ mln 1999	% p.a. 1990-99	No. 1999
Bangladesh	2.4	0.9	11.6	1.9	76.1	2.6	6.5	211
Egypt	29.5	32.8	38.4	6.1	46.1	31.6	..	1033
Indonesia	23.5	64.1	25.6	10.3	14.5	47.0	-5.2	277
Iran	13.1	14.9	-8.9	1.2	..	9.3	-12.3	242
Jordan	79.0	5.8	12.6	8.8	-1.7	9.4	-8.1	152
Malaysia	136.0	145.4	12.9	39.8	5.8	39.8	5.5	757
Morocco	44.1	13.7	34.3	3.9	41.7	17.6	..	55
Nigeria	7.0	2.9	8.8	0.4	33.5	5.1	21.2	194
Oman	29.4	4.3	16.8	13.0	39.6	33.8	11.9	140
Pakistan	8.5	7.0	10.4	14.4	49.4	345.2	50.5	765
Saudi Arabia	33.0	60.4	2.5	10.6	23.8	28.8	..	73
Tunisia	11.4	2.7	19.8	0.9	25.3	13.3	16.7	44
Turkey	16.9	112.7	21.8	34.5	31.4	102.8	10.3	285

Note: Levine (1997) presents liquidity measures for 1976-93 (averages of value traded and turnover, in %) for Bangladesh (0.0, 1.5), Egypt (3.0, 6.0), Pakistan (0.8, 10.5), Indonesia (1.0, 19.3), Jordan (8.5, 15.4), Turkey (2.6, 20.7), and Malaysia (24.3, 23.0). For other data on size, activity and efficiency of stock and bond markets, see also Statistical Annex, Table 3.5.
Source: Statistical Annex, Table 3.5.

In addition to secondary markets, in which existing securities are traded between investors, there is evidence of the emergence of primary markets in IDB member countries, as well. In primary markets, issuers (firms and governments) place securities directly with investors. Although primary bond markets have been active for some time, the growth of primary equity markets is largely a phenomenon of the late 1980s. According to some data, international issues of debt rose from an annual average of US$ 22.7 billion in 1980-85, to US$ 87.6 billion during 1985-90, and to US$ 136.2 billion during 1990-95, the latest period for which data is available.[83]

The comparable data for international equity issues were US$ 0.7 billion during 1980-85, US$ 8.0 billion during 1985-90, and US$ 50.2 billion during 1990-95. Although both markets are dominated overwhelmingly by the Group of Four (G-4) countries, the share of the so-called "Asian Tigers" and "Emerging Markets" has risen over time.[84] Table 2.13 presents what might be the only cross-country data that exist on primary market activity in selected IDB member countries.[85]

Equity issue in Emerging Markets was concentrated in a few countries. The top five countries, accounting for 62% of equity issue, were Thailand, Portugal, Malaysia, Indonesia, and Brazil (in decreasing rank order). As a percentage of GDP,

[83] Aylward and Glen (1999), on which this section relies.
[84] Asian Tigers consist of: Hong Kong, Korea, Singapore, and Taiwan. Emerging Markets consist of 24 countries: Argentia, Brazil, Chile, China, Colombia, Greece, Hungary, India, Indonesia, Jamaica, Jordan, Kenya, Malaysia, Mauritius, Mexico, Pakistan, Peru, Philippines, Portugal, Sri Lanka, Thailand, Tunisia, Turkey, and Venezuela.
[85] Aylward and Glen (1999).

however, three smaller countries – Mauritius (2.9%), Jordan (3.2%), and Tunisia (3.3%) – feature in the top 5 equity issuers, together with Portugal (3.9%) and Malaysia (2.8%). These rankings have changed over the years. Among IDB member countries, Indonesia joined the rank of leading equity issuers in the 1990s, from a relatively low rank in the 1980s, while Tunisia and Jordan became less prominent starting in the late 1980s. Tunisia's rank, however, improved again in the 1990s.

Table 2.13 Primary Securities Market Activity in Selected Member Countries, 1980-95

	Equity Issues ($ billion)	*Long-Term Debt Issues ($ billion)*			*As % of GDP*	
		Govern-ment	*State Owned Enterprises*	*Private Sector*	*Equity*	*LT Private Sector Debt*
Indonesia	17.2	0.0	2.8	1.6	0.7	0.1
Jordan	2.6	0.6	0.2	0.2	3.0	0.2
Malaysia	18.8	0.0	0.0	15.6	2.3	2.8
Pakistan	1.7	48.9	0.0	0.0	0.2	
Tunisia	5.8	1.1	0.0	0.5	3.2	0.5
Turkey	8.3	64.8	0.0	2.0	0.5	0.1

Note: Primary markets link issuers to investors.
Source: Aylward and Glen (1999).

In private long-term debt issue, the top 5 Emerging Market issuers, in decreasing rank order were Mexico, Brazil, China, Thailand and Malaysia. As a percentage of GDP, Malaysia (4.2%) was ahead of Chile (3.0%), Thailand (2.3%), Portugal (1.8%), and Mexico (1.2%). Among IDB member countries, Malaysia also joined the rank of leading private debt issuers in the 1990s, from zero issue in the 1980s, while Tunisia also became more prominent in the late 1980s. Jordan's rank declined in the 1990s.

In the long-term debt government market, Venezuela, followed by Mexico and Portugal, are the major issuers. Relative to GDP, however, Portugal and Pakistan rank second and third, after Venezuela, which remains the largest issuer. In terms of growth, Hungary, the Philippines, Turkey and Venezuela were notable. IDB member countries do not feature among the leading issuers of state enterprise long-term debt.

2.4 Summary

There is great diversity in the state of financial markets in member countries. With the exception of Albania and the CIS member countries, where much depends on the pace of bank restructuring and privatisation, member countries have seen greater macroeconomic stability in the 1990s than in the past. Nevertheless, due to structural and historical reasons, the financial sector in most of the least developed member countries remains underdeveloped, and little is known publicly about the state of the financial sectors of most Arab and Asian member countries.

The social, economic, and business environment remains worrisome for most IDB member countries. Many of the higher income and more populous member countries have improved the social and financial infrastructure necessary for healthy private and financial sector development but much more remains to be done. In the area of accounting standards, efforts so far have addressed technical issues, not conceptual ones. There is a need for IDB, along with other concerned institutions and scholars, to take a lead in undertaking fundamental research in Islamic accounting.

By any measure of financial development, no more than 15 member countries can be said to have developed financial sectors. Where available, statistics reveal high concentration ratios and significant presence of government and foreign banks in the banking sector. Even fewer countries have developed stock markets, and with the exception of a handful of member countries, market capitalisation, value traded and turnover is low both in absolute terms and in relation to national income. Although information is becoming available in a few countries, little is known in general about insurance and pension funds.

3. FINANCIAL SECTOR DEVELOPMENT

Although finance does not appear to be among the primary constraints to private investment and growth, it does feature as a prominent secondary concern of the business sector in member countries (Chapter 1). In addition, there is good reason to promote the development of the financial sector, in its own right. From a policy perspective there is a need to distinguish financial sector *development*, from financial sector *reform* (and, one kind of reform, *liberalisation*). By financial sector development we mean the establishment of key institutions in countries where these institutions either exist in rudimentary form, or do not exist at all. By the second, the reform of more developed financial sectors, with the aim of improving the system. The first subject, is dealt with in this chapter; the second, in the next.

Both development and reform are normative concepts that reflect the values and purposes of nations. Enjoined as IDB is to promote development in accordance with the *shari`ah*, it becomes important to define the ideal financial system under the *shari`ah*, and an efficacious course of development toward this ideal. Naturally, at the present juncture, such an ideal system should only be designed for national economies. An important component of such a system would be the definition of a *modus vivendi* for *shari`ah*-compatible transactions with the much larger global financial system with which it would have to interact.

3.1 Designing an Islamic Financial Architecture

In designing a general blueprint for national financial systems that can guide the efforts of IDB member states, it is important to be clear on the key terms used in this discussion, the objectives of financial sector development and reform, and the requirements of the *shari`ah*.

3.1.1 Terminology: Instruments, Institutions, Structure, and Development[86]

All societies possess durable physical assets that are the result of human labour on natural resources. In the last five hundred years or so, *financial assets* – claims against individuals or enterprises, not backed by any specific physical assets – have also come into existence.[87] Financial *instruments* are evidences of claims against physical or financial assets.[88] The earliest, and probably the most important, financial instrument is scriptural (non-metallic) money – in the form of bank notes, and deposits transferable by check, or other similarly easy procedure. Other

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[86] The definitions presented here follow, mostly, Goldsmith (1969, pp. 3-48).

[87] Note that in distinguishing *financial* from *physical* assets in this technical way, any direct on indirect claims on specific physical assets – such as shares in an industrial enterprise, for example – cease to be a financial asset. By failing to make such a strict distinction there is much confusion in the Islamic Economics literature on whether or not the *shari`ah* permits profits from trade in financial assets.

[88] Islamic law (*shari`ah*) forbids trading for profit or loss in *financial assets*, and in those *financial instruments* that consist of – or mainly of – claims on financial assets, both terms as defined here. Much confusion in the Islamic Economics literature could be eliminated by distinguishing physical assets based financial instruments, from mixed, or purely financial assets based, financial instruments.

financial instruments are various forms of deposits, loans, claims arising from contractual savings (life insurance and pension funds), sales credit extended by one enterprise to another, and evidence of participation in the equity – i.e. profit and loss, and net worth – of an enterprise.

Many of these financial instruments are issued or held not by governments, enterprises or households, who hold mainly physical assets (like buildings, equipment, durable goods, inventories, and land), but by financial *institutions* – enterprises whose assets and liabilities consist primarily of financial instruments. The financial *structure* of a country refers to the attributes of the types of financial institutions and instruments that exist in the country. These attributes of financial institutions and instruments can be viewed in terms of their character, mode of operation, relative size, degree of concentration, and – perhaps most important for economic analysis – the relative volume of financial instruments to real economic magnitudes like national wealth, income, saving, and capital formation. The manner in which financial structure changes over time is referred to as financial *development*.

3.1.2 Objective of Financial Sector Development

The objective of financial sector development can either be a replication of institutions and practices in Europe or North America, or a functional response to existing needs and constraints. Unfortunately, as with much else with development strategy and policy, the former is by far more frequent; the latter, extremely rare.

Like other sectors, the financial sector provides services for which there is a demand. The institutional make up of the financial sector should therefore be dictated by the efficient fulfilment of this demand. What financial services are typically in demand? In the theoretical literature it has been suggested that financial systems "may arise" to facilitate amelioration of risk, acquire information about investments and allocate resources, monitor managers and exert corporate control, mobilise saving and facilitate the exchange of goods and services.[89] This may well be the case. In practice, however, the main function of the financial system, especially in IDB member countries today, is to facilitate public finance.[90] All other functions that the financial system can be expected to fulfil – mobilising saving, allocating resources, ameliorating risk, and facilitating trade and investment – are in some senses subsidiary to this function. This obvious fact should be borne in mind in the design of financial sector development (and reform) proposals.

These services – to government, businesses, and households – can be provided under a number of alternative frameworks. In Europe and America, the key choices have been between bank-based and market-based financial systems,[91] and be-

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[89] Levine (1997) provides a comprehensive survey of the issues, while making a cogent case for a functional approach to financial sector development. Other ways of classifying functions are provided by Merton and Bodie (1995), and Cole and Slade (1991).
[90] It is surprising that this obvious political economy function does not find mention in any of the several classifications of functions of finance in the literature.
[91] Zysman (1983) suggests a three-way division: (1) capital-market based, with resources allocated by competitively established prices, (2) credit-based, with administered prices, and (3) credit-based, bank-dominated system.

tween integrated (or universal) banking and specialised banking.[92] Once again, the choice of frameworks – or features of different systems – is best made in the light of functional requirements, rather than fashionable imitation. The choice should lead to the best feasible framework to regulate, supervise and motivate the participants in the financial system (service providers – owners and managers, service recipients – traders and investors, and supervisors).

Table 3.1 Types of Financial Structure

Characteristics	Contemporary Examples	Historical Examples
1. Only commodity money; no financial institutions but occasional credit transactions	Isolated tribal communities	Early antiquity
2. Metallic money, bills of exchange, and indigenous small-scale financial institutions (moneylenders)		India and China before ca. 1850 Japan before 1868 Classical antiquity Most of medieval Europe and large parts of Europe through the 18th century
3. Central bank the only, or predominant, financial institution	USSR and other centrally planned economies	France & Russia in early 19th century
4. Deposit banks, but no central bank and no paper money		Medieval Italian cities (from 13th century on)
5. Multiple note issuing and deposit banks; beginning of other financial institutions		Scotland (1st half of 19th century) USA to 1913
6. Central bank; modern deposit banks; indigenous small-scale financial operators	Most of tropical Africa, Middle East and Southeast Asia	
7. Central banks; deposit banks; beginnings of other financial institutions (particularly savings banks, mortgage banks, development banks, and insurance companies)	Spain Latin America India Egypt	Western Europe from mid-19th century to World War I
8. Full complement of financial institutions and instruments.	USA, former British dominions, Western Europe, Japan (all since late 19th or early 20th century)	

Source: Goldsmith (1969, p. 34)

[92] Demirgüç-Kunt and Levine (July 1999), and Claessens and Klingebiel (September 1999)

3.1.3 Toward the Design of a (National) Islamic Financial Architecture

Clarity of objectives is but one ingredient of success in implementing change. Of equal importance is a clear appreciation of constraints to development and reform. These constraints occupy a continuum from informal ones at one end of the spectrum, to formal constraints at the other.[93] While there is greater diversity in informal constraints – which require close study in each country, or region – formal laws and regulations are grouped more closely together around a limited number of ideal types. Deficiencies in the formal legal framework – mainly in terms of weak property rights, and deficient contract enforcement – are now recognised as a binding constraint to financial sector development. In IDB member countries, a major impediment to reform of the legal framework arises from deep-rooted unresolved conflict about the role of the *shari`ah* versus laws inspired by European examples. A key step toward progress in this difficult area would be to define an appropriate legal framework, especially of commercial law, in these conditions.

With the injunction to foster economic development, "in accordance with the principles of the *shari`ah*," it becomes necessary for IDB to ask what would be the ideal design of a national Islamic financial system?[94] This is relevant not only to this chapter, which deals with laying the foundations of a financial system, but also to the next, in which reform of more developed systems are discussed. This framework should benefit from a study of developments in Christian-Modern societies. But it will have to reject those developments that cannot be brought within the ambit of the *shari`ah*, adapt those that can, and devise new institutions and instruments that respond to the nature of market demand for financial services in Muslim society and communities. In effect, these differences arise largely from a difference in emphasis on charity and commerce in the two societies. Due to developments within Christianity, starting mainly in the 15th century, Christian-Modern societies placed commerce ahead of charity – and lent the full authority of the state to promote commerce, while relegating charity largely to the private sector.[95] The *shari`ah* continues to place charity ahead of commerce.

The design of an Islamic financial architecture must therefore start with this basic difference between Christian-Modern and Islamic financial arrangements. One way could be to start with the principle of Islamic jurisprudential hermeneutics (*fiqh*) that *prima facie* all arrangements are acceptable (*mubah*), unless they can be shown to be in conflict with the *shari`ah*. There are then three aspects of existing financial systems that need attention:

(i) First, the *shari`ah* does not allow exchange or trade in financial assets or instruments that consist mainly of financial assets,[96] with the intent

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[93] North (1990, pp. 36-53).
[94] The adjective Islamic will be used interchangeably with *shari`ah*-compatible.
[95] These developments are well known in the economic history literature, among others. For a recent work that documents how usury (*riba*) became acceptable to Christian *ulama* under the pressure of commerce in early modern England, see Jones (1989).
[96] As this term is defined in section 3.1 above.

to profit, or – to put it in the economist's language – does not permit a market in (i.e. buying and selling of) loanable funds;[97]

(ii) Second, the *shari`ah* does not permit "games of chance" (*maysar* or *qimar*), under which, in particular, all scholars of Islamic law (*fuquha*) consider modern insurance practice to be against the *shari`ah*.[98]

(iii) Third, the *shari`ah* does not allow transactions involving uncertainty (*gharar*) – like the sale or exchange of goods that are not in the possession of the seller at the time of contract, or is in unspecified quantities – under which most risk-hedging transactions are judged to be against the *shari`ah*.[99]

These are not the only constraints on exchange and trade, but they represent the major impediments to the adoption of modern financial instruments as they have evolved in Christian-Modern countries. For at least the last two hundred years, Muslim scholars have been engaged in reviewing these new financial instruments, as they have come to their attention, and in pronouncing judgements on them and devising alternative arrangements to achieve the legitimate objectives served by these instruments. These efforts have gained considerable momentum during the last thirty years, when a systematic effort was carried out in a number of Muslim countries to adapt financial instruments to Islamic forms. There is now a need however to look not just at instruments, but to consider the implications of these important piece-meal reforms for the financial structure in general. Given the importance of the subject, the Islamic Development Bank should consider establishing a committee to undertake the study and design of an Islamic Financial Architecture to guide international and national efforts in financial sector development and reform.

3.2 Toward a Strategy for Financial Sector Development

Given these objectives and constraints, what should be the key elements of a strategy for financial sector development in IDB member countries?

3.2.1 General Considerations

As a general policy guideline, it seems reasonable to suggest that financial sector development – whether in developing countries, or in industrial ones – should be in response to current and anticipated market demand for financial services. In many

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[97] This may be a better formulation for the modern reader than that the *shari`ah* bans *riba* (any excess over the principal lent, by prior contract), as it highlights that it is the existence of credit markets to which the *shari`ah* objects. The classical formulation (of a ban on *riba*) is more comprehensive, covering as it does non-institutional private transactions, but as it resonates with the history of anti-usury laws in European societies, it commonly leads to false parallels and misunderstandings.

[98] See for example Al-Qaradawi (1960).

[99] "However, not every sale involving what is unknown or uncertain is prohibited… What is prohibited is the selling of something about which there is an obvious element of uncertainty which may lead to dispute and conflict, or may result in the unjust appropriation of other people's money. Again, if the risk of uncertainty is small – and this is determined by experience and custom – the sale is not prohibited." Al-Qaradawi (1960).

developing countries, the bulk of the demand for credit is by government and public sector institutions, and comparatively smaller proportion – sometimes very little if any – by private enterprises and households. In these countries, the existing financial structure may well be more or less appropriate to the volume and nature of demand for financial services, and policy efforts should aim at modest, non-systemic, development.

A second consideration is that of the scale of operations at which conventional financial institutions become viable, and the size of the market in which competition can be promoted. Where these considerations permit the existence of only a few institutions, important questions of regulatory design must be addressed. In the light of these considerations, key data on selected least developed IDB member countries (LDMCs) is presented in Table 3.2.

Table 3.2 Population, Urbanisation & Credit Demand in Selected LDMCs

	Population				% Urban	Dom. Credit (% share), to			
	Mil-lion	% Ur-ban	% in Cities of over 1 million		In Larg-est City	Public Sector	Pvt. Sector	Fin'l Inst'ns	M2/ GDP
	1998	1998	1995	2015	1995	1998	1998	1998	1998
African									
Guinea [a]	2.2	31	23	39	81	35.7	64.3	-	9
Togo	6.0	64	23	27	31	27.0	73.0	1.0	22
Mozambique	6.4	38	14	24	41	-472.0	571.5	0.5	20
Cameroon	6.8	47	10	15	22	49.6	48.7	1.7	14
Sierra Leone	9.7	34	9	14	27	94.3	5.3	0.4	13
Uganda	2.3	85	0	0	41	28.8	71.2	0.0	11
Benin	2.4	41	0	0	..	-4.2	104.2	-	21
Senegal	1.7	35	0	0	..	28.0	71.0	1.0	22
The Gambia	0.4	31	0	0	..	-5.3	105.3	0.0	28
Mali	3.0	29	0	0	35	-11.0	111.0	-	22
Chad	1.7	23	0	0	55	59.2	36.3	4.5	11
Guinea Bissau[b]	0.3	23	0	0	..	23.6	76.4	-	13
Niger	2.0	20	0	0	..	56.2	43.6	0.2	7
Burkina Faso	1.9	17	0	0	52	10.0	89.4	0.6	23
Comoros	0.5	..	..	..	..	31.6	67.9	0.5	..
Arab									
Palestine	17.5	85	21	23	17	..	..	..	..
Mauritania	1.4	55	0	0	..	-833.5	932.4	1.1	15
Yemen	4.0	24	0	0	..	82.5	17.5	0.0	43
Djibouti [b]	0.7	..	..	..	..	18.4	81.6	0.0	..
Asia									
Maldives	0.3	..	..	..	..	40.1	60.0	-0.1	..

Note: Data for public sector includes central government, local government, and non-financial public enterprises. Afghanistan and Somalia have been excluded because there is no data; Bangladesh, because it is large; and Gabon, because it is not least developed.
[a] 1997 [b] 1996
Source: *WDI* 2000, and *IFS Yearbook 1999*.

As evident from Table 3.2, many LDMCs do not have even one city – urban agglomerations – of 1 million persons or more, and are not expected to have them in the next 15 years. The design of financial sector development programmes for these countries must proceed from a country-by-country assessment of market demand, rather than the replication of standardised patterns of financial development elsewhere. In many cases, it is likely that these programmes would include the development of postal savings, credit co-operatives and other traditional financial institutions and instruments. At the same time, policy effort should be directed to strengthening and formalising existing institutions and instruments that have emerged naturally in response to market conditions. Finally, recent developments in saving-cum-lending micro-finance institutions may well be suitable for adaptation to individual circumstances.

As for the second group of countries – those with at least one city of over one million persons – the design of financial sector development programmes can include a modest viable banking sector. This should be in addition to specialised institutions and instruments directed at mobilising savings and meeting the financial services needs of the dispersed non-urban population. Because of the small size, however, it is unlikely that there would be much competition among the institutions that are established. The existence of foreign banks – monopolising much of the foreign trade business – is also likely to impair the viability of local institutions. In this environment, regulatory design would have to address issues arising from market segmentation, and provide incentives to efficient operations.

Finally, data in Table 3.2 also point to the large share of government and public sector institutions in the credit market. In fact, the government is a more powerful presence in financial markets than its numerical share would indicate. Depending on the system of external checks and balances on government, the design of financial sector development should also address the specific needs of government and establish procedures to safeguard against the misuse of market – and other – power by government.

3.2.2 Establishing a Central Bank

With the exception of Liberia and some former French colonies in West Africa, most countries in the world have their own central banks. Should IDB's West African member countries also move toward establishing their own central banks? Should they be more independent in the conduct of their monetary policy? Or, are present arrangements satisfactory? The enormous literature that has appeared in the last decade on economics and finance in Africa is silent on these questions.[100]

Present monetary arrangements in nine African IDB member countries (see Table 2.1 above) have resulted from a series of regional integration agreements, reached over the course of the last forty years, among a number of West African states.[101]

[100] Neither World Bank (2000), nor a recent paper by an IMF staff team led by Hernández-Cáta (1998), examines the justification for the present system, or proposals for reform.

[101] A protocol establishing the Equatorial Customs Union (UDE - *Union Douanière Equatoriale*) was signed in Paris on January 17, 1959, by representatives of the four autonomous republics within the French Community formerly comprising French Equatorial Africa – Central African Republic, Chad, Congo, and Gabon. This Union came into being on June 3, 1959. Cameroon became associated with the UDE on June 23, 1961. On January 1, 1996, UDE was replaced by the Customs and Economic Union of Central Africa (UDEAC – *Union*

These agreements have resulted in the West African Economic and Monetary Union (WAEMU), and the Central African Economic and Monetary Community (CAEMC). The WAEMU and the CAEMC countries, together with the Islamic Federal Republic of Comoros, constitute the Franc Zone. They share a common currency, the CFA Franc, standing by happy coincidence for the *Communauté Financière Africaine* in the WAEMU countries and Comoros, and *Coopération Financière en Afrique* in the CAEMC countries. Monetary affairs within each sub-zone are managed by a separate central bank: the Central Bank of West African States (BCEAO) for the WAEMU, the Bank of Central African States (BEAC) for the CAEMC, and the Central Bank of Comoros.

Member countries of the CFA Franc zone maintain a fixed proportion (currently 65 percent) of their foreign exchange reserves in an operations account with the French Treasury. In return the French Treasury provides members with an unlimited overdraft facility, thus guaranteeing the CFA Franc's convertibility. The CFA Franc is pegged to the French Franc.[102] There is free capital mobility throughout the CFA Franc zone. Finally, the central banks are required by their statutes to maintain 20% foreign exchange coverage of their sight liabilities.[103]

Box 3.1
Privilege of Central Banking

…for a country in which the banking system is but little developed, the right or privilege of note issue is one of the most effective means both of eliciting a rapid growth in the number of banks and of habituating the public to the utilisation of financial intermediaries.

- Cameron (1967, 295)

Where there are many benefits from membership in the CFA Franc zone, it does take away one of the major instruments of macroeconomic policy – monetary policy – from member governments. This may well be a judicious choice, but at the turn of the century the gains and losses from this arrangements should be discussed.

3.2.3 Conducting Monetary Policy

Where central banks exist, as they do in most member countries, the key issues relate to their independence, the nature of monetary policy that they formulate and execute, their regulation and supervision of the banking sector, and their role in the Islamisation of commercial banking (and the financial sector).

Of late, the issue of central bank independence has attracted some attention in policy discussions. As has been pointed out, until World War II, the few central banks that were in existence – the Bank of England and perhaps a dozen others – were quite independent of government. This was because the idea that fiscal pol-

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Douanière et Économique de l'Afrique Centrale), under a treaty signed on December 8, 1964, following an agreement on February 11-12, 1964.

[102] Since the 50% devaluation of January 12, 1994, the exchange rate has been CFAF 100 = F 1. On January 1, 1999 the French Franc became a national denomination of the new European Monetary Union currency, the Euro. The parity between the CFA Franc and the Euro is determined automatically from the parity between the French Franc and the Euro.

[103] Klau (March 1998).

icy could be used to influence output, employment, and other macroeconomic aggregates had not gained ground.[104] Even though there is now a consensus that while fiscal policy can be counter-cyclical, it cannot cause permanent changes in the real economy, governments continue to incur deficits for good reasons and bad. To strengthen the ability of the central bank to resist pressures by government, it has been found effective to lengthen the term of office of central bank governors, and place procedural impediments in their removal.

Can monetary policy – activities of the central bank to influence financial variables (money supply and, in un-Islamic economies, interest rates – be conducted in *shari`ah*-compatible ways? In effect, an answer to this question depends on the design of suitable instruments for influencing liquidity and profit rates, through the sale and purchase of instruments to fund government. In a recent paper, Sundarajan, Marston and Shabsigh (September 1998), suggest that the historical *Qabala*[105] system of raising funds for general government purposes can be used as the basis for designing Islamic instruments for general government finance:

> "In the former Qabala (acceptance) system, an investor accepted (Taqabul) to pay the state a fixed sum of money and in return made claim on the tax revenue of a certain tax locality; the investor was often allowed to collect the tax himself to ensure that the state would not default or as a matter of convenience. The investor paid the state mostly up-front, but sometimes in instalments, or at a determined time in the future (usually around tax collection time). This method, however, was disliked by most Islamic scholars for two reasons. First the system was often abused, particularly when investors realised that they could incur a loss due to lower than expected revenue and hence attempted to extract more revenue by over taxing the tax payer utilising in many instances the abusive force, in absence of proper government supervision. Second, scholars feared that the Qabala contract could degenerate into a Riba contract (i.e. interest-based contract) in cases where investors or investors' funds were not reinvested in the tax base. Both concerns are addressed under the GMC [Government Musharika Certificate] scheme. The government will not delegate the tax collection to investors and the funds raised from issuing the GMCs are reinvested in the tax base (i.e. the economy) through the provision of government services."

Whether this is historically accurate or legally sound is for scholars to judge. In any event, however, these developments in Sudan herald a breakthrough in Islamic finance of the ways and means position of governments, and an important step forward for the conduct of monetary policy without violence to the *shari`ah*. In effect, what this experience offers is the prospect of government floating a mutual fund of public enterprises; and the central bank, of government-owned Islamic banks. In this way, open market operations can be conducted in Islamic instru-

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[104] Caprio, Jr. and Vittas (1996). Also England was on a gold standard.
[105] A *qabaalah* or *qibaalah* refers to a deed of conveyance or transfer of right or property or, more generally, any contract or bargain or sale signed by a judge (*Hidayah*, Vol. II, p. 569).

Table 3.3 Design Comparisons between the CMC and the GMC in Sudan

In principle the Central Bank Musharaka Certificate (CMC) and the Government Musharaka Certificate (GMC) are similar in the sense that both instruments are based on the *musharaka* principle. Investors share with the Bank of Sudan (BOS) and the Ministry of Finance (MOF) the profits generated by the funds supporting the CMC and GMC. However, there are significant differences between the two instruments, reflecting the different objectives that they intend to achieve.

Central Bank Musharaka Certificate (CMC)	Government Musharaka Certificate (GMC)
I. Basic Function	
The CMC is intended to be used for managing banks' liquidity (by banks themselves and by BOS). Therefore, liquidity becomes a prime design objective to allow the instrument to be traded at very short notices.	The GMC is intended to raise funds for the budget and to be a reliable investment instrument for holders. Therefore, the stability of the instrument, in terms of prices and maturity, becomes an important design objective.
II. Intended Market	
CMC is intended to be used by banks, and possibly other nonbank financial institution.	GMC is targeted for the public at large.
III. Supporting Funds	
The CMC fund consists of shares in commercial banks only. The availability of banks' balance sheets on a monthly basis would allow the monthly calculation of the fund's fair value (book value plus retained profits) which is an important reference for pricing the CMC (particularly for short-term trading).	The GMC fund consists of shares in profitable public and joint venture enterprises. Since the fund's fair value does not need to be published frequently, the constraints on compiling the accounts of the chosen public enterprises in less than on quarterly basis will not hinder the trading in GMCs
IV. Maturity	
CMCs are issued without maturity. This would improve banks' ability to conduct secondary trading on short notice basis.	GMCs are issued with maturity. This would allow for a better public finance management and enhance the attractiveness of GMCs to longer term investors.
V. Dividends	
The CMC does not distribute dividends. Hence, banks can realise profits only from secondary trading or when BOS buys back the CMCs.	The GMC distributes dividends.
VI. On-Demand Re-Purchase Option	
The BOS stands ready to buy the CMCs on demand. This enhances the CMC liquidity.	There is on-demand repurchase option.

Source: IMF (April 28, 1999, p. 43).

ments issued by government.[106] A comparison of the design of the two certificates is presented in Table 3.3.

3.2.4 Transforming Commercial Banking

There is now a large body of experience in transforming commercial banking to Islamic banking. Clearly, any design of financial sector development in IDB member countries should incorporate the design for such a transformation. In this, the experience of Sudan appears to be the most advanced. However, Pakistan, Malaysia, and Iran have also made significant efforts. The Islamic Development Bank may wish to consider putting together a *Handbook for Islamising Commercial Banks*, for use by member governments who wish to do so.

At the same time, an effort should be made to eschew unnecessary (and possibly inefficient) separation of commercial from investment banking in smaller economies. The case against universal (or integrated) banking rests on fears of increased risks due to unduly close links between banks and enterprises (leading to misuse of loans, and higher financial risks), market concentration (leading to reduced competition), and greater difficulties in regulation and supervision of complex financial conglomerates. In smaller member countries, these concerns about safety and soundness are outweighed by advantages from informational advantages, economies of scale (in both banking and supervision), and greater diversification of risks.[107]

3.2.5 Promoting Equity Markets

The development of a (primary and secondary) market in equities should be priority component of financial sector development in IDB member countries. There is now ample evidence that stock markets promote development (see, for example, Box 3.2). Yet, it is surprising that there are no stock markets in African member countries, when twelve non-member countries have developed stock markets.[108] To some extent this reflects, naturally, the low level of investment demand, and hence the derived demand for corporate finance. Even so, the design of financial sector development in

Box 3.2 Equity vs. Debt

We have found a large effect of stock markets on subsequent development. We have failed to find a similar effect of bank lending. That this differential effect should exist is itself surprising. But if it is true, then it is even more surprising that more countries are not developing their stock markets as quickly as they can as a means of speeding up their economic development.

- Atje and Jovanovic (1993)

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106 Naturally, there are many attendant difficulties. First, the underlying banks and enterprises must be judged to be Islamic, within the meaning of the *shari`ah*. Second, they must also be profitable. Finally, since they must be government-owned, the role of the state in the economy would have to be more prominent than is currently thought wise.

107 For these and other arguments broadly sympathetic to universal banking see Claessens and Klingebiel (September 1999), Honohan and Vittas (August 1996), and Benston (1994).

108 Based on a review of markets in 12 Sub-Saharan African stock markets, Kenny and Moss (1998) conclude that their “positive economic effects … are far larger than any negative effects.”

IDB member countries should include the promotion of equity markets – ahead perhaps, and certainly of greater priority than, commercial banks – in any programme design.

To give some idea of the role of equity markets in enterprise financing, the experience of Turkey and Malaysia is revealing. In Turkey and Malaysia, more than 70% of the growth of corporate net assets during 1980-90 was financed from external funds; more than 40%, by new share issues.[109] In Malaysia, during 1986-91, 61% of corporate spending was financed by retained earnings, and only 34% by bank finance.[110]

In addition to infrastructure (transparency, laws, accounting and auditing standards and practices, etc.), the development of equity markets requires four types of policy intervention. First, a legislation framework is required to support the establishment of both a primary and a secondary market in equities. Second the tax regime needs to be reviewed and reformed to ensure that the fiscal regime is at least neutral between recourse to equity versus debt financing. Third, there is typically a need for technical assistance and training in institutional practices and procedures. Finally, arrangements must be made to provide adequate liquidity to the market.[111]

One area that has grown rapidly over the last decade – in both Islamic and other countries – has been of leasing (Table 3.4). Financial leasing is a contractual arrangements that allows one party (the *lessee*) to use an asset owned by a leasing company (the *lessor*) in exchange for specified periodic payments. The separation of legal ownership of assets (held by the leasing company) from the economic use of the asset (by the lessee) is critical to this arrangement. This arrangement is especially favoured by small and medium-scale enterprises.

Table 3.4 Leasing Volume & Market Share

(US$ billion, and % of total private investment)

	1990		1991		1992		1993		1994		%
	$b	%	$b	%	$b	%	$b	%	$b	%	Change
Bangladesh	..	..	..	..	..	..	0.1	7	..	..	..
Indonesia	1.9	9	2.0	9	1.8	8	3.2	14	2.7	7	2.4
Malaysia	0.6	7	0.8	7	0.7	5	0.7	5	0.8	5	-2.0
Morocco	1.0	2	0.2	5	0.2	5	0.2	4	0.2	6	2.0
Pakistan	0.1	2	0.1	4	0.3	5	0.3	5	0.3	6	2.9
Turkey	0.3	2	0.3	2	0.4	3	1.0	6	0.4	2	1.9

Source: International Finance Corporation (1996, pp. 49-50, 60).

Finally, member governments are sometimes advised to encourage portfolio flows, by easing (or abolishing) exchange and capital account controls. The wisdom of this advice came into serious question after the 1995 Mexican crisis. In the wake of the 1997 East Asia crisis, the enthusiasm for portfolio flows has all but disappeared.[112] This is probably all to the good. While portfolio flows are good, the bal-

[109] Singh and Weisse (1998, p. 610).
[110] Stiglitz (1994, p. 22). The balance was due to equity (2%) and asset sales (3%).
[111] Gelb and Honohan (1991, p. 85).
[112] Faiz Mohammad (October 1998) reviews lessons of the crisis for IDB member countries.

ance of advantage does lie in placing some restrictions to reduce, if not prevent, volatile movements of short-term capital.

3.2.6 Ameliorating Risk

A strategy for ameliorating risks to production, trade, and investment should be devised in the light of specific country circumstances, and should cover the entire spectrum of risks that constrain these activities. At least two kinds of risks, however, should feature in any strategy that is devised. First, in most low-income countries, where agriculture (including forestry, fishery and livestock) is a predominant or major activity, there is a need to devise mechanisms and instruments that are addressed to the risks specific to these activities. Second, toward the other end of the spectrum, there is a need to ameliorate corporate risks in the urban, formal sector.

3.3 Informal Finance and Micro-Finance

The adjective, informal, refers to activities that take place outside the authority, patronage, or coercive influence of the state.[113] Although, as is true for most countries, very little is known about the informal sector in IDB member countries, there is evidence that the share of the informal economy is large, and is larger in lower income economies. This makes the informal sector of special relevance to IDB members. Informal finance – mainly for seasonal agricultural needs, ceremonial consumption (on marriages, etc.), and disaster relief – is an ancient and significant component of informal activities.

What should be the government's policy toward the informal sector, in general, and informal finance, in particular? One view is that the informal sector is engaged in socially undesirable, if not outright criminal, activities that should be stopped. The growth of the informal sector, it is held, is largely a by-product of harsh government policies, including macroeconomic policies. In this view, by enforcing the law and rationalising government policies, the formal sector can in time serve the needs of those presently served by informal finance. In this way the informal sector can be fully integrated into the formal sector.

Of late, however, as disenchantment with government has grown, a more sympathetic view is being taken. It is being realised that where the informal sector seeks to avoid the gaze of the formal state – by avoiding registration, resisting monitoring, etc. – it does not escape the unauthorised registration, monitoring, taxation, and supervision by the informal state – state officials, themselves acting outside the ambit of the law. (In addition to corrupt officials, it is also subject to "regulation" by influential private individuals who provide patronage to, and enjoy the patronage of, state officials.) In this state of affairs, where the state fails to provide a large

[113] There are numerous alternative definitions of informal. The earliest, equate informality with the low-wage, low-productivity segment of the labour market (Lewis, 1954; Harris and Todaro, 1970). Of late, informality has been equated with unregulated self-employment (Hart, 1972; de Soto, 1989). The issue is reviewed by Thomas (1992), among others. The definition offered here relies on the three-part definition of the concept of power provided, among others, by Galbraith (1984).

group of its citizens with protection of life and liberty, their ability to continue to serve the needs of their communities is being seen with sympathy.

In terms of policy, therefore, it would be wiser to foster the growth of the informal sector, in parallel with the formal sector, while trying to eliminate the socially undesirable practices that affect it and that affects its dealings with its customers. By far the most frequent complaint against informal lenders is the exorbitantly high rate of interest that they tend to charge.[114] The large differential between interest rates in formal and informal markets, however, has created a niche market for micro-finance that is attracting a great deal of attention across the world. A recent study by the Regional Bureau for Arab States, United Nations Development Programme, in co-operation with the Middle East and North Africa Region of the World Bank has examined the application of Islamic banking principles to the practice of micro-finance.[115]

The practice of micro-finance operations is now well known.[116] While there are many approaches afield, five mechanisms have been identified that are common to most, if not all – micro-finance institutions.[117] Two – peer selection and peer monitoring – are associated with group lending, in which individuals are encouraged to form a group that selects the project and assumes responsibility for the loan. In this way, not only are the problems of moral hazard and adverse selection mitigated, but individually shared and joint liability is created as a substitute for collateral.[118] As a result, interest rates can be lowered and social welfare, enhanced.

As data presented in Table 3.5 show, however, group lending is by no means universal. In addition to peer selection and monitoring, micro-finance programmes also use dynamic incentives, regular payments, and collateral substitutes. By lending small amounts initially and then increasing loan amounts upon satisfactory payments dynamic incentives are created for securing high repayment rates without high monitoring costs, while mitigating information problems. Also, keeping repayments frequent, even if small, serves to screen out undisciplined borrowers, and ensures that the borrower has additional savings from which loans can be repaid (in advance of the flow of investment benefits). Finally, while few programmes require collateral, many involve substitutes like reciprocal deposits, and contributions to various kinds of forced saving schemes.

There is, however, never any unqualified good news on the policy front. Studies of microfinance programmes – themselves subject to criticism and qualifications – have raised questions about their sustainability and their impact. On sustainability, it seems that while none of the programmes are financially sustainable, the best among them do provide a cost-effective way to subsidise the poor. On social and

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[114] From a *shari`ah* perspective, all interest – whether at a low rate or high – is equally reprehensible.
[115] Dhumale and Sapcanin (No date given).
[116] For a Handbook, see Ledgerwood (1999).
[117] Morduch (1999), on which much of this section relies.
[118] Adverse selection occurs before the transactions and refers to situations where undesirable outcomes are most likely to be selected. Moral hazard occurs after the transaction where one party can shift the burden of undesirable behaviour to the other party. Mishkin (1997) examines these concepts in relation to financial crises.

economic impact, there are serious questions about methodology, which can only be resolved by more careful study. On balance, it is perhaps best to reproduce the assessment with which a recent authoritative survey concludes:

> The microfinance movement has made inroads around the world. In the process poor households are being given hope and the possibility to improve their lives through their own labour. But the win-win rhetoric promising poverty alleviation with profits has moved far ahead of the evidence, and even the most fundamental claims remain unsubstantiated.[119]

Table 3.5 Characteristics of Selected Leading Microfinance Programmes

	In IDB Member Countries			**In Non-Member Countries**	
	Grameen Bank, Bangladesh	Bank Rakyat Indonesia *Unit Desa*	Badan Kredit Desa Indonesia	Banco Solidario Bolivia	FINCA Village Banks
Membership	2.4 million	2 m borrowers; 16 m depositors	765,586	81,503	89,986
Average loan balance	$ 134	$ 1,007	$ 71	$ 909	$ 191
Typical loan term	1 year	3-24 months	3 months	4-12 months	4 months
Percent female members	95%	23%	–	61%	95%
Mostly rural? Urban?	rural	mostly rural	rural	urban	mostly rural
Group-lending contracts?	Yes	No	No	Yes	No
Collateral required	No	Yes	No	No	No
Voluntary saving emphasised?	No	Yes	No	Yes	Yes
Progressive lending?	Yes	Yes	Yes	Yes	Yes
Regular payment schedules?	Weekly	Flexible	Flexible	Flexible	Weekly
Target clients for lending?	Poor	Non-poor	Poor	Largely non-poor	Poor
Currently financially sustainable?	No	Yes	Yes	Yes	No
Nominal interest rate on loans (per year)?	20%	32-43%	55%	47.5-50.5%	36-48%
Annual consumer price inflation (1996)	2.7%	8.0%	8.0%	12.4%	–

Note: FINCA stands for Foundation for International Community Assistance. Although started in the mid-1980s in Latin America, FINCA-sponsored village banks can now be found all over the world, including in Uganda and the Kyrgyz Republic, among IDB member countries.
Source: Morduch (1999).

Even so, as micro-finance institutions (MFIs) proliferate – and if current proclivities of international financial institutions are any guide, they will – policy-makers will have to decide whether and how to regulate and supervise these institutions. This is a current topic of discussion among those concerned with micro-finance, and a consensus is nowhere in sight.

[119] Morduch (1999, p. 1609).

One principle, however, that should guide policy in this area is that those institutions that take deposits should be regulated. In many ways, the need for government to protect depositors is even greater in the informal sector, where their abilities to monitor the financial health of MFIs is even more limited than in the formal sector.

3.4 Summary

In financial sector interventions, it is useful to distinguish development from reform. In most of the least developed countries, where very few financial institutions exist and financial dealings are small in relation to the level of economic activity, policy attention should be directed to the development of financial institutions and instruments. By contrast where financial structure has emerged, policy reform should address improvements not only in the capacity but also in the efficiency of the system. Where this structure has yet to emerge, most of the international discussion of financial reform – interest rate liberalisation, dismantling of directed credit arrangements, reduction of taxation of financial intermediation, liberalisation of the capital account of the balance of payments, etc. – may well be largely irrelevant.

Both development and reform are normative concepts. IDB member countries need therefore to define an ideal state of affairs, at the national level, and a path towards it, in the light of their own cultural values. Such an ideal may be called an Islamic Financial Architecture. While important steps have been taken toward it, a grand design of the ideal Islamic financial system has not been attempted. IDB may consider whether it would be opportune to constitute a committee of distinguished scholars, supported by a special group in IDB, to work on an Islamic Financial Architecture to guide national efforts at financial development and reform.

In the interim, efforts at financial development in member countries should proceed pragmatically. As a general policy guideline it seems reasonable that financial development should be in response to market demand for financial services, rather than in imitation of the course of developments elsewhere. Secondly, policy should consider both the scale at which financial institutions become viable, and the size of the market in which competition can be a source of efficiency. In smaller countries, financial development should be designed not from international blueprints, but from a specific assessment of market demand and country conditions. In larger ones more conventional paths of development can be pursued, but again with a special effort to adapt international patterns to domestic requirements.

In many least developed countries, the possibility of promoting the establishment of Islamic micro-finance institutions may be worth investigating. Finally, where there are many benefits from a regional central bank in West Africa, it may well be time to begin a discussion on the benefits and costs of this arrangement.

4. FINANCIAL SECTOR REFORMS

Under the heading, financial sector development, the previous chapter discussed the efficacy and direction of developing financial institutions and instruments – along with a supportive environment – primarily in least developed economies. This chapter discusses financial sector reforms in economies where a financial structure has emerged, but is not performing as well as it could. While this distinction is useful to differentiate between the emphases on priorities in financial sector policy in economies with less versus more developed financial structure, much that has been said about financial sector development holds true for financial sector reforms.

The package of policies now called financial sector reforms started out as financial liberalisation – abolishing ceilings on interest rates, and dismantling directed credit arrangements. Over the last two decades, a number of countries liberalised their financial sectors. The experiment did not prove to be a resounding success. While critics ascribe this to irredeemable flaws in design, apologists argue either that external pre-conditions – legal and regulatory reform – were not met, or that the sequencing of reforms – macroeconomic stability before financial liberalisation – went awry, or both. (A third argument – more theoretical than practical, given political realities – is that bank failures, like cathartic healing, are essential to increase welfare and efficiency in the financial sector.) In the face of mounting difficulties, there was a gradual accretion of other policy changes to the original liberalisation package.[120] This enhanced package is now referred to as financial sector reform.

4.1 Macroeconomic Pre-Conditions

More often than not it is excess demand from the public sector that is at the root of macroeconomic problems.[121] The ability to restrain government, however, depends almost entirely on political institutions rather than economic ones. In the last fifty years, it is political rather than economic development that has proved to be a more intractable problem. By contrast, private sector demand is much more amenable to influence by monetary and fiscal policies. In this situation, it is not surprising that the efforts of developing countries to promote symptomatic remedies by economic policy interventions have proved at best to be ineffective.

Amidst the many controversies surrounding financial reform, there is unanimous agreement that unless the public sector's finances are in order, most other reform initiatives are unlikely to meet with durable success.[122] There is also agreement on

[120] The liberalisation package was enhanced by all or some of the following: reducing the taxation of financial intermediaries (including by low interest rate on bank reserves), introducing open market operations, developing capital markets, introducing prudential regulations, and even liberalising capital account controls, etc.

[121] This is not to say that there can be no other causes for macroeconomic instability – the government may make other policy errors, or the private sector may indulge in imprudent behaviour. But budgetary disequilibrium is a sufficient – not necessary – condition for macroeconomic instability, and has been the most frequent culprit in recent history.

[122] Strengthening corporate governance is an equally important pre-condition that has been discussed earlier (section 2.2.1 and 2.2.2), and is discussed below under "Other Supportive Policies" (section 4.3).

the main constituents of budget reform, although there can be disagreements on the relative emphasis to be given to different components. In designing public finance reforms, an important question to ask is whether the budget crisis is primarily a revenue crisis or an expenditure crisis? Obviously, while both revenues and expenditures need to be addressed, depending on the answer to this question, the relative emphasis of programmes can vary.

In one view, most budget crises in developing countries are due to low taxation. Evidence in support of this view can often be found in low tax rates. As a result, governments have relied excessively on loans, exacerbating the problem by adding a rising and unsustainable interest payments burden. Where, as is often the case, expenditures on defence are also high, solutions are found in increasing tax rates and improving collection rates.

An alternative view, however, holds public expenditures to be the bigger culprit. In this view, even if under-taxation was the source of unsustainable fiscal deficits that led to excessive borrowing in the past, today it is the high and rising burden of debt service payments that stands in the way of achieving sustainable patterns of public sector financing. If this is correct, then control of expenditures should be given higher priority than revenue mobilisation. This is especially true where social spending has already been squeezed below reasonable levels.

In either case, however, controlling runaway growth in indebtedness needs to be addressed first.

4.2.1 Managing the Debt Burden

Table 4.1 presents the most recent classification by the World Bank of IDB member countries by level of indebtedness and 1998 income. The grouping can be a useful guide to sequencing and pace of policy reforms in member countries.

The World Bank classifies 17 (almost one third of) IDB member countries as severely indebted – 14 low income, and 3 middle income. The 14 severely indebted low-income (SILI) countries fall in three groups: (i) Nine of the fifteen African IDB member countries; (ii) Mauritania, Somalia, and Sudan (but not Yemen); and (iii) Afghanistan, and Indonesia (newly classified as low-income). The 3 severely indebted lower middle income (SILMI) countries consist of Iraq, Jordan, and Syria. Of the 14 SILI member countries, 13 are classified as LDMCs by IDB.

The design and sequencing of policy reforms for the development of the financial sector in these countries should be quite different from those in other – moderately or less indebted – member countries. The aim of debt management initiatives in severely indebted countries should be to put in place mechanisms of “stand-still” and “roll-back” of the debt burden. This calls first for putting in place effective and durable institutional measures to limit borrowing by government. A the same time, severely indebted countries need to put together a strategy both to make the most effective use possible of international initiatives on debt relief, and to take domestic measures to reduce rates of indebtedness. Finally, it is important to address the necessary need for organisational change and human resources.

Table 4.1 World Bank Classification of Indebted IDB Member Countries, July 1999

	Severely Indebted		Moderately Indebted	Less Indebted		Not Classified	
Low Income	Afghanistan Burkina Faso [1] Cameroon[1] Guinea [1] Guinea Bissau [1] Indonesia Mali [1]	Mauritania [1] Mozambique [1] Niger [1] Sierra Leone [1] Somalia [1] Sudan [1] Uganda [1]	Bangladesh Benin [1] Chad [1] Comoros Gambia Pakistan Senegal [1] Togo [1] Yemen [1]	Azerbaijan Kyrgyz Republic Tajikstan Turkmenistan			
Lower-Middle Income	Iraq Jordan Syria		Algeria Morocco Tunisia	Albania Djibouti Egypt Iran	Kazakhstan Maldives Suriname	The State of Palestine	
Upper-Middle Income			Malaysia Turkey	Bahrain Lebanon Libya	Oman Saudi Arabia		
High Income						Brunei Kuwait	Qatar UAE

[1] One of the 17 IDB members that were in the group of 41 countries first classified as Highly Indebted Poor Countries (HIPCs). This group included 32 countries that met the original criteria of 1993 GNP per capita of $695 or less, and 1993 present value of debt higher than either 220 percent of exports, or 80% of GNP. To these 32 were added 9 countries eligible for Paris Club rescheduling. Subsequently Malawi was added to this group of 41.
Source: World Bank (2000) and Andrews et. al. (1999).

Under the September 1996 IMF/WB Highly Indebted Poor Countries (HIPCs) initiative, by 1999 four IDB member countries had qualified for debt relief (Table 4.2).[123] Uganda was the first country to reach both its decision point and its completion point, and received a 20% reduction in its stock of debt.[124] Among IDB member countries, Mozambique was next, and received some US$ 3.7 billion in relief, re-

[123] Non-member countries consisted of Bolivia, Guyana, and Côte d'Ivoire. See Andrews et. al. (1999), IMF (May 2000), and also *www.imf.org/external/np/HIPC*, on all of which this section relies.

[124] In HIPC terminology, a country reaches its decision point after three years of satisfactory performance under IMF/WB adjustment programs, when its eligibility for HIPC assistance is assessed. It then reaches its completion point, when it receives the bulk of its HIPC benefits, without further policy conditions. Under the original HIPC initiative, this was reached after a second satisfactory period under IMF/WB adjustment programmes. Under the enhanced HIPC initiative, this will occur after the implementation of pre-agreed key structural reforms, including the Poverty Reduction Strategy (PRS) – floating completion point.

ducing its debt stock to a third of its pre-relief level. This is the biggest relief provided to any country under the HIPC initiative.[125]

Table 4.2 Debt Relief to IDB Members Under the Original HIPC Initiative

				Assistance (in present value terms at completion point)		
	Decision Point	**Completion Point**	**Debt Relief (US$ m)**	**% Reduction in Debt**	**All creditors (US$ mln)**	**IMF (US$ mln)**
Uganda	Apr 1997	Apr 1998	650	20	347	69
Burkina Faso	Sep 1997	Apr 2000	200	14	115	10
Mozambique	Apr 1998	Jun 1999	3,700	63	1,716	125
Mali	Sep 1998	Dec 1999	250	10	128	14

Source: Andrews et. al. (1999).

In July 1997 and April 1998, respectively, when Benin and Senegal reached their decision point, they were assessed to be ineligible for relief, as their debt burdens were felt to be sustainable after recourse to traditional debt relief.[126] Also, preliminary discussions have been held regarding Guinea Bissau and Mauritania, and by the end of 2000 the eligibility of additional countries – including Cameroon, Chad, Guinea, Niger, Sierra Leone, Togo, and Yemen – may be reviewed.

The HIPC initiative seeks to reduce the net present value of debt below certain target levels specified as a ratio of exports (of goods and non-factor services), or sometimes of government revenue. In the initial framework these targets were a debt/exports ratio of 200-250%, a debt service to exports ratio of 20-25%, and 280% of government revenues. Within these guidelines, country specific targets were determined in each case. In September 1999, after a review of the first three years of experience, an enhanced HIPC (EHIPC) initiative has been announced under which the debt-sustainability targets have been lowered. In present value terms, the debt/exports target has been lowered to 150%, or for countries eligible under the fiscal window, to 250% of government revenue, whichever provides greater relief. In addition, however, debt relief under EHIPC will be tied to the country's adoption and implementation of a poverty reduction strategy (PRS).

In addition to Burkina Faso, Mali, Mozambique and Uganda – who have received assistance under HIPC – Benin, Cameroon, Chad, Mauritania, Niger, Senegal, Sierra Leone, and Togo will be eligible for consideration under EHIPC. In addition, Somalia and Sudan are expected to reach decision points in 2001 or later. All of

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[125] Not only did IMF and WB agree to increase the original level of assistance envisaged, but both Paris Club creditors and Russia – Mozambique's largest creditor – offered exceptional terms and special treatment.

[126] Their eligibility, however, will be reassessed under the enhanced framework, discussed below.

these countries can benefit from a review of the successful experience of the four IDB members who have received debt relief under the initial HIPC initiative.

While the problems of the severely indebted LDMCs may be more intractable, the appearance of Iraq, Jordan, Syria and especially, Indonesia, among the severely indebted countries is notable. The complexity of these economies and limitations of space preclude further discussion of approaches to debt management in these economies. Nevertheless, the priority of the problem cannot be overemphasised.

In many ways, the problems of moderately indebted countries can be just as difficult, because mechanisms of special relief are not available to them. Among these, several African LDMCs – Benin, Chad, Senegal, Togo – would be eligible for debt relief under the EHIPC initiative. For the other two – Comoros and Gambia – special efforts would be needed to formulate a debt management strategy, independent of reliance on international initiatives. This will also be true of the larger, Arab and Asian countries – Yemen, Bangladesh and Pakistan.

On the other hand, the moderately indebted middle income countries – Algeria, Morocco and Tunisia in the Maghreb, and Malaysia and Turkey in Asia – will have to rely to a much greater extent on market-based approaches to debt management.

Finally, it should be pointed out that the debt experience of the indebted member countries is not without relevance to the less indebted and the not classified member countries.

While macroeconomic strategy has to be tailored to the initial conditions and specific circumstances of each country, best practice in organisational arrangements for debt management is well-known.[127] The system of debt management should be organised along three specialised units: (i) a Statistical Unit, (ii) a Control Unit, and (iii) an External Finance Unit. The Statistical Unit should assemble timely information on the country's external debt. The Control Unit should assess the country's ability to service future debt service payments. The External Finance Unit, what types of borrowing are appropriate at any given time. Much the same requirements apply to the organisation of the domestic debt unit. Where member countries have not attended to them, a high priority could be accorded to these matters.

4.2.2 Controlling Public Expenditure Growth

After debt, the management of public expenditures should be given priority. The reform of public expenditure management (PEM) systems ("how to do it") and policies ("what to do") requires a change in the *behaviour* of public officials. Behaviour change requires institutional reform.

In designing proposals for institutional reform, there is a need to distinguish institutions from organisations.[128] Thus administrative reorganisation, restructuring, or re-

[127] See, for example, Klein (1994), UNCTAD (1989), UNDP (1989), and World Bank (1985, 1990). See also Husain and Diwan (1989).
[128] In technical terms, "institutions" refers to the *rules* under which "organisations" function. These rules can be, and usually are, both formal and informal.

engineering may or may not embody institutional reform. Institutional reform seeks to change human behaviour by altering the rules under which such behaviour occurs.

Human behaviour in organisations depends on four factors. First, clear rules and regulations have to be established to constrain undesirable behaviour. Second, procedures to detect deviations from these rules and enforce compliance need to be put in place. Third, moral and ethical behavioural norms, to reduce enforcement costs, need to be articulated. Finally, a system of education and training to inculcate respect for, and practice of, rule-governed behaviour, is required.

Box 4.1 The Dolma Bace Palace

[Sultan] Abdul Medjid himself could not pose as an example [in fiscal prudence] for his palace followers. At this time he was in the midst of indulging his pet fancy of constructing palaces. The jewel of his collection was the superb building of Dolma Bagtché. The Sultan manifested sufficient interest in its cost to inquire concerning it of his minister of the Civil List. The figure supplied by this official (thirty two pounds sterling), shocked the intelligence of the Sultan, until he was further informed that this sum represented the expense entailed by the Treasury in having issued promissory notes to the amount of the real cost of construction, 2,800,000 pounds sterling.

– Senior (ca. 18??), quoted in Blaisdell (1929)

In many member countries, public spending behaviour, like political and economic behaviour in general, suffers from grave deficiencies on all four counts. Rules are neither clear nor uniform—informal rules enjoy greater legitimacy than formal ones, the latter often being changed to accommodate the exigencies of the former. Procedures to enforce compliance are extremely deficient, with informal procedures often overriding formal ones. Moral and ethical norms underlying formal rules are often at variance with prevalent cultural norms. Finally, education and training is often grossly neglected.

In this environment, institutional reform should seek to build on low but solid ground. In particular, reforms designed to replicate institutions that have worked elsewhere are unlikely to prove durable. Although international experience should be a source of ideas on features of reform design, the reform itself should address problems as they exist. Equally, there should be some concern for how we get from where we are to where we want to go.

Until the early 1950s, the intellectual roots of reform proposals were in the colonial administration traditions. Since the early 1950s, with the start of Cold War, there was a shift to the related (American) public administration tradition in countries that established relations with the West. Both were informed by an appreciation of the political context in which administrative change takes place, and by an intimate knowledge of the details of existing practices and procedures.

During the last decade, international financial agencies (IFIs) have been promoting a new set of reform proposals, based on the application of (American) management practices to public sector “management” (vs. “administration”). Arguably, these practices were applied successfully to the reform of governments in the United Kingdom (UK), the US, and other member countries of the Organisation for Economic Co-operation and Development (OECD), in the wake of the Thatcher-

Reagan revolution. It is in this tradition that there is talk of a "best practice" in public expenditure management (PEM).[129] Based on this, a number of reports prepared in recent years have advocated the application of these principles to developing countries.[130]

In countries like the United States and the United Kingdom, the focus of financial administration is on relations between the legislature and the executive branch of government, and on improving operational procedures and accounts for rendering better accountability to the legislature. A secondary goal is to introduce flexibility in budget administration to give a little more discretion to the executive branch in using the budget as a tool of management. International best practice—to the extent that it is meaningful to speak of *a* best practice, suitable to all countries—assumes this political context to administrative and management reforms.

Box 4.2 Lessons of PEM Reform

- Never transpose into a different social and economic context budgeting reforms introduced elsewhere, without a realistic assessment of their impacts and requirements and appropriate adaptation if necessary;
- Never move beyond the basics of public expenditure management until certain that the basics have been set right;
- Never hope for a quick-and-easy technical solution to complex and longstanding budget process problems; and above all
- Keep the local authorities firmly in charge of the PEM reform process, and provide for adequate contestability of experts' advice.

– Schiavo-Campo and Tommasi

In many IDB member countries, legislatures are transient, and the ministry of finance is forever. Accordingly, administrative wisdom has sought to invest the ministry of finance with some of the powers of financial control that are normally associated with the legislature. This is often observed as an excessive concentration of financial management within the executive branch of government, and an undue emphasis of financial control by the ministry of finance, and the situation is traced to colonial practices. Accordingly, a foreign adviser may well find the ministry of finance engaged in tasks that in his experience are not proper to a ministry of finance. Before the finance ministry divests itself of these tasks, to align itself with best practice, it is essential to ensure that other elements will take these up. If this is not done the problem that the reform was aimed at solving would have been worsened after the reform. This too is recognised in the literature (Box 4.3).

Successful reform, therefore, requires both an appreciation of the institutional context of economic reform, and an intimate knowledge of the systems and policies on the ground. In addressing the problems that exist, global best practice can at best be a source of ideas. An uncritical adoption of the so-called best practice, without worrying about initial conditions for their success can only lead to a worsening of the situation.

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[129] Extensive details are provided in Schiavo-Campo and Tommasi (1999) and Potter and Diamond (1999), among others.

[130] In PEM, the example of New Zealand is being promoted, much as Korea was for trade and industry.

4.2 Financial Sector Reforms

Unlike prudent national financial management – aimed at strengthening budgets and balance of payments – financial sector reforms are much more controversial. This is not because financial sectors in developing countries are sound, nor because reforms are opposed. Instead, the problem is that the blueprints for financial sector liberalisation (and now, reform) that have guided reform efforts in developing countries since the early 1980s have been beset with severe problems. As misguided reform has led to a boom in financial crises, the literature on financial sector reforms has grown even faster. Most IDB member countries would be better served by devising such reforms as seem wise to them in the light of felt needs, quite independently of the current debates on financial sector reform. Present debates may be relevant for half a dozen IDB member countries, at the very best.

4.4.1 Theoretical Debates

It makes little practical difference whether financial sector development causes growth, or vice versa, or that there is no link.[131] Both are desirable goals of public policy that should be pursued on their own merits. Nevertheless, the issue is important to theoreticians, and although data refuse to oblige the protagonists categorically, beliefs continue to be expressed as self-evident truth. In itself, this would be harmless. However, the mechanisms needed to support these claims – the interest-elasticity of consumption (and therefore, saving), the mechanical transformation of saving into investment (even in open economies), and the fixed relationship between investment and growth – must also be held to exist, and to be efficacious.[132]

From a policy perspective, however, it would seem unwise to place faith in a Say's Law – that supply creates its own demand – of financial structure. Even if it is accepted that historical data reveal a pattern in which increasing sophistication of financial institutions and instruments tends to precede economic growth in the sample analysed, the suggestion that financial structure should be created so that it leads to growth may not be accepted. Given the severe shortage of financial and human resources – both of which are required in abundance to implement successful financial reform – for practical purposes, it would seem wiser to design reform in response to market demand.

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[131] A series of recent papers – Levine (1997), and King and Levine (1993a, 1993b) – establish a *post hoc, ergo propter hoc* causality, running from finance to growth.
[132] These are the most common but not the only mechanisms that are posited in support. Rajan and Zingales (1998), for example, argue that financial markets reduce the cost of external funds to an enterprise, by reducing moral hazard and adverse selection. They find support for this hypothesis in data for 41 countries – including Bangladesh, Egypt, Jordan, Malaysia, Morocco, Pakistan, and Turkey. Although, as they note "Much of our analysis rests on dependence of US firms on external finance being a good proxy for demand for external funds in other countries" (p. 565).

4.4.2 Lessons from the De-Repression Experience

The principal lesson of the financial sector liberalisation experience of the 1970s and 1980s is a simple one: in policy making, market-friendly approaches will work, and *dirigiste* approaches may work, but dogmatic implementation of recommendations – even if they are based on theoretically sound propositions – will quite likely lead to disaster.

Under the influence of Keynes, conventional wisdom had it that as a policy matter the financial sector could be treated with benign neglect. Following the Great Depression, however, it was increasingly felt that money did matter, at least in its ability to cause damage.[133] With Gurley and Shaw (1955), financial institutions started to be seen less as suppliers of liquidity (in the form of money), but in developed – not in underdeveloped – countries, as financial *intermediaries* that play an important role in the credit supply process.[134] It remained for McKinnon (1973) and Shaw (1973) to extend the argument to developing countries by arguing that financial *repression* – mainly, interest ceilings and directed credit – reduced or misallocated saving, depressing investment and growth.[135] On this theoretical foundation, the policy recommendation was advanced that financial markets should be liberalised immediately and completely.[136]

> **Box 4.3 Bagehot on Reform**
>
> *A system of credit which has slowly grown up as years went on, which has suited itself to the course of business, which has forced itself on the habits of men, will not be altered because theorists disapprove of it, or because books are written against it.*
>
> – Bagehot (1873, 331-2)

In retrospect, the implementation of these recommendations were disastrous – first, in Argentina, Chile and Uruguay (the so-called “Southern Cone”) in the late 1970s and early 1980s, and then in a number of African and Asian countries in the 1980s and 1990s. In all cases, financial liberalisation led to enterprise bankruptcies (especially, of leveraged borrowers), and bank insolvencies (see Table 4.3), and often exacerbated macroeconomic problems. Finally, it is now being debated whether and to what extent financial liberalisation contributed to causing or exacerbating the 1997-98 East Asian crisis.

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133 Early support for this view can be found in John Stuart Mill: “[money] exerts a distinct and independent influence of its own only when it gets out of order.” Quoted in Caprio, Jr., Atiyas and Hanson (1996, p. 1).

134 Goldsmith (1969) established the importance of market structure, and showed that financial sophistication and economic development moved together. He pointedly rejected any finding of causality between the two. For details on developments summarised all too briefly in this paragraph, see Fry (1988), and Gertler (August 1988), among others.

135 There were subtle but unimportant differences in the mechanisms envisaged. McKinnon saw investments as being lumpy and self-financed, requiring large savings that could only be accumulated if incentives were appropriate (deposit rates were high). Shaw saw benefits from higher deposit and lending rates in terms of higher savings and increased efficiency of investment.

136 World Bank (1989a) is probably the canonical reference, in which the faith is maintained against growing evidence of disarray. See also Gelb and Honohan (1991), prepared for a 1989 World Bank symposium on adjustment lending.

Table 4.3 Financial Liberalisation and Banking Crises in IDB Member Countries

Country	Financial Liberalisation, 1973-1998	Crises
Turkey	Interest rate ceilings on loans and deposits eliminated in 1980. Directed credit was phased out in 1988. Capital flows were liberalised in 1990.	1982-85 5 banks were rescued 1991 1994 Bank closures
Jordan	Interest rate liberalised in 1988.	1989-90
Egypt	Interest rates and foreign exchange controls were lifted in 1991. Ceilings on credit to private sector were lifted too. Foreign banks were permitted to conduct business in foreign currency in 1992.	1981-83 1990-91
Indonesia	Most deposit and loan rates were freed in 1983. The monopoly of state-owned banks over the deposits of state-owned enterprises were removed in 1989. New foreign banks were allowed to establish joint ventures in 1988.	1992-98
Malaysia	Interest rates and capital accounts were liberalised by 1978. Controls on interest rates were then re-imposed in 1985, and completely eliminated in 1992.	1985-88
Mali		1987-89
Togo	Interest rate liberalised in 1993	1993-95
Uganda	Interest rate liberalised in 1991	1994

Note: IDB members are selected from a sample of 56 countries. Syria is omitted because entries are blank in the original sources. With minor variations, this data set has been cited earlier in Demirguc-Kunt and Detragiache (1998), Lindgren, Garcia and Seal (1996), and Caprio and Klingebiel (1996) The last reference also includes Benin (1988-90), Burkina Faso (late 1980s), Cameroon (1987-), Chad (1980s & 1990s), Guinea (1985), Mozambique (1987-), Senegal (1988-91), Kuwait (1980s), Mauritania (1984-93), Morocco (early 1980s), and Bangladesh (late 1980s-) in its systemic banking crises data set.
Source: Mehrez and Kaufman (February 2000).

The reasons for the crises could have been anticipated. In most developing countries, the government is the largest player in the financial market. Moreover, neither its consumption, nor its demand for credit is sensitive to interest rate changes. Consequently, a rise in interest rates tends to depress public saving, as interest payments on domestic borrowing by government rise.[137] At the same time, higher interest rates create difficulties for the other borrower from the banking system – private enterprise. An unanticipated increase in interest rates – coupled, as it often is, with devaluation and trade liberalisation – leads to enterprise insolvency, especially where leverage and recourse to foreign borrowing is high. These developments in enterprise and government 'balance sheets' lead naturally to deterioration in the quality of bank portfolios, and balance sheets.

[137] Where interest rate liberalisation is accompanied by devaluation the local currency cost of foreign debt service also rises. If import liberalisation has also taken place, revenues from import duties – often a large component of government revenues – also fall.

In addition to pressures from the external environment on financial institutions, there are often significant internal problems as well. Where portfolio quality has already been compromised by poor loans – at the behest of government, the bank's board, staff indiscretion, or fraud – many institutions have been at the brink of insolvency to begin with. In institutions owned by government, often established in pursuit of specific public sector objectives (like finance of state enterprises), there is an implicit government guarantee that encourages such mismanagement. Finally, poor banking decisions – excessive exposure to sectors, enterprises, and individuals – have also been a contributing factor. For all these reasons, a close look at initial conditions would have been sufficient to dissuade most governments from the kind of liberalisation that led to extremely expensive mistakes.[138]

Box 4.4 Lessons from Banking Crises

What lessons can be learned from the crises of the last two decades? The main candidates for explaining the boom in bank failures and the unprecedented fiscal cost of these episodes are that:

- *With the demise of colonialism and rise of nation-states, there has been more local banking – more countries attempting to have banks that specialise in lending to the home market, leading to greater bank fragility and more banks to fail;*
- *Macro volatility, post-Bretton-Woods, has increased or shocks are transmitted more readily; and/or*
- *Government safety nets are encouraging greater moral hazard, without commensurate improvements in the information and incentive environment.*

– Caprio, Jr. (September 1998)

As much of this was realised, the concept of financial sector reforms was widened from the earlier emphasis on interest liberalisation, and dismantling directed credits. Increasingly, the talk was of financial "reform" and not just liberalisation. Yet, in 1994, the received wisdom was summarised as follows:

> …An emerging consensus, and one that is based overwhelmingly on the Southern Cone experience, appears to be that gradual financial liberalisation – indeed, perhaps very little – is to be preferred. Cho and Khatkhate (1989), McKinnon (1988), and Villanueva and Mirakhor (1990) all urge caution in liberalisation, emphasising the achievement of macroeconomic stability and adequate bank supervision as preconditions for successful financial reform, while Calvo (1988) and Rodrik (1989a,b) use credibility arguments to support a narrow focus of adjustment programs, leaving the financial sector for last.
>
> Dornbusch and Reynoso (1989) are even more doubtful about the benefits of liberalisation in all but the most repressed economies, arguing that it instead exacerbates macroeconomic instability by robbing the government of tax revenue. Indeed they go so far as to … state that 'financial

[138] In practice, the balance of payments and budgetary needs of governments often prevailed over a clear appreciation of the costs involved, in what turned out in retrospect to have been a mistaken belief that these costs could be contained.

factors are important only when financial instability becomes a dominant force in the economy.'[139]

Table 4.4
Restructuring Exercises following Bank Insolvencies in IDB Member Countries

Successful	Mixed Results	Unsuccessful/not yet resolved/insufficient time	
African Members			
	Benin (1988-90) Senegal (1988-91)	Burkina Faso (late 1980s) Cameroon (1987–) Chad (1980s and 1990s)	Guinea (1985) Mozambique (1987–) Togo (1993–) Uganda (1994)
Arab Members			
	Egypt (early 1980s) Mauritania (1983-93)		
Asian Members			
Malaysia (1985-88)	Bangladesh (late 1980s) Turkey (1982-85)	Indonesia (1994–)	

Source: Caprio, Jr. and Klingebiel (1996).

Despite these voices of caution, financial liberalisation proceeded apace in Africa and Asia. Not surprisingly, it met with similar results. Among other problems, financial liberalisation was followed by a spate of banks becoming insolvent, requiring restructuring efforts (see Table 4.4, evaluating the success of these efforts in IDB member countries).

Box 4.5 Financial Repression

Empirical research on the relationship between interest rates and savings in countries that have liberalised their financial markets has generally failed to find clear evidence of a significant and sizable positive correlation.

– Demirguc-Kunt and Detragiache (1998, n. 1, p. 329)

…there is no convincing empirical support for the proposition that a higher real interest rate leads to substantial increases in domestic saving in developing countries.

– Schianterrelli et. al. In Caprio, Atiyas and Hanson (1996, p. 72)

It has been said that all history is an argument about the future. So it is with lessons of experience. What lessons then can be drawn from the experience of countries that liberalised their financial sectors over the last two or three decades? Or, what amounts to the same thing, what can be recommended about policies to be pursued in the future.

To begin with, it should be pointed out that in retrospect the key premises on which the McKinnon-Shaw propositions were based are no longer held to be true. Of these, the more important premise is the "savings-investment-growth" view of the "process" of development. This view is now regarded to be hopelessly naïve. No one believes that capital formation is a primary

[139] Gerard Caprio, Jr. in Caprio, Jr., Atiyas and Hanson (1996, p. 4). References cited in the quote may be seen in the original. The book was first published in 1994. See also Caprio, Jr. and Klingebiel (1997), and Caprio, Jr. (March 1997).

Box 4.6 Lessons from World Bank Financial Sector Reform Operations in IDB Member Countries

Indonesia The audit report for the PSDLs [private sector development loans] draws a number of important conclusions about the correct sequencing of reforms. First, the legal, regulatory, and supervisory environment of the financial sector must be strengthened before or at the same time as entry is liberalized. Second, establishing a strong legal infrastructure for banking activities should have priority from the start, rather than be one item on the continuing agenda. This would have sent a clearer signal to the private sector that the government was irrevocably committed to a fundamental change in relationships. Only in November 1997, did the Bank approve a technical assistance loan to directly strengthen the structure and improve the soundness of the banking system. [p. 11]

Pakistan An important lesson from Pakistan is the need to maintain the presence, analysis, and dialogue on the sector and to follow-up with regular operations, preferably adjustment-type, to reinforce whatever progress is made under one operation. The Bank has had a stop-and-go approach to the financial sector in Pakistan; essentially the Bank backed-off when it should have continued. The Bank made one financial sector adjustment loan in FY89 and nine years later approved another, the Banking Sector Adjustment Loan. Pakistan would have benefited from much earlier introduction of financial sector reform, particularly reform aimed at establishing uniform and transparent accounting, developing legal, regulatory, and enforcement infrastructure; and strengthening the banking system. Institution-building through FILs [financial intermediary loans] is more time-consuming and vulnerable to political intervention than the policy-based components of SADs [sector adjustment loans], which provide for market-based determination of interest rates and improvements in institutional infrastructure. [p. 31]

Pakistan It is very difficult to mount successful loans to be channeled by DFIs [development finance institutions], through unreformed, or only partly-reformed state banks in a heavily distorted financial sector. It is also very difficult to achieve the objectives of financial sector reform in a macroeconomic environment characterized by public overspending, inflation, and high real interest rates. ESW [economic and sector work] certainly deepened the knowledge of the sector and identified major structural issues. But ESW alone is not enough to develop a timely and clear financial sector strategy with an appropriate sequencing of policy measures. [p. 44]

Senegal A lesson to be derived from the Bank's overall experience in Senegal is that the Bank need to place considerably more emphasis on "getting it right" in the first place, be it with regard to the basics of the country's economic situation, its sectoral reform requirements, or the need for individual institutions or particular forms of lending. [p. 49]

Turkey Experience from the two FSALs [financial sector adjustment loans] indicates incomplete government ownership of the reform program, partly because of lack of a political consensus, a reflection of continued political opposition to some of its measures by entrenched groups. The Bank was also responsible for not having asked for ownership of the most critical components of the reform. [p. 22]

Source: World Bank (Mathieu, 1998)

determinant of economic development or even growth.[140] Nor does anyone today view economic growth as a disembodied process, independent of history and institutions. At the same time, there is a greater realisation that saving need not be translated into investment in open economies. Since no one believes that higher saving is sufficient for higher investment-growth, it becomes irrelevant whether higher interest rates would or would not lead to higher saving. Even so, empirical work since McKinnon and Shaw published their seminal papers has failed to find support for the link between saving and interest rates (see Box 4.6).

What then should be the purpose of policy interventions in the financial sector by IDB member countries? Clearly, the first priority of policy should be to prevent crises, manage them if they occur, and to restore stability and growth after a crisis. Major lessons for IDB member countries from the Asian financial crisis have been reviewed comprehensively in an earlier paper in this series.[141] This section therefore focuses on a different set of issues that are also relevant to financial reform in IDB member countries. In what ways can Muslim countries adapt the experience of Western Europe and the United States to avoid the mistakes that were made there, and design a path of financial sector development and reform that is more consistent with the *shari`ah*?

4.4.3 Toward a Strategy for Islamic Financial Reform

Among the gifts of modern economic growth, banking may well be a Trojan horse. Even in industrial economies, banking crises have not been uncommon and as income levels have risen, the share of banking in the financial sector has fallen, while that of equity markets has risen. In a recent study, Bossone (October 1999) goes so far as to ask whether, in the face of persistent crises, countries should not in fact plan to phase out banking in a planned way:

> …whereas early in development, banks provide essential financial infrastructural services as integral part of their exclusive relationship with borrowers, further economic development requires such services to be provided extrinsically to the bank-borrower relationships, clearly at the expense of bank rents. Financial sector development thus seems to be characterised by a fundamental discontinuity in that banks are to be supported early on in development, while later on they need to be – so to say – "weakened" precisely to foster development. This raises the question of *when* and *how* optimally to generate and manage the discontinuity before it is forced upon society by traumatic and costly events such as bank crises. [Italics in original]

[140] King and Levine (1994) mock the investment growth link as "capital fundamentalism." Easterly (August 1997) concludes his epitaph on the Harrod-Domar model that underpins this view: "In sum, there is no theoretical or empirical justification for assuming a short-run proportional relationship between investment and growth. There is no theoretical or empirical justification for calculating a 'financing gap' between 'investment requirements' and saving. There is no theoretical or empirical justification for using such a 'financing gap' calculation to influence policy or the allocation of foreign aid. After forty years, the Ghost of the Financing Gap can finally be laid to rest." A cursory look at recent publications will show, however, that ghosts are hard to lay to rest.
[141] Faiz Mohammad (1998).

Although not for the same reasons, the Islamic banking movement – especially in Sudan, Pakistan, Malaysia, and Iran – does provide a body of experience that can be studied to synthesise a blueprint for *how* this can be done in IDB member countries. In this way, not only will IDB members avoid the costs that developments in industrial countries have imposed upon them – and their followers – but will also put in place a system that is more responsive to the cultural aspects of the demand for services in their financial markets. As Demirgüç-Kunt and Levine (July 1999) point out in yet another recent paper:

> Economists have long debated the advantages and disadvantages of bank-based financial systems vis-à-vis market-based systems. This debate has primarily focused on four countries. In bank-based financial systems such as Germany and Japan, banks play a leading role in mobilising savings, allocating capital, overseeing the investment decisions of corporate managers, and in providing risk management vehicles. In market-based financial systems such as England and the United States, securities market share centre stage with banks in terms of getting society's savings to firms, exerting corporate control, and easing risk management.

With this concern, they have compiled extensive data on financial structure across the world. This data includes 9 IDB member countries on the basis of which, Table 4.x presents data on financial structure and development for these countries (except Iran, for which data in this form is not provided; in each of the four sub-groups, the countries are ranked by level of development).[142] In order to develop strategies for Islamic financial reform, there is a need to study in some depth the experience of Malaysia and Turkey. This should provide guidelines for transforming bank-based economies to market-based ones, especially in the case of Malaysia, Islamic market-based ones. These lessons should be of specially interest to Jordan and Tunisia that have relatively more developed financial systems, and to Pakistan where as a result of a decision of the Supreme Court the government is engaged on an ambitious exercise of Islamising the entire financial system.

Table 4.5
Financial Development & Structure

Economy	Financially underdeveloped	Financially developed
Bank-based	Bangladesh Egypt Indonesia Pakistan	Tunisia Jordan
Market-based	Turkey	Malaysia

Source: Demirgüç-Kunt and Levine (July 1999).

Clearly, the highest priority in a programme of Islamic financial reform would be the establishment of conditions conducive to the growth of stock markets. An essential pre-condition for success in this initiative would be the establishment of supportive social and financial infrastructure - accounting, auditing, contract enforcement, the existence of titles for assets and their exchange, transparency, etc. (discussed at some length in chapter 2).

[142] Nor is Sudan included in the data.

An important implication of the logic of this suggestion would be that Islamic economic reform should be entrusted to the securities and exchange regulators in member countries, rather than to central banks. Equally, much more attention would have to be given to the prudential regulation and supervision of securities markets, than to commercial banks. Although a great deal of work has been done in this area by the International Organisation of Securities Commissions (IOSCO), a comprehensive and internationally endorsed set of principles and practices for the regulation of securities and futures markets is yet to be developed.[143]

Regulation and supervision of securities markets entail both the formulation and supervision of sound market practices and the oversight of financial intermediaries that specialise in securities business. The activities and institutions over which securities authorities exercise oversight are diverse and subject to substantial change over time. A major responsibility of securities authorities is the licensing of investment firms and other entities primarily engaged in securities business and the development of standards for their sound operation. As with the licensing of banks, authorities need to have clear and well-defined procedures and standards to ensure that owners meet objective licensing norms, that there is a sound business plan and that capital is adequate given the risks taken on by the firm.[144]

In promoting equity market development in member countries, a major role can be played by reform of contractual savings – especially pension funds.[145] Even though, traditionally, family members provide for the care and support of the elderly in most member countries, the existence of state pensions does create a pool of saving of considerable size. It is also a feature of Islamic societies that individuals become more devout in their old age, and are anxious to ensure that their pension incomes are free of *riba*. Typically, however, equity markets are small, volatile, and subject to fraud and other malpractice. In this situation, few are willing to entrust their retirement saving to equity-based pension funds. There is need, nevertheless to devise appropriate instruments – and perhaps widen the market to a regional one – to meet this demand for a financial service that is characteristic of the Islamic market.

Finally, there is also a need for special efforts to promote mutual insurance (*takaful*) on a wider basis, especially in rural areas. According to some recent studies, it is felt that in many least developed countries, the demand for risk amelioration may well exceed the demand for finance in rural areas.

A package of Islamic financial reform, then, may consist of the promotion of equity markets – in a move toward market-based rather than bank-based system – especially supported by appropriate pension reforms, the creation and promotion of innovative Islamic insurance, and the Islamisation of commercial banking. The prospect of Islamic micro-banking also holds promise for inclusion in such a package.

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[143] Nor do international standards for insurance supervision exist, although the International Association of Insurance Supervisors is developing principles relating to the supervision of insurance companies, and supplementary guidelines for application by national authorities.
[144] BIS (April 1997).
[145] Life insurance, in its present form, is not considered permissible under Islamic law by most scholars.

To this transformation of existing financial practices should be added innovative institutions and instruments designed to meet the specific needs of Islamic markets. Finally, the example of Sudan provides ideas on Islamic ways of conducting monetary policy by the central bank.

4.4.4 Role of the Central Bank: Prudential Regulation and Banking Supervision

As long as banks exist, regulation and supervision of financial institutions – along with laws governing financial transactions and procedures to enforce them, accounting and financial accounting standards and disclosure policies, and the dissemination of legal and financial information – will remain a key component of the financial infrastructure of an economy.[146] Ever since their creation, banks have been troubled by frequent crises. In recent years, this inherent fragility of banks has been brought into sharp focus by the financial crises that have occurred in East Asia, Russia, and Brazil, among other countries, in the wake of pre-mature liberalisation of the financial sector and volatile capital flows. As a result, the design of appropriate regulatory and supervisory structures has once again emerged at the top of the policy agenda.

Financial crises can result from weaknesses in the management of financial institutions, or of the enterprises that borrow from them, or both. In addition, the operational performance of both banks and enterprises can be adversely affected by changes in the economic environment. Large currency devaluation, for example, motivated by a desire to relieve pressures on the balance of payments, often leads to a deterioration in the financial position of enterprises that have borrowed in foreign exchange. In time, this can have a potentially adverse effect on bank balance sheets. These pressures can be aggravated where devaluation is accompanied by trade liberalisation that weakens the competitive position of affected enterprises, and by financial liberalisation that raises the cost of funds.

The impact of the economic environment on financial sector fragility is only now beginning to be understood. The early literature on aggregate indicators, drawing on the thinking on corporate bankruptcy, followed the categorisation that has come to be known as the CAMELS rating – for capital adequacy; asset quality; management soundness; earnings (trends and quality); liquidity (and asset and liability management); and sensitivity to market risk.[147] More recent studies, focusing on non-performing loans, find that this kind of assessment is empirically significant only if non-performing loans and capital adequacy are considered together.[148] This finding is in line with explanations that attribute the East Asian financial crisis to weaknesses in the financial institutions.

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[146] Khanna, Adkins and Meyanathan (1992).

[147] Altman (1968), Sinkey (1978), and Thomson (1991). The traditional CAMEL system analyses the first five aspects, considered to be the most important indicators of the financial strength and operational strength of a financial intermediary.

[148] Gonzalez-Hermosillo, Pazarbasioglu, and Billings (1997), which includes a recent survey of empirical studies on banking failures.

The CAMELS system provides the basis for the Basle Core Principles (CPs),[149] which constitute the current international standard for prudential regulation and supervision of banks. These standards were established by the Basle Committee on Banking Supervision (BCBS),[150] following a call by the Group of Seven (G-7) countries, at the Lyons Summit in June 1996, to define a set of basic elements for an effective system of banking supervision.[151] The CPs comprise 25 basic principles that need to be in place for a supervisory system to be effective (see Table 3.4).

Table 4.6 The Basle Core Principles

Principle(s)	**Relate to …**
Principle 1	Preconditions for effective banking supervision
Principles 2 to 5	Licensing and structure
Principles 6 to 15	Prudential regulations and requirements
Principles 16 to 20	Methods of ongoing banking supervision
Principle 21	Information requirements
Principle 22	Formal powers of supervisors
Principles 23 to 25	Cross-border banking

Note: Principle 1 is different from the general preconditions, covering issues like independence, responsibilities, legal framework, and information sharing.
Source: BCBS (September 1997).

Before establishing the main CPs, the document outlines a series of general preconditions that are beyond the control of the supervisory authority, but affect the ability to supervise: “Banking supervision is only part of wider arrangements that are needed to promote stability in financial markets. These arrangements include: (1) sound and sustainable macro-economic policies; (2) a well developed public infrastructure; (3) effective market discipline; (4) procedures for efficient resolution of problems in banks; and (5) mechanisms for providing an appropriate level of systemic protection (or public safety net).” These “wider arrangements” need greater attention than they have received. The 25 CPs cover seven broad areas (Table 3.4), and are seen as minimum requirements for effective bank supervision

[149] Embodied in BCBS, *Core Principles for Effective Banking Supervision*, September 1997. Indonesia and Malaysia, from IDB members, were associated with the development of these principles.

[150] The BCBS was established by the central bank governors of G-10 countries in 1975. It consists of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. Its secretariat is located at BIS in Basle, Switzerland. See BCBS (September 1997, June 1999, and October 1999).

[151] They were, and continue to be aided in their work by a number of committees and working groups, like Arab Committee on Banking Supervision, Caribbean Banking Supervisors Group, Association of Banking Supervisory Authorities of Latin America and the Caribbean, Eastern and Southern Africa Banking Supervisors Group, EMEAP Study Group on Banking Supervision, Group of Banking Supervisors from Central and Eastern European Countries, Gulf Co-operation Council Banking Supervisors' Committee, Offshore Group of Banking Supervisors, Regional Supervisory Group of Central Asia and Transcaucasia, SEANZA Forum of Banking Supervisors, Committee of Banking Supervisors in West and Central Africa.

that should be supplemented by supervisory authorities in the light of country conditions.

Table 4.7 Summary of Macroprudential Indicators

Aggregated Macroprudential Indicators		Macroeconomic Indicators
Capital adequacy Aggregate capital ratios (CRs) Frequency distribution of CRs **Asset quality** ***Lending Institutions*** Sectoral credit concentration Foreign-currency denominated lending Non-performing loans and provisions Loans to loss-making public sector entities Risk profile of assets Connected lending Leverage ratios ***Borrowing entity*** Debt/equity ratios Corporate profitability Other indicators of corporate conditions Household indebtedness **Management soundness** Expense ratios Earnings per employee Growth in the number of financial institutions **Earnings/profitability** Return on assets Return on equity Income and expense ratios Structural profitability indicators	**Liquidity** Central bank credit to financial institutions Deposits in relation to monetary aggregates Loan-to-deposits ratios Maturity structure of assets and liabilities/liquid assets ratios Measures of secondary market liquidity Indicators of segmentation of the money market **Sensitivity to market risk** Foreign exchange risk Interest rate risk Equity price risk Commodity price risk **Market-based indicators** Market prices of financial instruments, including equity Indicators of excess yields Credit ratings Sovereign yield spreads	**Economic growth** Aggregate growth rates Sectoral slumps **Balance of payments** Current account deficit Foreign exchange reserve adequacy External debt (including maturity structure) Terms of trade Composition and maturity of capital flows **Inflation** Volatility in inflation **Interest and exchange rates** Volatility in interest and exchange rates Level of domestic real interest rate Exchange rate sustainability Exchange rate guarantees **Lending and asset price boom** Lending booms Asset price booms **Contagion effects** Financial market correlation Trade spillovers **Other factors** Directed lending and investment Government recourse to the banking system Arrears in the economy

Source: IMF (December 15, 1999). See also Evans et. al. (April 2000)

A number of scholars have suggested that the Basle CPs are inadequate for developing countries, and that they should pursue more stringent standards even if it means discouraging some borrowers. Of late, it has also been realised that both banks and the enterprises to which they lend can suffer from changes in the economic environment. Alternative explanations of the East Asian crisis have focused on short-term capital flows. Accordingly, a different strand in the recent literature on prudential regulation emphasises exposure to currency and inflation and risks as a result of short-term foreign borrowing.[152] Other indicators of vulnerability include segmentation (often measured by inter-bank interest rate differential, as a proxy), the ratio of deposits to broad money, and aggregate stock indices.

As suggested earlier, however, the apparatus of regulation and supervision should bear some relation to the level of development of the financial sector. Otherwise, not only will development be impeded, but regulations themselves will be hard to enforce. Finally, recent financial crises have led to a flowering of literature on indices of fragility of financial systems, and on early warning indicators. Although they can sometimes be marketed more aggressively than is warranted, they do provide a useful input into policy-making. The IDB could help member governments in the design and monitoring of such indicators.

4.4.5 Regulation and Supervision of Islamic Financial Institutions

Another key question is whether central banks should regulate Islamic banks under the same regulatory framework that they apply to commercial banks? Indeed, more generally, how should Islamic financial institutions – banking, securities markets, and insurance – be regulated and supervised? In addressing these questions, it is important to distinguish the contexts in which they arise.

So far, these questions have been raised in the context of how bank regulators in Western countries should treat branch and cross-border activities of Islamic banks in their jurisdiction. In addressing this question, a distinction has been made between canonical versus practical Islamic banking, and it has been observed that "for all practical purposes, Islamic banking is being carried out in a hybrid way that is somewhere in between the paradigm version and conventional banking."[153] Also, that since neither the principal nor the return on deposits is guaranteed in (canonical) Islamic banking, Islamic banks "basically pool depositors' funds to provide depositors with professional investment management … [underscoring] an interesting similarity between the operation of Islamic banks and [US] investment companies." In this view, then, it is suggested that Islamic banking may well be a higher risk activity than conventional banking, and should therefore attract higher capital adequacy standards. As these are somewhat different from the concerns of this paper, the issue is not discussed further.[154]

Of greater interest to this paper is how these questions should be addressed in the context of IDB member countries. Once again, given the diversity of the fortunes of Islamic banking within member countries, it is important to distinguish countries actively pursuing the Islamisation of financial institutions from those where only a permissive stance has been adopted.[155] In countries where Islamic banks are seen

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[152] Frankel and Rose (1996), Sachs, Tornell, and Velasco (1996), and Honohan (1997).
[153] The first and perhaps only paper being by Errico and Farahbaksh (1998) at the IMF. (What is called canonical Islamic banking here, they call "paradigm version of Islamic banking.")
[154] Although, clearly, national arrangements worked out by member countries should be cognisant to their reception in non-Islamic countries.
[155] Within the first category a further distinction can be made between countries moving toward a unified Islamic financial system, and those working toward a dual system. Within the second, between sympathetically versus reluctantly permissive countries.

essentially as banks, albeit with a difference, it makes sense to regulate them as banks, albeit with a difference – leading to treatment not unlike that suggested in the previous paragraph. This is in fact the practice in most member countries where Islamic banking is taking place.[156] Where Islamic banking (and finance) is taken more seriously, as a constitutive element of a radically different programme of social and political change, the question becomes more complex. For if the claim is taken seriously that Islamic "banks" are in fact not deposit-banks but investment companies then the paradigm of bank regulation – in which the European Union (or Basle) approach is only one of several sensible approaches – provides little or no guidance to regulation of Islamic banks. What is then required is a rethinking of regulatory aims, constraints, and approaches from first principles that is well beyond the scope of this paper.[157]

Before leaving the subject, however, attention should be drawn to the North European approach to integrated financial supervision, which would seem suitable for Islamic countries moving toward market-based integrated financial systems, advocated in this paper.[158] For smaller countries (or those with scarce supervisory resources, or countries in which banking dwarfs securities and insurance), and those moving toward integrated financial systems, the economies of scale from establishing a single supervisory agency for the entire financial sector would seem to outweigh the costs of transition.

For practical purposes, however, these issues arise only for canonical Islamic banking. In practice, with the exception of a handful of countries, the "hybrid" form of Islamic banking and finance remains much closer to European canonical forms. The regulatory and supervisory questions that arise therefore can be addressed within the framework of conventional practices. It is important, however, that at least in member countries an objective view is taken of the risks associated with Islamic finance. Otherwise, a discriminatory regulatory framework would lead to a non-level playing field, which would not be in the best interest of efficiency and welfare.

4.3 Other Supportive Policies

In many ways, the success of all efforts at financial development or reform rest on the prior creation of an adequate financial infrastructure and strengthening corporate governance – legal framework and procedures, accounting policies and disclosure, transparency, and prudential regulation and supervision. Of these, the first two have been discussed earlier (sections 2.2.1 and 2.2.2), in the context of a review of the state of these standards, in selected member countries. At the same time, it is important that information about laws and accounts is easily accessible to

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[156] See Al-Omar (2000).

[157] It also raises important questions about the appropriate role of the state in regulating, supervising, and adjudicating normal commerce, which require a wider discussion of social and political philosophy.

[158] The discussion in this paper is based on Taylor and Fleming (November 1999), who examine the experience of three Scandinavian countries that have practised integrated supervision for the past 10 years.

lenders and investors. In this concluding section, therefore, the regulation and supervision of banks, and access to information are discussed.

In the absence of information, or with unequal access to information – or *asymmetric information*, lenders and investors are unable to tell good companies from bad. In this situation, they tend to make their decisions on the basis of market averages. This leads both to a lack of capital, and to its wasteful use. It is important therefore not only that information of good quality exists, but also that it be available.

In large measure, with the appropriate incentive framework, the private sector ensures that this is done. In addition to financial newspapers, periodicals and journals, private firms analyse the performance of banks and companies. This can often be supplemented by credit rating agencies, established either by government or with government encouragement. Finally, regulatory agencies should publish and disseminate suitably processed information for the information of the general public.

4.4 Summary

There is now fairly conclusive evidence that over the last twenty years experiments at financial liberalisation and reform have led frequently to financial distress in the experimenting countries. Critics of the reforms claim that this is due to fundamental flaws in design; apologists, either that institutional pre-conditions were not met, or that sequencing was wrong, or that bank failures are an essential cost for improving welfare and efficiency. All agree, however, that macroeconomic stability is an essential pre-condition to successful financial reform.

Budget deficits are the root cause of macroeconomic problems. While low taxation and weak expenditure controls may have been the source of rising pressures on public finances in the past, leading to increasing indebtedness, today it is the burden of debt that is the main impediment to the sustainability of macroeconomic policies. The restoration of macroeconomic stability therefore requires an effective debt management policy on the part of member countries. At the same time, there is a need to put in place effective public expenditure control mechanisms.

The principal lesson of the financial sector reform experience of the last two decades may be a simple one: in policy-making, market-friendly approaches will work, *dirigiste* ones may work, but the dogmatic pursuit of a policy design will quite likely lead to disaster. Numerous IDB member countries, among others, that pursued these policy reforms faced financial crises as a result. On the basis of these mishaps, there is now an extensive literature on bank fragility and insolvency, early warning indicators, and financial crisis avoidance, management and resolution. As this debate is of relevance to no more than half a dozen member countries, it is not pursued further. Instead, a strategy for Islamic financial reform is outlined.

4. Financial Sector Reforms

There have been suggestions in the recent literature that market-based systems are superior to bank-based systems. Also, universal (rather than specialised) banking may be more suitable to the circumstances of most member countries. With increasing sophistication, it may well be wise to phase in equity markets at the expense of banks in financially developed countries. At the same time, regulatory design should encourage universal banking. In this a study of the experience of Malaysia should be valuable. This suggests a reform design that emphasises equity market development, especially through promotion of Islamic pension management schemes; the promotion of mutual insurance (*takaful*); promotion of universal banking; and the Islamisation of commercial banking. This would not rule out the role of the central bank in regulation and supervision of banks, but would place the task of financial reform with the security market regulation agency in member countries, rather than the central bank. Equally, member countries should explore the North European experience of integrated financial sector regulation.

5. CONCLUSIONS

The main purpose of this paper is to review the state of the private sector and financial markets in IDB member countries, and to examine how financial markets should be developed and reformed so as to promote private sector development in these countries. The focus of the paper therefore is not on IDB, but on IDB member countries. On the basis of this review, however, this final chapter turns to an identification of some strategic directions for IDB, with particular emphasis on its newly created affiliate, the Islamic Corporation for the Development of the Private Sector (ICD).

Naturally, to do full justice to the task would require a study of the operations of IDB and its affiliates that would be well beyond the scope of this paper. The conclusions presented in this chapter therefore are both limited (to some directions suggested by the analysis of conditions in member countries), and selective (confined mainly to IDB and ICD, without greater attention to IDB's other important affiliates – see Table 5.1).

Table 5.1 Islamic Development Bank & its Affiliates

Entity	Relationship	Equity Ownership	Nature of Business
Islamic Development Bank	Self	Not applicable	Development finance
Islamic Corporation for the Insurance of Investment and Export Credit	Management services & equity participation	56.5%	Insurance services
Export Financing Scheme	Management services & equity participation	42.4%	Export finance
Islamic Banks' Portfolio for Investment and Development	Management services	—	Investment finance
IDB – Unit Investment Fund	Management services	—	Investment finance
Special Account Resources Waqf Fund	Management services	—	Social sector finance
Islamic Corporation for the Development of the Private Sector	Management services & equity participation	50.0%	Private sector finance
IDB Infrastructure Fund	Equity participation	25.0%	Investment finance

Source: IDB, Audited Financial Statements, 30 Dhul Hijja 1420 (5 April 2000), Note 1.

5.1 Findings, Recommendations and the Way Ahead

This paper has presented an overall view of the state of the private sector and financial markets in IDB member countries. On the basis of this review, the paper has advanced the proposition that policy discussion of financial sector reforms should distinguish between issues relating to capacity building (development) from those relating to efficiency improvement (reform). In both cases the pattern of demand and the requirements of the *shari`ah* suggest a course of financial sector development that is quite different from that which Europe and America have followed in the last five hundred years – the experience that underlies all international policy discussions.

This is not to say that lessons should not be drawn from Western experience. Within this experience, however, member countries should pay greater attention to market-based financial systems rather than bank-based ones, and to experience with universal rather than specialised banking. Even so, there would be a need to adapt these systems to the requirements of Islamic law, and to develop innovative institutions and instruments to better match the provision of financial services to the pattern of demand for these services by the Muslim community. Clearly, this would be superior to emulating European-American patterns of financial sector development, oblivious of the structure of local demand. Equally, specific *shari`ah*-compatible modalities would have to be worked out for trade and investment relations with non-Muslim individuals, communities, corporate bodies and states.[159]

For most least-developed member countries, the current international debate on financial policy reform is largely irrelevant. In countries where there are urban agglomerations of sufficient size to make the commercial provision of financial services viable, policy should be directed to providing support and incentives to the creation of appropriate institutions. For those, where such agglomerations do not exist yet, public policy should attend to higher priority objectives, while seeking at best to formalise existing informal arrangements in the financial sector.

Among the non-least-developed members, there are clearly (at least) two groups of countries whose situations warrant different approaches. The low and lower middle income countries have financial structures in which issues of financial liberalisation and reform are being discussed; and externally-assisted programmes, implemented. In most of these countries a high (and rising) debt burden, along with weakened expenditure controls, are the proximate determinants of budgetary crises and macroeconomic instability. The political economy – domestic and international – of the budget deficit leads to a demand for external resources that precludes the luxury of a policy dialogue with visiting lenders. In these countries, debt management, expenditure control, and other macroeconomic policies to achieve sustainable growth should precede financial sector liberalisation, to the extent possible. Financial reform should focus on creating social, economic and financial infrastructure – effective legal and judicial framework, efficacious market structure, enterprise conduct, and performance, and sound accounting standards and practice – before embarking on liberalising interest rates, dismantling selective credit controls, and liberalising the capital account of the balance of payments.

For the twelve higher income (8 upper-middle and 4 high-income) member countries, however, there is scope for greater freedom of action. For both groups of countries, however, the key lesson seems to be that policy design and implementation should respond to prevailing economic conditions, eschewing the imitation of patterns of development elsewhere. Above all, policy intervention should be dynamic, responding to changing situations, and should never be rigid – whether in pursuit of theoretical constructs, or in replication of stylised patterns. This means

[159] There would be nothing new or difficult in this. From the earliest times, Muslims have had commercial and economic relations with non-Muslims.

that general lessons are likely to be of little practical use in any concrete situation. In such situations, policy can only be made in the light of an in-depth study of specific country economic conditions. Accordingly, the paper has not discussed policy design issues in these twelve countries, but has explored instead some generic issues in the design of *shari`ah*-compatible financial systems. In this, the Islamic Development Bank is the recognised leader in the field, and must play an even greater role in the future.

5.2 Role of the Islamic Development Bank

The establishment of the IDB in 1975 was a major milestone in the pursuit of material progress by the Muslim nation (*ummah*). Since then, the Bank has committed US$ 18.0 billion to Muslim states. Over the same period, IDB's government shareholders have transferred just over US$ 3.0 billion in capital to the Bank, in payment for their shares.[160] In 1975, however, when IDB was established, the world was a very different place – in terms of its political and economic dynamics. There is a need now to take stock of the many solid achievements of the last 25 years, draw lessons from this experience, and formulate a new vision to guide the Bank in the next 25 years, on the basis of a re-assessment of global conditions and prospects.

This would not be new for the Bank. As part of ongoing exercises, in 1994 the IDB had formulated a *Strategic Agenda for the Medium-Term* that provides priorities and guidance on main operational aspects. Based as they are on a continuing assessment of experience, these priorities appear to be sound. It is within these priorities therefore that this paper locates its recommendations on how IDB and ICD can further support the development of financial markets in member countries, in aid of private sector development. Although there is bound to be overlap, flowing from their respective mandates, it would be natural for IDB to focus its efforts more on the public sector, while ICD – along with ICIEC, IBP, and UIT – attend to the private sector. There will, however, be a need for strategic co-ordination between ICD and with IDB and its other affiliates – especially ICIEC, but also IBP, UIT, and possibly the Infrastructure Fund.[161]

5.2.1 Seizing the Intellectual High Ground

In terms of the overall strategy outlined at the end of the last section, it will fall mainly to IDB to seize the intellectual high ground on financial sector strategy and policy for Islamic countries. In almost all areas of economic policy, the task of adapting economic research carried out at the IMF and WB does not require much imagination. In the area of finance, however, the moral and intellectual premises on which much of IMF/WB research are quite different from the perspective of the

[160] As of 16 April 1999, based on audited balance sheets and figures provided in IDB (1999).
[161] In addition, there would be a need for liaison with Accounting Standards Organisation for Islamic Banks, and the Association of National Development Finance Institutions in the Member Countries (ADFIMI).

shari`ah on these matters. There is therefore a need to carry out basic research on many of the issues involved.[162] This is fully consistent with the *Strategic Agenda*:

> 7. Apart from its direct involvement in project and trade financing, the IDB serves another most significant catalytic function as a prime source of ideas and inspiration in the realm of *shari`ah*-based development financing. In this distinctive role, the Bank comes into its own as the leading institution for the development of the *ummah*, particularly in developing Islamic banking and finance.

The Islamic Research and Training Institute (IRTI) has done a commendable job in its area of operation. There is a need, however, to constitute a special group within the IDB Group to undertake basic research in devising a blueprint for a national Islamic Financial Architecture that can guide reform efforts by individual member countries.[163] Within this framework, principles and strategies of Islamic financial reform should be formulated. This effort should not be insular. The group involved should maintain close links with researchers not only at international financial institutions but also at universities and research institutions across the world. Nor should it be confined to the research agenda of international institutions. The group should study not only the recent experience of developing countries – especially IDB member countries – but also the early experience of medieval[164] and modern Europe. The first task of such a group should be to design a research program, for management approval.

The research programme should not be open-ended. The group constituted should be given two to three years to design the intellectual framework for policy analysis and design that would be of practical use for member countries. This policy research could be the basis for expanding the scope of IDB's current technical assistance programmes. Based on this initial work, a continuing programme of research should be designed. For greater cost-effectiveness, the first priority of this programme should be on creating a capacity within IDB to absorb international research in this area. This should be supplemented by a highly focused programme of research on selected issues of interest to IDB that are neglected in contemporary international research. Once again, for greater cost-effectiveness, IDB should

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[162] A handful of economists at the IMF are to be commended for the fine work that they have done on Islamic Economics, and the formulation of *shari`ah*-compatible financial instruments.

[163] The exact organisational arrangement can be worked out within the IDB. Without recommending it, it may be pointed out that the World Bank is using functional "networks," which include all staff working with a given sector and which have permanent boards, to deal with specific topics. The Finance, Private Sector, and Infrastructure Network includes both the Financial Sector Board and the Private Sector Board, as well as a number of different thematic groups devoted to specific sector issues.

[164] This is a neglected field in modern financial research, but is highly relevant to IDB's work as the scholastic analysis of usury bears a very close resemblance to many current debates in Islamic Economics. See, for example, Noonan, Jr. (1957). This is not surprising as the scholastics borrowed much of their analytical methods from the work of the *ulama*. Langholm (1984) is also of interest because of the influence of Aristotelian philosophy on developments in Islamic *fiqh*.

create and rely on an extensive network of researchers, to whom it can outsource the great majority, if not the bulk, of the work, while ensuring quality and focus.[165]

5.2.2 Enhancing Relations with IOSCO, IAIS, and BIS

At the same time, IDB should make systematic efforts to enhance relations with the International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), and the Bank for International Settlements (BIS).

This suggestion follows naturally from the strategy of promoting equity markets and mutual insurance (*takaful*) institutions that is advocated in this paper. In fact, the paper argues that member countries carrying out Islamic economic reform should entrust the task to the securities regulator, rather than to central banks. This is because, unlike the securities regulator, the central bank has a vested interest in preserving and promoting the banking system. To entrust the promotion of Islamic financial institutions – that emphasise equity-based transactions at the expense of banking – is to create an inherent conflict of interest for the central bank. If accepted, this would be a radical departure from the practice of Islamisation in member countries where such reforms are being carried out.

Naturally, attention must be given to the prudential regulation and supervision of securities markets (and insurance), as well as to commercial banks. As pointed out in the paper, although IOSCO has worked on this, a comprehensive and internationally endorsed set of principles and practices for the regulation of securities markets is yet to be developed. By contributing to this effort, the IDB Group can play an important role in shaping in a *shari`ah*-friendly way the contours of the global financial architecture that is emerging in this area.

The paper has also argued that the paucity of instruments to mitigate risks is probably a greater constraint to both income generation and entrepreneurship in least developed member countries, than the absence of financial instruments. As the IDB Group has done pioneering intellectual and practical work in the area of mutual insurance (*takaful*), there is a need for greater attention to wider dissemination of these achievements and to participation in international discussions on regulation of insurance. Both IRTI and ICIEC should be encouraged therefore to establish closer links with the International Association of Insurance Supervisors (IAIS), and other international bodies working in this area.

Finally, the IDB has taken important steps to forge closer relationships with the Bank for International Settlements (BIS) in their deliberations on prudential regulation and supervision of banks, especially Islamic banks. This is an important area in which intellectual leadership is being provided presently by the IMF. Given its natural comparative advantage, the IDB should assume a much higher profile in this area, and should establish stronger links with BIS, IMF and other international bodies active in this area.

[165] This was the pattern of organisation of the research programme at international financial institutions in their early years (1970s), and is still a significant feature of its organisation.

This effort at networking should extend to establishing better links with the central banks of those higher income member countries that are involved in these global discussions. It is interesting to note that the BIS – unlike, say the World Trade Organisation (WTO), the IMF, or the WB – derives much of its effectiveness not from international law or agreement, but from informal practices that have evolved and enjoy the support of finance ministers of its powerful member states. In time, this support has contributed to the excellence of its work and consequently its influence. In this there are lessons for IDB.

Equally, it is important to note that IDB's effectiveness in pursuing all these initiatives will depend on the degree of success it can achieve in establishing its moral and intellectual credibility among its members and the world at large. This is a task in which IDB has already made considerable progress, but given its importance there is no room for complacency in continued and strengthened efforts.

5.2.3 Promoting Islamic Micro-Finance

Another area, of immediate application, is the promotion of Islamic micro-finance institutions and instruments, either on a country by country basis, or on a regional basis. The outline of a design for providing micro-finance on an Islamic basis has been worked out.[166] This design can now be applied to derive *shari`ah*-compatible practices from the rich body of experience with running conventional (un-Islamic) micro-finance institutions in member countries.

IDB has already formulated guidelines for identifying and financing medium, small, very small, and micro enterprise schemes. These guidelines, issued in May 2000, envisage separate procedures for "micro" and "very small" enterprises (MVSEs), on the one hand, and "small" and "medium" scale enterprises (SMEs),[167] on the other. The guidelines are quite realistic in acknowledging that for MVSEs a certain degree of subsidy, at least for the initial years of operation, would be required. Also, there is a provision for capacity building through funding for technical assistance. For MVSEs, it is envisaged that IDB will lend to member governments, who will on-lend these funds to suitable intermediaries, who would finance projects for and by identified groups of target beneficiaries. This design merits further thought. For SMEs, on the other hand, the intent is to provide a conventional line of credit to national development finance institutions or Islamic banks.

While these guidelines mark an important first step in the IDB Group's entry into this area, there is need for much more work to translate these guidelines into more detailed operational directives and procedures. Fortunately, much of this work – summarising theory and experience – has been done, and is readily available.[168] While there is little new to learn about lending to SMEs, judgements about micro-enterprise financing are still at a formative phase. In summarising the current de-

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[166] See discussion in section 3.3 above.
[167] For operational purposes, the project cost thresholds are: under $10,000 for micro-enterprises, and $10,000-25,000 for VSEs.
[168] For SMEs see, for example, Hallberg (2000). For micro-enterprises, Ledgerwood (1999) provides a practical guide to literature, practice, and unresolved issues. See also the WB/UNDP study by Dhumale and Sapcanin (No date given) on Islamic micro-finance methods, on the basis largely of the WB's experience in Yemen.

bate (in section 3.3), this paper recommends greater study of the experience of member countries, and of appropriate regulatory mechanisms in this area. IDB should consider initiating such studies to support its operations in this area.

One lesson of experience seems to be that organisation building and community (or business) support is an essential precondition for success in micro-finance. A purely banking approach has led to costly errors not only in SMEs financing, but especially in micro-finance. There is now ample experience in both rural support programmes and business development services that can be drawn on by IDB in project preparation. Given the complexity of the area, there seems to be a need to supplement the project identification arrangements envisaged in the guidelines with a provision for more specialised inputs from experienced quarters.

One possibility would be to design a high-impact viable rural support programme to promote saving and investment in the CFA-Franc member countries of West Africa. As an educated guess, the cost of such a project would be a one-time grant of around US$ 10 million to a (possibly non-government) apex authority, that would manage an extensive program of micro-saving and micro-investment in the entire CFA-Franc region. The same design, which is now fully worked out, can be applied at smaller scales to most member countries.

5.2.4 Mobilising Resources through Financial Engineering

It is widely believed that IDB should mobilise greater resources through the provision of new Islamic instruments, financial engineering, private funds, etc. As this paper has not analysed IDB's liquidity requirements and position, and absorptive capacity, it accepts this judgement at face value.[169] Whether or not IDB needs or can absorb greater liquidity, it is essential that IDB continue to find innovative *shari`ah*-compatible solutions to financial problems faced by enterprises and individuals. This is being termed Islamic financial engineering. It is important, however, that these efforts not only be fully compatible with the *shari`ah*, but also be responsive to emerging market demands.

> **Box 5.1**
> **Islamic Financial Engineering**
>
> *The Islamic economic system is neither holy nor divine. It reflects our human understanding of the scriptures, which is as human as we are.*
>
> – Al-Jarhi (August 2000)

One generic area of activity for IDB, perhaps in association with ICD, could be the market for Islamic ways of debt restructuring. A comprehensive global effort at dealing with the debt problem has been underway for some time. Quite separately from this effort, however, the IDB should look into the *niche* market for Islamic ways of debt restructuring that is likely to be created due to these global developments. With some research and development, it should be possible for IDB/ICD to securitise some of the debt of the highly-indebted Muslim countries, and market it in higher income member and non-member countries.

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[169] There seems to be some evidence, however, of absorptive capacity constraints in Islamic placements. According to audited financial statements, *shari`ah*-compatible investments of IDB liquid funds fell from ID 1,478 million (90%) in 14198H to ID 1,049 million (72%) in 1420H.

Similarly, IDB should make an effort to identify emerging opportunities in the market and design suitable financial instruments for positioning itself to take advantage of these opportunities.

5.2.5 Formulating a New Strategic Agenda

It should be clear from this discussion that IDB's 1994 *Strategic Agenda for the Medium-Term* has now been overtaken by events. It may well be time to embark on the formulation of a new long-term corporate strategy for the IDB Group to guide the group of institutions during the next decade. Should IDB decide to do this, it would be important to ensure that this is done with the widest possible consultation among key stakeholders both within the IDB Group and in member countries. Experience suggests that participatory approaches to strategy formulation prove to be more durable than those based on expert opinion.

5.3 Toward a Strategy for ICD

In April 1999, the Board of Executive Directors of IDB approved, in principle, the creation of an independent entity to deal with the private sector in IDB member countries. In September 1999, the Board approved the final proposal for the establishment of the Islamic Corporation for the Development of the Private Sector (ICD). ICD commenced operations in July 2000, and complements the role being played by IDB and its affiliates in supporting economic development by helping to strength-en the private sector in member countries.

Based on its feasibility study, it had been expected that ICD would develop in three phases – an initial set-up phase of 12-18 months, a growth phase of 30-36 months, followed by steady state operations and growth (by 2004). Since then, with the assistance of consultants, who carried out a market survey in five countries, ICD has prepared a five year strategic plan. With the realisation that ICD is a late entrant in a crowded field, the plan proposes a longer time-frame for ICD's development – a formative and developmental period of up to two years, an increased market presence and brand name building period of three to five years, followed by achievement of active leadership in Islamic financial markets in five to ten years.

ICD has an authorised capital of US$ 1.0 billion, and a paid up capital of US$ 500 million. Of this, IDB has subscribed 50%,

Box 5.2 ICD

Mission Statement

The mission of the ICD is to complement the role played by the IDB through the development and promotion of the private sector as a vehicle for economic growth and prosperity.

Vision Statement

The vision of the ICD is to become a premier Islamic multilateral financial institution for the development of the private sector

Objectives

The ICD focuses on the following objectives:

- Identifying opportunities in the private sector that could function as engines of growth.
- Provide a wide range of shari`ah compatible financial products and services.
- Expanding access to Islamic capital markets by private companies in IDB member countries.

and member countries 30%.[170] The remaining 20% will be offered to public financial institutions of member countries. Once ICD is firmly established (in some 5-7 years), it is envisaged that the private sector will also be invited to subscribe to the share capital.

At its inaugural meeting, held on July 8, 2000, the General Assembly of ICD elected its chairman and vice chairman, adopted the rules of procedure of the assembly, and the by-laws of ICD. Five public financial institutions were also accepted as members of ICD.[171] An advisory board,[172] and auditors to ICD, were also appointed.

A series of important decisions and preparatory exercises will be needed during the set-up phase to ensure the future success of ICD. Some of these are outlined in this concluding section of the paper.

5.2.6 Capital Structure and Corporate Governance[173]

On commencement of operations in July 2000, ICD had an authorised share capital of US$ 1.0 billion, and a paid-up capital of US$ 500 million. The IDB – fully owned by member governments – subscribed to 50% of the paid-up capital, while 30% is to be subscribed by member countries. The share of member countries is to be paid by IDB by way of bonus shares by capitalising their dividends, from profits of IDB. The balance, 20%, is to be offered to the public financial institutions of member countries. On present plans, it is only after 5-7 years that participation from the private sector might be solicited.

As a result, at least in its crucial formative years, ICD will be an institution owned fully by member governments. No doubt this will be a source of considerable strength and advantage to ICD. Yet, the fact that unlike IDB, ICD intends to participate in supporting the private sector, exclusively, raises important concerns about corporate governance.

ICD's Board of Directors is chaired by the President of IDB, and is to consist of 10 members. IDB is to nominate three more members, in addition to the President of IDB who is ex officio chairman of the board, and the General Manager of ICD. Of the remaining five, the largest shareholder country (Saudi Arabia) has a permanent seat. Three directors were elected by member countries, and one from public financial institutions.

In many ways, the success of ICD will depend on the nature and composition of the Board, and the quality of the General Manager who is recruited. While there is

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[170] The share of member countries will be paid by IDB by way of bonus shares, by capitalising their dividends from the profits of IDB, after its reserves reach 25% of paid up capital (presently expected after 1423H).

[171] The institutions, along with their initially subscribed share capital (to be paid in five equal annual instalments), are the Banque National d'Algerie (US$ 1 million); Bank Kesharvarzi (US$ 3 million), Bank Melli (US$ 1 million), and Iran Foreign Investment Corporation (US$ 20 million) of Iran; and Kuwait Auqaf Public Foundation (US$ 1 million).

[172] The first advisory board, appointed for a three-year term, consists of Br. Amr Al Dabbagh, Br. Boukhari Adji, Dr. Ibrahim Shihata, Br. Moeen Qureshi, and Br. Rashid Hussein.

[173] This section is inspired by Pfefferman (No date given), and private conversation with him.

likely to be little disagreement on the qualities of a chief operating officer, the composition of the board is both an important and a contentious issue. On the one hand, ownership of both IDB and ICD by governments militates for representation of government officials on the boards of both institutions. On the other hand, the fact that ICD seeks to support the private sector suggests the likelihood of better governance through private sector nominees of member country governments. One possibility could be to have IDB and the governments nominate prominent private sector individuals as directors of ICD, while allowing government officials as alternate directors. Other arrangements can no doubt be devised. Irrespective of what is decided, however, this is likely to be one of the most important decisions that member governments take on the establishment of the ICD.

5.2.7 Operational Strategy

The realisation that with the dissolution of the Soviet Union in 1991, the era of competition for allegiance by providing military and economic "aid" for defence and development in the "Third" World came to an end has dawned on everyone. Equally, the inability of highly indebted countries to resist the coercive integration of global markets – for capital, manufactures and services, but not primary goods or labour – has become just as apparent to all. Not surprisingly, the 1990s have seen a rise in the volume of capital flows to the private sector. At the same time, the share of private capital has risen at the expense of official capital flows.

Another important component of ICD's success would be the early formulation of a corporate strategy that takes account, among other factors, of the activities of other providers of finance to the private sector in developing countries (Table 5.2).[174] In 1997, investment by international financial institutions (IFIs) in private sector in developing countries was over US$ 31 billion. The two major multilateral providers were the International Finance Corporation (IFC, US$ 2.7 billion), and the European Bank for Reconstruction and Development (EBRD, US$ 1.9 billion).

Table 5.2 Investment by IFIs in Private Sector in Developing Countries

(US$ million)

	1991	**1995**	**1996**	**1997**
Development Institutions	2,992	7,138	7,556	8,129
Multilateral Institutions	2,039	5,128	5,354	6,067
Bilateral Institutions	953	2,010	2,202	2,062
Export Credit Agencies	5,309	15,348	19,186	23,243
US & Japan	1,214	6,020	7,435	7,934
Other	4,095	9,328	11,751	15,309
Total	**8,301**	**22,486**	**26,742**	**31,372**

Note: Long-term loans, equity, guarantees and full commercial insurance.
Source: International Finance Corporation.

Other multilateral institutions included the European Investment Bank (EIB), the three regional development banks (Asian Development Bank, African Development

[174] For a recent example of such an exercise, see IFC (Forthcoming). This will be the second of a series of continuing studies of private sector financing by international financial institutions.

Bank, and Inter-American Development Bank, and its affiliate the Inter-American Investment Corporation), and the Nordic Investment Bank (NIB). In addition to multilateral institutions, there are sizeable operations by bilateral institutions in this area. The major bilateral institutions are the British Commonwealth Development Corporation (CDC), the German Investment and Development Company (DEG – *Deutsche Investitions- und Entwicklungsgeselleschaft*), the Netherlands Development Finance Company (FMO – *Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden*), the *Société de Promotion et de Participation pour la Coopération Economique* of the *Agence Française de Développement* (AFD/Proparco), and the German Development Bank (KfW – *Kreditanstalt für Wiederaufbau*, or German Reconstruction Loan Corporation). With the exception of KfW, whose operations are smaller (US$ 172 million[175]), the other four bilateral agencies invested an average of over US$ 430 million in developing countries in 1997, more than most multilateral institutions. Finally the export credit agencies – mainly Germany's Hermes (US$ 6.8 billion) and the Japan and US export-import banks (US$ 3.9 billion and US$ 3.3 billion, respectively) – provide some US$ 23.2 billion to the private sector in developing countries.

These numbers are of relevance in establishing realistic expectations of ICD's aims, operations and performance, at least in its early years. Given its limited resources (start-up capital of US$ 87 million, increasing to US$ 265 million by 2002-2003), it would be unrealistic to expect ICD to offer noticeable competition to the established institutions. Instead, ICD should focus on building strategic alliances, and to participate in joint or parallel financing with the market leaders. Nevertheless, it would be important for ICD to study and keep under constant review the operations of these institutions in ICD member countries. In this way, even at this early stage of its development, it should be able to identify niches of activity – like Islamic financing – where, possibly with some financial engineering, ICD would enjoy a competitive advantage.

5.2.8 Some Strategic Directions & Investment Possibilities

A dynamic approach to management and marketing would call for a constant review of the market and emerging opportunities. ICD should not therefore rest on the results of the five-country market survey carried out by consultants, as part of their efforts to formulate an initial corporate strategy for ICD. It should continue to assess its strengths-weaknesses-opportunities-trade-offs, and to formulate updated corporate strategies and business plans for the institution. Without more study than is permitted by the scope of this paper, it would be premature to identify areas of activities. Nevertheless, in this concluding section, a few ideas are mentioned.

It would be important for ICD to build a high quality asset portfolio early in its operations. This could be done in three ways. First, ICD could establish strategic alliances with the key international financial institutions active in private sector financing in its member countries. An important component of its early activities could then be co-financing (or parallel financing) with these institutions in quality projects.

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[175] Financial Co-operation only. In addition, KfW provided US$ 3.9 billion in export credit financing (including Hermes Cover).

Second, ICD should develop a special programme to identify profitable investments in higher income member countries. If capacity can be built, this effort could include arrangements for the provision technical assistance.

In particular, ICD should attach priority in its staffing decisions to build up a special capacity in development of equity markets, pension funds, insurance (*takaful*), and Islamisation of banking.

The institution will have to spend a great deal of resources in the identification of suitable business partners and opportunities in member countries. It would be important therefore that management structures and financial allocations are responsive to this need. Wherever possible, it should be possible to arrange for sharing the cost of project preparation with ultimate beneficiaries. In this connection, some thought may be given, at this early stage, to the creation of a "Project Preparation Facility" to defray ICD's costs.[176]

In the area of capital market development, ICD could look into housing finance, on Islamic principles. While leasing and hire-purchase have been the preferred modes in this area, it may be possible to securitise real property, and provide *shari`ah*-compatible financing against such securities.

A second area, in which the IDB Group has already made progress is that of mutual funds. ICD could take this further by focusing on better marketing arrangements so that savers in Muslim countries have an opportunity to place their saving in *shari`ah* permissible instruments.

In addition, in keeping with its mandate, ICD should seek to identify a number of regional private sector projects. While this can only be done after careful studies, it may be possible to prepare a commercially viable regional fisheries project in the coastal West African region.

While more difficult, ICD should explore ways of acting as an intermediary between higher and lower income member countries. In this, services tailored to the requirements of Muslims are likely to be most successful. The payment of *zakat*, in conformity with strict *shari`ah* principles, has become a major problem for observant Muslims, even in lower income member countries. Like the IDB's *adahi* project, a tailor-made project to address this need would be a service to the Muslim community, and would create goodwill for ICD.

Promoting intra-OIC foreign direct investment is a more difficult proposition, but one well worth the effort. There is a vast literature and considerable experience relating to foreign direct investment that is outside the scope of this paper. This could be reviewed as the first step for the IDB Group to move in this area.

5.2.9 Evolving an Integrated Private Sector Strategy for the IDB Group

Finally, it will fall to ICD to evolve an integrated approach to direct private sector financing for the IDB Group. Over time, IDB has met emergent requirements with the creation of a variety of instruments for indirect support of the private sector in

[176] The Small and Medium Enterprise Department at IFC is reported to be putting together a Project Development Facility. ICD may wish to look into this initiative.

member countries – the latest initiative being the guidelines for medium, small, very small, and micro-enterprises. At the same time, a number of institutions – mainly IBP, UIT, ICIEC – have been established that have played an important role in serving the needs of the private sector in member countries. In time, it would be natural to expect that IBP, UIT, perhaps ICIEC, and some other operational activities presently with IDB itself, would all be merged into ICD.

Despite the early stage of its development, it is time to begin to look ahead by studying the objectives, constraints, and modalities of direct financing of private investment in member countries by the IDB Group in an integrated manner. Such a study should be co-ordinated by a committee consisting of senior managers from all concerned IDB departments and affiliates, with its secretariat in the ICD. Such a study could provide an important input into a New Strategic Agenda for the IDB Group (suggested in section 5.2.5), or be a part of the New Strategic Agenda exercise itself.

5.4 Summary

This paper is not about IDB, but about the private and financial sectors in IDB member countries. Even so, in this last chapter, some operational directions for the IDB Group are advanced, on the basis of the study. Clearly, the formulation of an integrated operational strategy for the IDB Group is a task beyond this paper. The suggestions of this paper are therefore both limited and selective.

The IDB's *raison d'etre* and its competitive advantage arises from its commitment to promoting *shari`ah*-compliant development. While economic research in most areas is readily transferable to the problems of Islamic countries, given the differences in the course of intellectual and institutional developments between Islamic and Christian-Modern countries over the last five hundred years, this is not true of finance. IDB may wish to constitute a special group within the Bank to undertake basic research, leading to the design of an Islamic Financial Architecture to guide development and reform efforts, at the national level, in member countries. Given the greater compatibility of equity (vs. bank) based development with the *shari`ah*, IDB should assume a higher profile in ongoing global discussions on the regulation of securities markets, insurance, and banking, by establishing closer working relations with IOSCO, IAIS, and BIS. IDB has taken an important initiative in formulating guidelines for indirect financing of micro-enterprises, but much more work needs to be done to translate these guidelines into detailed operational directives, and incorporate more recent lessons of experience. In particular, IDB should look into funding rural support programmes – perhaps in the CFA-Franc region in West Africa – as well as business development services. Naturally, these and other initiatives will call for continued attention to Islamic financial engineering. Finally, it may be time to undertake a wide-ranging, comprehensive, participatory exercise to formulate a New Strategic Agenda for the IDB Group.

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As for ICD, it would seem wise to keep its strengths-weaknesses-opportunities-tradeoffs, its corporate strategy, and its business plans under constant review. By way of some preliminary suggestions, ICD should attach priority in its staffing decisions to building up a special capacity in development of equity markets, pension funds, insurance, and Islamisation of banking. As the institution will have to spend a great deal of resources in the identification of suitable business partners and opportunities in member countries, some thought may also be given, at this early stage, to the creation of a "Project Preparation Facility" to defray costs. As an area of capital market activity, ICD could look into Islamic housing finance, not only by leasing and hire-purchase, but by securitising real property. A second area is that of mutual funds, in which ICD could develop better marketing arrangements so that savers in Muslim countries have an opportunity to place their saving in *shari`ah* permissible instruments. In addition, ICD should seek to identify regional private sector projects, like a regional fisheries project in the coastal West African region, which seems to be promising as a commercially viable project. ICD should also explore ways of providing services tailored to the requirements of Muslim communities in member countries. Promoting intra-OIC foreign direct investment is a more difficult proposition, but one well worth the effort. Finally, ICD should take the lead in studying the objectives, constraints, and modalities of direct financing of private investment in member countries by the IDB Group in an integrated manner.

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STATISTICAL ANNEX