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Abstract

A healthy and dynamic financial sector is essential to achieving high and sustainable economic growth in the Maghreb region—Algeria, Libya, Mauritania, Morocco, and Tunisia. Financial integration within the Maghreb region will help deepen financial markets, increase their efficiency, and enhance the resilience of economies to shocks. It can also play a catalyst role for the global financial integration of the Maghreb region. This paper provides an overview of the financial systems, takes stock of the reform effort and highlights the challenges ahead, and examines the prospects for financial integration in the five Maghreb countries.

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[1] The paper benefited from comments provided by the authorities and IMF colleagues.

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EXECUTIVE SUMMARY

Background

- With a population of over 81 million and per capita income averaging less than $3,000 in 2005, the Maghreb region—Algeria, Libya, Mauritania, Morocco, and Tunisia—has great potential but faces major challenges. The economic reforms undertaken by the five countries in recent years, albeit with differences in pace and intensity, have generally contributed to achieving macroeconomic stability and increasing growth in most of the countries. However, the growth dividend has been modest compared with other emerging market economies. Higher growth is required to bring down unemployment and raise living standards, the main challenges facing the Maghreb countries.

- A healthy and dynamic financial sector is essential to achieving high and sustainable economic growth. Financial intermediaries promote investment and growth by efficiently allocating resources over space and time by (a) facilitating the exchange of goods and services; (b) mobilizing savings; (c) lowering the cost of financing; and (d) facilitating risk management.

- Financial integration within the Maghreb countries will also help deepen financial markets, increase their efficiency, and enhance the resilience of their economies to shocks. It can also play a catalyst role for the global financial integration of the Maghreb region.

Overview of Financial Systems in the Region

- Although the financial systems in the Maghreb region have developed substantially in the last decade, their financial sectors still need further modernization and regional and global integration.

- The main characteristics of the financial systems in the Maghreb region include the following: (a) bank dominance and heavy public sector presence in most countries; (b) limited financial sector openness in some countries; (c) bank soundness exhibiting significant cross-country variations; (d) public banks burdened with inefficiencies and a high level of nonperforming loans (NPLs) in certain countries; (e) still embryonic fixed-income and equity markets, with the exception of Morocco and Tunisia; (f) nascent institutional investor industry and generally underdeveloped microfinance; (g) shortcomings in the legal, regulatory, and supervisory frameworks despite tangible progress; and (h) a largely cash-based payment systems that is being modernized.

- All five Maghreb countries are well aware of the importance of modernizing their financial sectors and have been implementing reforms for some time, with encouraging results. Despite progress and a number of successful reforms in the Maghreb countries—many of which ought to be implemented in the other countries of the region—several problems remain and need to be addressed. Some of the necessary reforms would also facilitate financial integration in the region.

- *Strengthen the soundness of the banking systems in all the five countries.* In particular it is important to reduce the high level of NPLs, to restructure state-owned banks, and to secure compliance with prudential rules.

- *Increase competition in the banking system.* Notably, extensive state ownership and restrictions on foreign bank entry stifle competition and financial deepening in the region. State banks saddled with high NPLs are also a burden on national budgets.

- *Deepen the financial markets.* The Maghreb financial systems are bank-dominated. Financial markets—money, interbank, foreign exchange, equity, and securities markets—are nascent or shallow in most countries, and nonbank financial institutions are generally underdeveloped.

- *Strengthen financial sector oversight*. Despite a significant wave of reforms during the 1990s, prudential controls remain only partly effective in most Maghreb countries. The overall weakness of financial sector supervision is reflected in the limited observance of relevant international standards and codes in some countries.

- *Upgrade financial sector infrastructure*. In particular, accounting and auditing practices, transparency and governance, the legal and judicial framework, and the payment systems need to be strengthened.

Toward Regional Financial Integration

- So far, only *limited actions and progress have been made toward financial integration within the Maghreb region.* A 1991 agreement among the five central banks on payment systems has not been implemented by all the countries. More recently, a long-awaited decision was taken to establish a Maghreb investment bank. The recent interest in reinvigorating regional cooperation is therefore very welcome and would benefit all the countries.

- *What can be learned from previous integration experiences?* While there is no blueprint on how best to achieve regional integration, useful lessons can still be garnered from other experiences, particularly that of the European Union (EU) and Gulf Cooperation Council (GCC) countries. These lessons would include: (a) adopting a gradual approach; (b) consolidating macroeconomic stability in all the countries; (c) strengthening financial markets; (d) harmonizing rules and regulations;

(e) improving regional coordination; and (f) lifting restrictions on cross border flows of goods and services.

- *Steps toward financial integration*.

– *Implementing the necessary reforms in each country.*

– *Harmonizing regulatory and supervisory frameworks*: Regional financial integration will present challenges for financial sector supervision. Reforms in the supervisory and regulatory frameworks should be coupled with efforts at harmonization, so as to prevent regulatory arbitrage and reduce the costs of regulatory compliance.

– *Harmonization of financial contracts and standardization of financial information* would help financial deepening and financial integration.

– *Harmonizing payment systems*: There is growing interest in the efficiency gains to be achieved from the adoption of harmonized frameworks for regional payment systems. Ongoing efforts in the Maghreb at upgrading national payment systems provide an opportunity for work toward closer harmonization within the region.

– *Facilitating trade financing:* Short-term measures need to address barriers to intra-Maghreb trade stemming from bottlenecks in the financial sector. In addition to weaknesses in regional payment systems (see above), this includes: (i) the cost and availability of facilities to finance trade; and (ii) streamlined administrative requirements for trade-related banking operations.

– *Proceeding with the establishment of the Maghreb Bank for Investment and Foreign Trade* (*BMICE*). The BMICE could serve as a catalyst to financial integration and promote trade and investment within the region.

– *Gradual liberalization of the capital account*: Restrictions on capital movements (including barriers to foreign bank entry) are a key obstacle to increased financial integration in the region. At the same time, they shield national financial systems from the volatility of global financial markets. The inevitable trend toward increased openness is likely to be a challenge for financial stability.

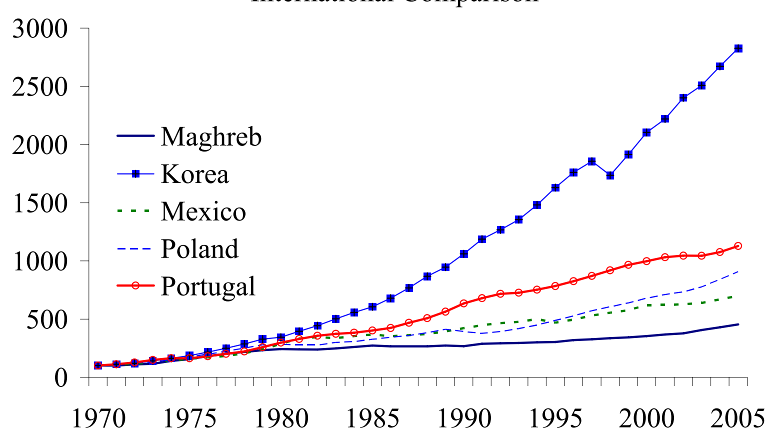
– *Improving regional coordination.* As cross-border linkages deepen, enhanced exchange of information between national supervisors, both within the region and elsewhere, becomes increasingly important.

I. INTRODUCTION

1. **This paper provided background information for the conference on Financial Sector Reform and Prospects for Financial Integration in Maghreb Countries, that took place in Morocco in December 2006**. This conference was part of an effort to energize the process of economic cooperation in the Maghreb region with renewed commitment from member countries with the support of the International Monetary Fund. A precursor conference focused on trade facilitation between Maghreb countries and took place in Algiers in November 2005.

2. **The Maghreb—Algeria, Libya, Mauritania, Morocco, and Tunisia—an economically diverse region, has a population of more than 81 million people bound by a common heritage**. The five Maghreb countries are at various stages of economic development and have different endowments of natural resources. The economic reforms that have been undertaken in all Maghreb countries over the past two decades have generally achieved macroeconomic stability and contributed to raising growth in some countries. However, the growth dividend has been relatively modest: growth in GDP per capita in purchasing power parity (PPP)[2] terms in the Maghreb has accelerated somewhat during the past decade but it has been weaker than in some other emerging market economies (Figure 1).

Figure 1. GDP per capita in PPP terms (1970=100)
International Comparison



3. **The aggregate growth performance, however, conceals important differences between the five countries**, reflecting not only differences in initial economic, social, and

[2] PPP converts the GDP of different countries to a common currency using an exchange rate that equalizes the cost of a representative basket of goods across countries. PPP is the most suitable exchange rate measure when comparing standards of living across countries because it reflects differences in the volume of goods and services produced, not differences in prices.

political conditions but also differences in pace and strength of economic reform (Table 1). Countries that have implemented deeper and broader structural reforms have reaped the highest growth dividend (Figure 2).

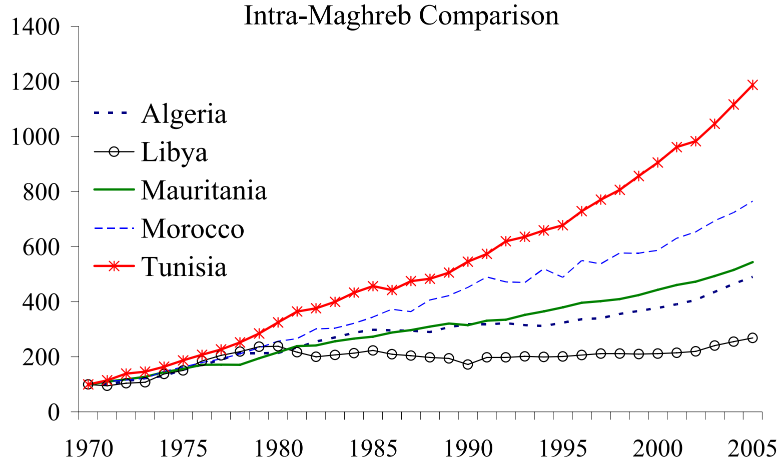
Table 1. Macroeconomic Performance in Maghreb Countries 1/

	Population (millions, 2005)	GDP per capita in USD (2005)	Real GDP growth 2/		Jnemployment Rat	Average Inflation	
			1991–2000	2001–05	2005	1991–2000	2001–05
Algeria	33.1	3,086	1.7	4.9	15.3	16.9	2.7
Libya	5.8	6,696	2.3	5.0	...	5.9	-4.1
Mauritania	2.8	663	3.0	4.0	...	6.5	8.2
Morocco	30.1	1,953	2.4	4.9	11.0	4.1	1.4
Tunisia	10.1	2,713	4.8	4.5	14.3	4.5	2.6
Average	81.9/3	3,022	2.8	4.7	13.5	7.6	2.2

Sources: Authorities; and Fund staff calculations.

1/ The data for Morcco reflect revised national accounts data starting in 1998.
2/ Average annual growth rate.
3/ Total population.

Figure 2. GDP per capita in PPP terms (1970=100)
Intra-Maghreb Comparison



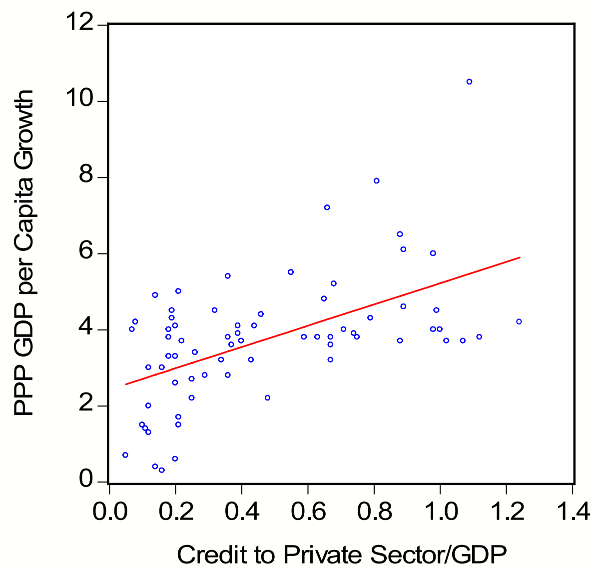
4. **As a result of generally insufficient economic growth and mounting demographic pressures, the Maghreb region, like other parts of the Middle East and North Africa, faces a daunting challenge:** improve the living standards of its population and create enough jobs so as to reduce substantially unemployment even as the labor force continues to expand at a rapid pace over the medium term. Meeting this challenge will require helping the region's economies reach a significantly higher growth path. To this end, the region will need to considerably increase productive investment and, given the limited fiscal space in non-oil producing countries, most of the investment would have to be privately financed. For the oil

producers, the challenge is how best to use the increased oil resources in their own countries but also in the region. In addition, relatively low total factor productivity in the region points to the relatively low quality of past investment, stressing the need for a more dynamic private sector and more efficient financial intermediation.

5. **Therefore, it is critical that the implementation of the necessary reforms to improve the investment climate and enhance productivity be accelerated**, including financial sector reform; the creation of a transparent regulatory environment with adequate incentives for private sector initiative; further trade liberalization and enhanced regional cooperation; labor market reform; and improved transparency, governance, and quality of institutions. While the complementary nature of these reforms calls for stepping up their concurrent implementation, the focus of this paper is on the reform of the financial sector and prospects for regional integration of financial systems.

6. **The financial sector plays a crucial role in the process of capital accumulation and productivity growth**. It contributes to employment and economic growth directly as financial services represent a fast growing industry worldwide. But its indirect contribution to growth is even more important as efficient financial intermediaries promote investment and growth by facilitating the exchange of goods and services, mobilizing and allocating savings, and helping the management of risks. In sum, they efficiently allocate resources over space and time. An efficient financial sector is essential for achieving high and stable long-term growth (Figure 3).[3]

Figure 3. Financial Development and Growth

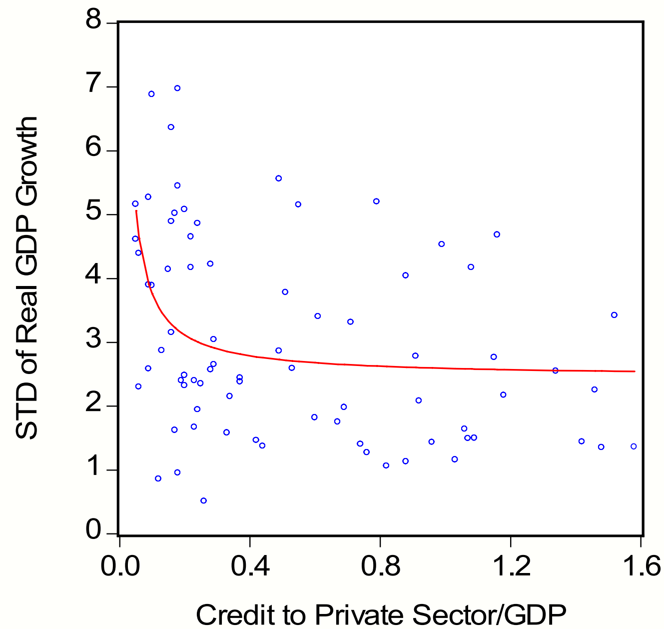


7. **In addition to promoting growth, a sound financial sector strengthens the resiliency and enhances the flexibility of the economy when hit by shocks.** Economic growth has been particularly volatile in the Maghreb region due primarily to an insufficiently diversified production structure and large terms of trade changes. An efficient financial

[3] Figure 3 shows a positive relationship between financial depth (measured by average credit to the private sector divided by GDP over 1990–2004) and growth (measured by average growth of GDP per capita in PPP terms over 1990–2004). Each observation corresponds to a particular country. On the relationship between financial development and growth, see Ross Levine (2005).

sector allows households to smooth consumption during downturns and helps firms to reallocate capital and labor when faced with structural change. Indeed, countries with highly developed financial systems benefit from a more stable growth path as evidenced in Figure 4.[4]

Figure 4. Output Volatility and Financial Depth



8. **Further deepening of financial systems is essential for lowering the cost of financing and promoting productive investment**—as shown in Figure 5.[5] Although steadfast implementation of the remainder of the reform agenda can substantially enhance the efficiency of financial systems in Maghreb countries, national savings would likely remain inadequate to finance the necessary investment to achieve the dual objective of reducing unemployment and significantly improving living standards.

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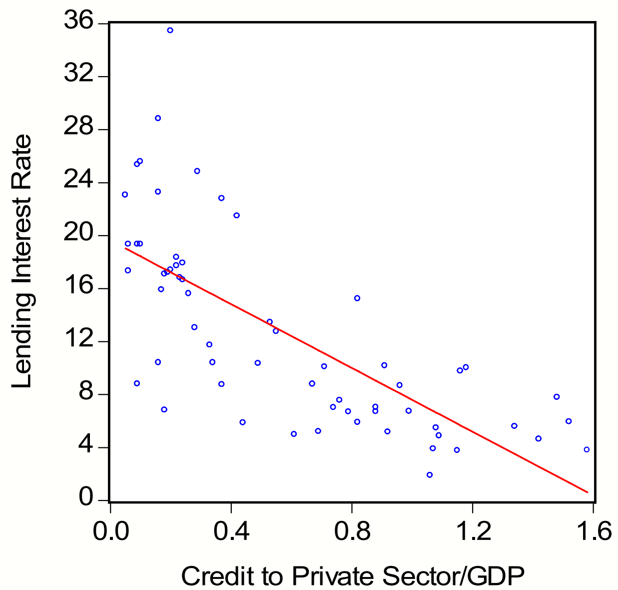
[4] Figure 4 depicts a negative relationship between output volatility (measured by the standard deviation of real GDP growth over 1990–2004) and financial depth (measured by average credit to the private sector divided by GDP over 1990–2004).

[5] Figure 5 shows that borrowing cost (measured by average lending interest rates over 2000–04) declines steeply with financial depth (measured by average credit to the private sector divided by GDP over 2000–04).

Figure 5. Borrowing Cost and Financial Depth



9. **Further integration of domestic financial systems with international financial markets could enable Maghreb countries to tap into global savings.** While the process of integration with international financial markets has already started, it remains limited. Some foreign banks (especially from Europe and the Gulf region) have been allowed to gradually enter domestic markets but often are subject to a number of restrictions. Capital flows remain highly regulated. While FDI inflows have picked up somewhat in the past few years, they have largely been driven by privatization activity. Integration will likely take time in view of the still relatively fragile domestic financial systems.

10. **Regional financial integration could facilitate broader financial integration by providing a new impetus to financial sector reforms necessary to prepare regional financial systems for broader competition while minimizing the risks of financial instability**. Regional financial integration would enhance competition, provide scope for economies of scale, spur financial deepening, increase efficiency, lower the cost of financing to households and firms, provide more diversification opportunities to investors, and enhance the resilience of the Maghreb economies to shocks. Looking ahead, a Maghreb region where goods, services, and capital can flow relatively freely would be a very attractive market for domestic and foreign investors.

11. **This paper is organized as follows**: Section II describes the financial systems in the five Maghreb countries, with emphasis on common elements and main differences. It provides an overview of the financial systems, including some of their salient structural features, characteristics of their oversight frameworks, their main strengths and vulnerabilities, and the current status of their integration into regional and international financial markets. Section III takes stock of the reform effort in these countries and highlights the challenges ahead. The focus is on promoting competition in the banking

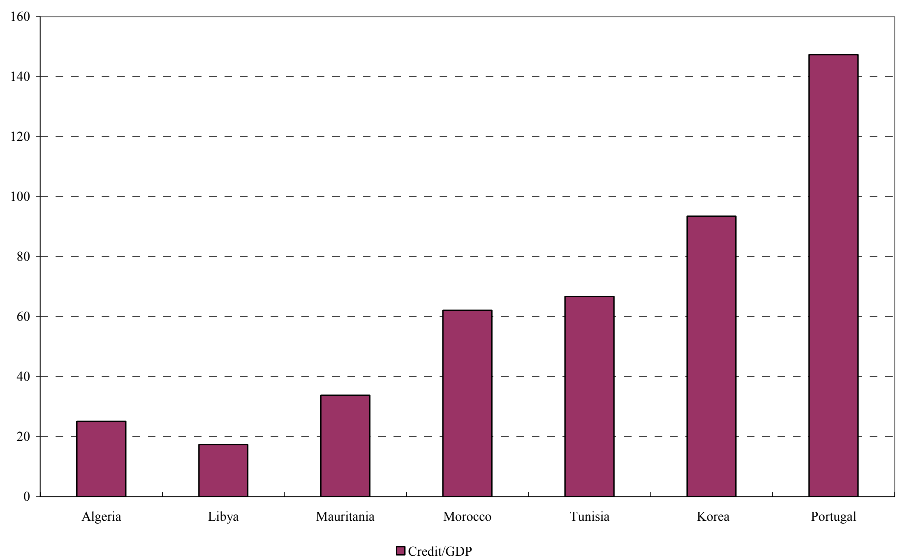
system, deepening financial markets, strengthening financial sector oversight, and upgrading financial sector infrastructure. Finally, Section IV is devoted to financial integration, including a brief review of the main lessons from other regional integration efforts, namely the ongoing financial integration in the European Union (EU) and the Gulf Cooperation Council (GCC) countries, and a discussion of the measures that are necessary to facilitate financial integration.

II. Overview of Financial Systems in the Region [6]

12. **Financial systems in the Maghreb have developed substantially in the last decade**. Countries to different degrees, have improved, their legal and regulatory frameworks, privatized state banks, and enhanced competition in the financial sector. In quantitative terms, the credit to GDP ratio for the five countries combined rose from 33 percent in 1995 to 40 percent in 2004, while the M2 to GDP ratio rose from 50 to 53 percent. Despite these gains, the economies in the region remain underbanked, as only a relatively small share of the population has access to bank services and small and medium-size enterprises typically face severe constraints when seeking funds from banks. Moreover, financial development varies significantly from one country to another (Figure 6).[7]

Figure 6. Indicators of Financial Development in 2005 1/

(Credit to the economy in percent of GDP)



Sources: National authorities; and IMF staff estimates.

1/ Credit comprises claims on private sector and claims on non-financial public enterprises.

[6] This section as well as section 3 draw largely on the counties' Financial Sector Assessment Programs (FSAPs).

[7] The ratio of credit to GDP may underestimate financial development in countries with large hydrocarbon sectors (such as Algeria) because the latter do not use local credit although it represents a significant share of GDP (around one-third of GDP in Algeria). The ratio of credit to nonhydrocarbon GDP in Algeria is 43 percent.

13. **Bank dominance and a heavy public sector presence broadly characterize the systems in the region** (Box 1 and Table 2). The share of commercial banks in total financial system assets at end-2004 ranged from 49 percent in Morocco to 93 percent in Algeria. Even in more diversified Morocco, banks play a central role in financial activity because of their ownership links with other financial intermediaries, such as insurance companies and mutual funds. With the exception of Mauritania, where a wave of bank privatization took place in the 1990s, the state controls an important share of the banking system, most notably in Algeria and Libya where public banks account for over 90 percent of banking sector assets. Recent efforts at bank privatization in Morocco and Tunisia have brought down public banks' market share to 24.4 percent (including specialiazed banks) and 30.6 percent, respectively. Similar efforts are underway in Algeria and Libya.

Table 2. Financial System Structure, 2004 1/

(In percent of total assets)

	Commercial banks			Specialized banks	Insurance companies	Pension Funds 2/	Other institutions
	State-owned	Private	Total				
Algeria	83.4	9.4	92.8	…	2.8	…	4.4
Libya	76.5	3.7	80.2	17.2	2.6	…	…
Mauritania	…	…	88.2	…	5.0	…	6.8
Morocco	13.4	35.3	48.7	11.0	10.6	15.6	14.1
Tunisia	30.6	39.1	69.7	3.0	3.4	6.5	17.4
Korea	6.5	43.2	49.7	22.0	18.2	…	10.1
Mexico	--	50.3	50.3	12.6	7.5	12.7	16.9
Poland	14.3	52.0	66.3	…	10.5	10.3	12.9
Portugal	17.6	54.7	72.3	6.8	9.0	3.8	8.1
Turkey	18.3	39.6	57.9	1.8	0.8	0.6	38.9

Sources: National authorities; and Bank-Fund staff estimates.

1/ As of 2001 for Morocco; 2002 for Algeria; and 2005 for Poland, Spain, and Mexico (June).
2/ For Morocco, includes the *Caisse de Dépôt et de Gestion*.

14. **Financial sector openness in the region is limited**. There are restrictions on foreign currency purchases by residents, including surrender requirements on foreign exchange receipts that are high in some cases. Capital transactions are also limited in all five countries, although capital transfers abroad are typically not completely prohibited (Table 3). Overall, financial transactions in the money, securities, and derivative markets face restrictions—for instance, banks have access to forward foreign exchange hedging instruments only in Algeria, Morocco, and Tunisia. The entry of foreign banks remains limited in Algeria, Libya, and, until recently, Mauritania.

Box 1. Maghreb: Financial Sector Structures and Oversight Arrangements

Algeria

Financial intermediation in Algeria is provided almost exclusively by banks, with bank credit standing at about 34 percent of GDP. Although 15 private banks have been licensed since 1998, the banking sector is dominated by the six state banks, which accounted for 93 percent of banking assets in 2005. Confidence in private banks is now recovering after the failure in 2003 of the largest private bank as well as one small private bank, and privatization is envisaged for two state banks—with the first divestiture underway.

Nonbank financial institutions are marginal. Housing finance is dominated by a state-owned commercial (formerly specialized) bank, the *Caisse Nationale d'Epargne et de Prévoyance*. The insurance sector comprises six state-owned, two mutual, and six small private insurers, plus one state-owned reinsurer; premia amount to 0.5 percent of GDP, almost all from nonlife business. The stock exchange is embryonic.

Banking sector oversight is entrusted to three institutions: the Banking Commission, in charge of on- and offsite supervision and with jurisdiction for imposing sanctions; the Monetary and Credit Board, with licensing and regulatory authority; and *Banque d'Algérie* (the central bank), which drafts regulations and carries out audits, either directly or as delegated by the Banking Commission. The stock market is regulated by the *Commission d'Organisation et de Surveillance des Opérations de Bourse*.

Libya

The Libyan financial sector is dominated by five state-owned commercial banks, all formerly international banks, nationalized in 1971, and majority-owned by the Central Bank of Libya (CBL). There are also four private banks, three of which have entered the market since 2001; 48 regional banks owned by the citizenry and capitalized through mandatory deductions from salaries; and three state-owned specialized banks. Three state banks were recapitalized by the CBL in 2005 and one was partially divested; the authorities' plans call for the eventual privatization of all state banks.

The nonbank financial sector is very small, comprising one offshore investment company and two state-owned nonbank finance companies. There is little insurance activity, and no equity market.

The CBL regulates and supervises all commercial banks and, under a recently promulgated Banking Law, the specialized banks. Its Bank Supervision Department has been reorganized and is taking steps to bring its oversight practices in line with international standards.

Mauritania

Banks also dominate the Mauritanian financial landscape; there are ten commercial banks, of which nine are fully privately owned and one is owned in equal parts by the Mauritanian and the Libyan governments.

The insurance sector is underdeveloped, with total assets equivalent to less than 1 percent of GDP. The sector was reformed and liberalized in 1994; six companies have entered the market and now compete with the state-owned insurance firm. The microfinance sector is expanding rapidly, with a total of 64 institutions as of end-2005. There is no stock market.

The *Banque Centrale de Mauritanie* is the regulator of all financial institutions except insurance companies, which are supervised *by Direction du Contrôle des Assurances* under the Ministry of Commerce.

Box 1. Maghreb: Financial Sector Structures and Oversight Arrangements (concluded)

Morocco

Morocco's financial system is the largest and most diversified in the region, with total assets equivalent to about 155 percent of GDP; an increasingly healthy commercial banking sector; a rapidly expanding insurance sector; a growing number of securities firms, leasing companies, and consumer finance firms; and a vibrant stock market.

Banks (including specialized banks), accounting for about 60 percent of total financial system assets, play a central role—not only by virtue of relative size, but also because of their growing links with other financial intermediaries such as insurance companies and mutual funds. The banking industry is broadly divided into three subsectors: commercial banks, publicly owned specialized banks, and offshore banks. There are 22 registered banks (not including the 11 regional popular banks), of which six are offshore banks.

Morocco's insurance industry, with over 16 percent of financial system assets, is the largest in the region; nonlife business generated over 70 percent of the sector's income in 2003. The pension fund industry represents close to 10 percent of financial system assets. The Casablanca Stock Exchange is the largest exchange in the Maghreb and one of the largest in North Africa, with a market capitalization of 72 percent of GDP.

Bank Al-Maghrib (the central bank) oversees all institutions engaged in banking activities, including the public *Caisse de Dépôt et de Gestion*, the offshore banks, and microfinance institutions, the ministry of finance supervises the insurance and pension fund industries, and the *Conseil Déontologique des Valeurs Mobilières* supervises the stock exchange and the other segments of the financial system.

Tunisia

After Morocco, Tunisia's financial system is the second most developed in the region, with total assets equivalent to about 90 percent of GDP. The system is dominated by banks, with the domestic bond and equity markets playing a limited role in savings mobilization.

The banking system in a broad sense (comprising all establishments under the control of the Central Bank of Tunisia) includes 20 commercial banks (of which five are development banks recently converted into full-service banks, one microfinance bank, and one SME financing bank), eight offshore banks, 11 leasing companies, two factoring companies, and two merchant banks. Following two privatizations, in 2002 and 2005, the state banks, the local private banks, and the foreign banks now have roughly equal market shares. The current policy priority is to merge and privatize five small state banks recently converted to commercial banks and owned jointly with the governments of certain GCC countries as well as Libya.

The nonbank financial sector comprises a large and growing number of (mostly bank-owned) mutual funds and venture capital companies; two pension funds; eight offshore banks; 16 insurers; 11 leasing companies; a postal savings scheme; and two factoring companies. The Tunis Stock Exchange is small.

The banking system is supervised by the *Banque Centrale de Tunisie*, the insurance sector by a Directorate General of the ministry of finance, and the securities markets by an autonomous Conseil du Marché Financier reporting directly to the President of the Republic. Control over state-owned financial institutions is exercised through the ministry of finance.

Table 3. Capital Controls

Controls on:	**Algeria**	**Libya**	**Mauritania**	**Morocco**	**Tunisia**
Capital transactions	Capital transfers abroad are subject to the central bank's approval.	Subject to controls	Subject to controls	Subject to controls	Subject to controls
Portfolio investment (money, bond, equity market instruments)	Repatriation by nonresidents of proceeds from these instruments must be conducted through authorized intermediaries.	Residents' purchase abroad of these instruments requires approval.	Capital transactions subject to exchange control. Outward flows require central bank approval; inward flows are free, although the subsequent investment may need approval.	Trading of these instruments by residents are subject to approval. Nonresidents face no limitations. Foreign residents are free to purchase securities, provided they use their foreign exchange holdings.	There are controls on all transactions in capital and money market instruments.
Credit operations	Controls apply to all credit transactions, guarantees, sureties, and financial backup facilities.	Residents must obtain central bank approval to borrow from abroad. Public enterprises are allowed to sell foreign exchange to open or settle credit through the banking system, provided they report the sources and uses of the foreign exchange.	Controls apply to all credit transactions, guarantees, sureties, and financial backup facilities.	Some transactions are subject to approval.	Credit by residents to nonresidents requires approval by the central bank, except for some credits granted on the money market.
Direct investment	FDI is permitted freely except in certain specified sectors.	Foreign participation in industrial ventures is permitted on a minority basis and only under certain circumstances. Full ownership must be approved by the Foreign Investment Board.	FDI is governed by the investment code (Law No. 2002–03).	Outward FDI is subject to approval, but residents of foreign nationality are free to invest abroad provided they use their foreign exchange holdings. There are no restrictions on inward FDI.	Outward direct investments are subject to approval by the central bank. Foreigners may invest freely in most economic sectors.

Source: IMF, Annual Report on Exchange Arrangements and Exchange Restrictions.

15. **Bank soundness exhibits significant cross-country variations** (Table 4). Private banks in Algeria are well capitalized and profitable but they only represent 10 percent of financial system assets. Overall, the ratio of NPLs to total loans remains high. In Morocco, commercial banks are generally profitable and efficient and the overall ratio of NPLs to total loans was reduced from 15.6 percent in 2005 to 10.9 percent at end 2006. In Tunisia, commercial banks are also generally profitable and efficient, but are saddled with a relatively high level of NPLs, reflecting an ageing backlog of nonperforming directed credits and more recent problems from a downturn in tourism activity in 2002–03 (NPLs to the tourism sector now account for about a quarter of total NPLs). In Libya and Mauritania, weaknesses in banking data prevent a full assessment of banks' health. Nonetheless, there are concerns in Mauritania about high loan concentration, connected lending, and NPLs—notably as most banks belong to large nonfinancial conglomerates. In Libya, pervasive directed credit policies and interest rate controls have likely had an adverse effect on bank performance.

Table 4. Financial Soundness Indicators for Commercial Banks, 2005

(End of period, in percent)

	Capital Adequacy	Nonperforming Loans to Gross Loans	Provisioning to Nonperforming Loans	Profitability (ROA)	Growth of Credit in Real Terms over 2000–05
Algeria	12.9	32.4	55.6	0.4	100.7
Libya 1/	13.7	25.0	66.0	0.4	26.1
Mauritania 1/	22.2	46.0	...	...	33.7
Morocco 2/	11.5	10.9	71.0	0.5	32.2
Tunisia 3/	12.4	20.7	48.4	0.6	30.0
Korea	12.8	1.2	...	1.2	36.5
Mexico	14.5	1.8	232.1	1.9	11.5
Poland	15.4	6.3	59.4	1.5	18.7
Portugal 4/	10.4	1.6	83.4	0.8	15.4
Turkey 5/	23.3	5.2	89.6	1.3	30.4

Sources: National authorities; and Bank-Fund staff estimates.

1/ As of 2004, except for real growth of credit.
2/ As of end 2006.
3/ As of June 2006.
4/ Provisioning figures as of 2004.
5/ As of September 2005.

16. **Public banks in the region are often burdened with inefficiencies and a high level of NPLs**—the legacy of directed credit policies and continued provision of credit to unprofitable public enterprises. In Algeria, the cost of the government's taking over of public banks' NPLs has been about 3 percent of GDP annually from 1991–2001. The ministry of

finance estimated public banks' remaining NPLs to public enterprises at 4 percent of GDP at end-October 2006. Public enterprise debt represents a significant part of public banks' NPLs in Libya, and despite various schemes to restructure these exposures—such as public enterprise debt buy-back operations by the treasury and the central bank—state banks still require considerable restructuring. In Morocco, the restructuring of specialized public banks—which have long been undercapitalized, unprofitable, and burdened with large NPL portfolios—is nearing completion. Finally, Tunisia faces similar challenges for its remaining public banks, albeit less severe than in other Maghreb countries.

17. **The region has experienced a period of significant credit growth since 2000** (Table 4). In Algeria in particular, credit to the economy in real terms doubled during the period 2000-05. The other countries also experienced very strong growth in credit over the period, although, in the case of Libya and Mauritania this growth started from a very low base.

18. **There has been tangible progress in the privatization and restructuring of public banks**. Mauritania privatized all but one public bank in the mid-1990s. In Algeria, privatization is envisaged for two of the six state-owned banks and the first privatization, twice attempted before, is now on track. The authorities have also taken steps to improve the governance of public banks, notably by strengthening performance contracts of public bank managers and submitting all public banks to external audits. Libya intends to gradually privatize all its public banks and launched its first privatization operation in 2005; three other public banks were also recapitalized in 2005. In Morocco, considerable progress has been made in restructuring the specialized public banks, including the sale of the government's share in one bank and a commitment to ensure full compliance of the two previously exempted public banks with prudential regulations by June 2007. Tunisia sold one large state bank to a major private French bank in early 2002, and another one to a Moroccan-Spanish banking consortium in 2005.

19. **With the exception of Morocco and Tunisia, fixed income and equity markets are in their infancy**. Morocco's stock exchange, with a market capitalization of 55 percent of GDP, is by far the largest in the region. Over fifty companies were listed on the exchange in 2005, but market concentration remains high (the top five stocks account for over half of capitalization and trading). In Tunisia, government bonds represent the bulk of tradable securities, largely due to the absence of companies that are able and willing to make public offering of securities. The Tunis Stock Exchange, although growing in importance, remains small and relatively illiquid. In Algeria, only three stocks are listed on the stock exchange and their trading is almost nonexistent. There are no fixed income and equity markets in Libya and Mauritania. A comprehensive financial markets law is at the drafting stage in Libya that will allow the establishment of a stock exchange and of a secondary market for financial instruments.

20. **The institutional investor industry is nascent**. Despite being liberalized in most countries in the region in the 1990s, the insurance sector remains relatively insignificant. Morocco and Tunisia, where premiums reached 3 and 1.5 percent of GDP, respectively, in 2003, are important exceptions. Nonlife—notably automotive insurance—accounts for the bulk of premiums. The insurance industry underwent important restructuring in recent years in response to regulatory tightening, with consolidation in the sector through mergers and acquisitions and the adoption of a new insurance code in Morocco, and ongoing efforts to replenish mathematical reserves and technical provisions in Tunisia. The pension and mutual funds industry is in its infancy in the region, with the exception of Morocco where the sector has expanded considerably as a result of the activity of insurance companies, nonfinancial enterprises, and provident and pension funds.

21. **Microfinance is generally underdeveloped, but is growing sharply in some countries**. In Morocco, where the sector is efficient and very dynamic, outstanding loans extended by these institutions have tripled in the last three years and they service over 800,000 people, two-thirds of which are women. Several microfinance institutions operate in Tunisia. In Algeria, the microfinance programs are associated with government-run social services. In Mauritania, even though the legislation introduced in 1998 has spurred growth in microfinance institutions, this activity is still heavily dependent on foreign aid for its funding.

22. **All five countries have made tangible progress at strengthening the legal and regulatory framework governing the financial system**. New central bank laws have been passed in Algeria (2003), Libya (2005), Morocco (2005), and Tunisia (2006). The regulatory framework has been overhauled in most countries in the region to bring it more in line with international standards and good practice. In Algeria, the central bank is placing more emphasis on banks' internal controls and strengthening on-site supervision, while young supervisors are being hired and trained. The banking supervision departments of the central banks of Libya and Mauritania were recently reorganized, and new staff was hired and trained. In Libya, new regulations on loan classification and provisioning and guidelines on bank risk management have also been issued. In Morocco, important advances have been made to grant the central bank more regulatory and supervisory powers and extend its oversight to all institutions engaged in banking activities (including offshore banks and microfinance institutions). In Tunisia, rules on credit risk management, connected lending, consolidated accounting, and remedial measures (in case of noncompliance with prudential regulations) have been tightened recently.

23. **Despite these efforts, a number of shortcomings in banking supervision remain**. The remaining weaknesses are reflected in a lesser degree of compliance with the Basel Core Principles (BCP) for Effective Banking Supervision than the average for all countries in the Middle East and Central Asia as well as European countries (Figure 7).[8]

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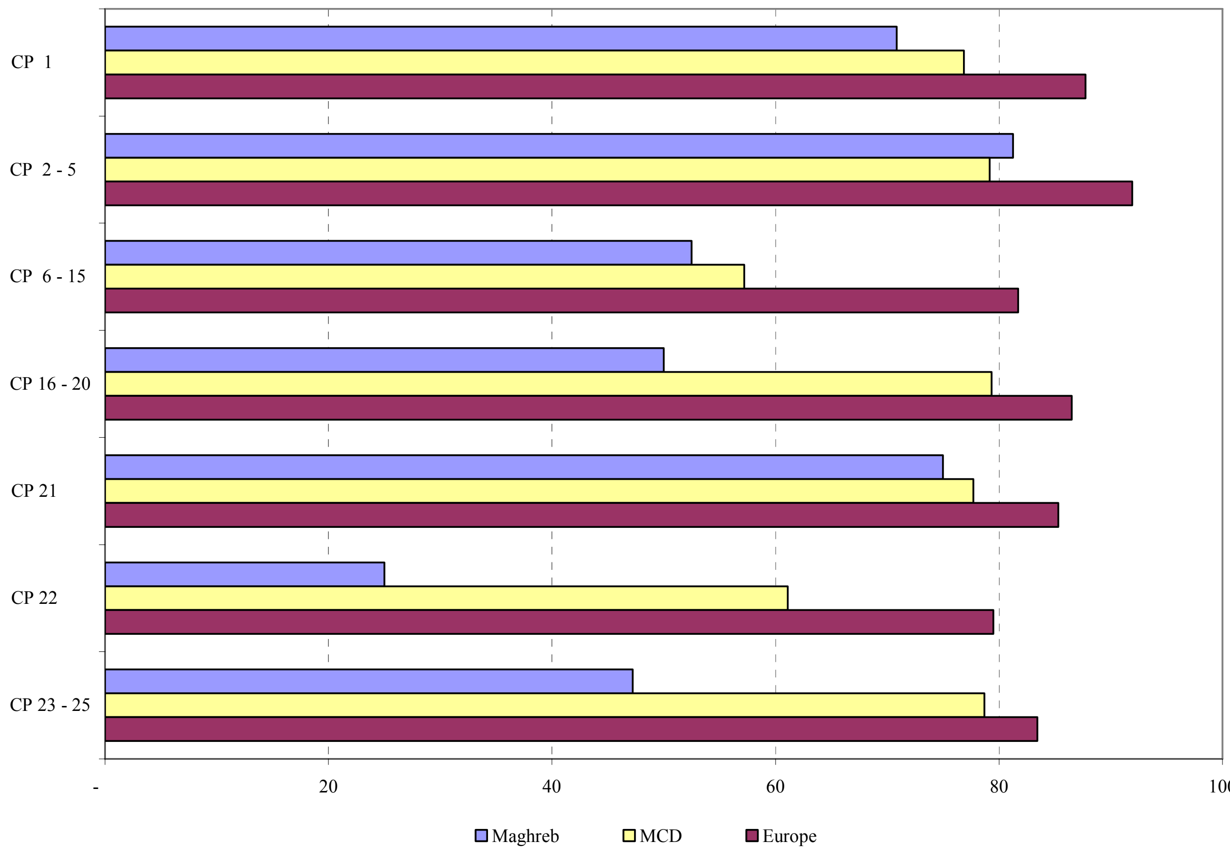
[8] The figure reflects the level of compliance with BCP assessments in Algeria (2003), Mauritania (2005), Morocco (2002), and Tunisia (2006) at the time of the assessments. Therefore, it does not reflect changes that may have been adopted thereafter. Since 2002, Morocco has undertaken a number of reforms implementing almost all the Basel principles. The 2006 FSAP Update in Tunisia found that banking supervision was largely compliant with the Basel principles.

Figure 7. Compliance with the Basel Core Principles 1/ 2/



Source: Standards and Codes Gateway (MCM).

1/ Average percentage of compliant and largely compliant principles.
2/ Maghreb countries include Algeria, Mauritania, Morocco, and Tunisia

- *Preconditions for effective banking supervision* (BCP 1): In most countries in the region, the lack of central bank autonomy—most notably, the absence of clearly defined legal grounds for the dismissal of central bank governors and board members—remains a key challenge (Table 5). There is also a need to establish formal arrangements for information sharing with other domestic supervisory agencies as applicable, following the example of Morocco, where a new banking law, introduced in February 2006, establishes a commission for coordinating financial sector supervisory agencies.

- *Licensing* (BCPs 2–5): Licensing criteria appear broadly adequate in most countries in the Maghreb, which is reflected in a higher degree of compliance than the average for Middle East and Central Asian countries.

Table 5. Central Bank Autonomy

	Selection, Removal, Terms of Office of Governor and Board Members	**Credit to Government**	**Operational and Financial Autonomy**	**Legal Protection of Supervisors**
Algeria	The governor and the three vice-governors are nominated by presidential decree. Members are chosen based on their competence in the fields of economics and finance. There is no fixed term of office for the central bank governor and the members of the Monetary and Credit Board. The governor and members of the central bank board may be dismissed for serious infringement of the law.	The central bank may provide advances to the government not exceeding 10 percent of the previous year's revenues. The repayment period cannot be longer than 240 days (consecutive or not) in any given year.	The central bank has financial autonomy. The Council of Money and Credit, as monetary authority, decides on monetary policy instruments needed for the conduct of monetary policy, which is the mission of the central bank.	Requests to overturn decisions taken by the supervisory authorities may be submitted to the Council of State. This has no bearing on the personal or institutional responsibility of the officials involved in the decision as part of their duties.
Libya	The governor and deputy governor are appointed by congress for a renewable five-year term. Grounds for removal comprise breach of the law, health reasons, or incompatibility with other posts in other institutions.	The central bank may provide banking services to public administrative units. Art. 11 allows the CBL to provide advances to the Treasury, not exceeding 20 percent of the total annual revenues in the general budget.	The central bank has financial autonomy.	
Mauritania	The governor is appointed to a five-year renewable term by presidential decree. His term may be revoked by decree following recommendation by a 2/3 majority of the Board. The Vice-governor is similarly appointed to a five-year term by decree upon recommendation by the governor, and his term too may be revoked by decree under similar conditions as the governor. Directors are appointed for five years and may be dismissed by decree.	The banking law gives the central bank the responsibility to manage all government credit operations. The central bank may provide advances to the government not exceeding 5 percent of the previous year's revenues and which shall be outstanding for no more than 300 days in any calendar year.	The central bank has adequate financial and operational autonomy.	The Banking Law does not explicitly indemnify inspectors against personal liability for actions taken in good faith to meet their responsibilities. However, the new banking ordinance stipulates that supervisors and inspectors are liable only to the BCM in carrying out institutional and personal responsibilities

Table 5. Central Bank Autonomy (concluded)

	Selection, Removal, Terms of Office of Governor and Board Members	Credit to Government	Operational and Financial Autonomy	Legal Protection of Supervisors
Morocco	The governor and vice-governor are appointed by royal decree. The law does not specify grounds for dismissal of the governor; members of the central bank board may be dismissed in the event of their incapacitation or of a serious infringement of the law.	Direct financing of the government by the central bank is prohibited, except for a cash facility limited to 5 percent of the previous year's tax revenue, for a total duration not to exceed 120 days per year. This facility is remunerated. The central bank may suspend the facility when, in its estimation, the money market situation so warrants.	The central bank has financial and operational autonomy	Central bank officers responsible for supervising credit institutions are held safe from liability (1) under civil law, except when the complaint alleges personal misconduct; (2) under criminal law, except when the charges involve fraudulent acts defined and punished by law (breach of professional secrecy, etc.).
Tunisia	The governor and vice-governor are appointed by decree for six-year terms (renewable indefinitely). Removal is by decree also. Their service is incompatible with holding any other public office. Board members are also appointed by decree for three-year terms (renewable). The law does not specify grounds for dismissal of the governor and members of the central bank board.	The central bank acts as a treasurer and provides financial services for the government and other public entities. However, the central bank does not directly finance the treasury.	The central bank has financial autonomy and its annual budget is approved solely by its Board. The law gives the central bank the necessary instruments to conduct monetary policy, although a ceiling on government securities held by the central bank may constrain the conduct of monetary policy.	The central bank protects its staff against threats and attacks of any type whatever to which they may be subject in the exercise of their functions and compensates them, where applicable, for any harm they endure as a result of their work.

- *Prudential regulations and requirements* (BCPs 6–15): Supervision is often rules-based and backward looking rather than risk-based and forward looking, and in some of the countries, the supervisory authorities lack a formal system to detect difficulties in individual institutions and scrutinize prudential returns.

- *Methods of ongoing banking supervision* (BCPs 16–20): The frequency of on-site inspections has generally increased but in some of the countries, not sufficiently to ensure adequate oversight. In some cases, off-site monitoring is the result of a painstaking exercise to put together inconsistent data from a variety of sources.

- *Information requirements* (BCP 21): With the exception of Morocco and Tunisia, where accounting practices and compliance by banks are broadly adequate, there is room to improve the accuracy and timeliness of banking data (see below).

- *Formal powers of supervisors* (BCP 22): The sanctioning powers of supervisors have been upgraded in some countries in the region—notably Morocco and Tunisia—but need considerable strengthening in others.

- *Cross-border banking* (BCPs 23–25): Formal agreements on information exchange with foreign supervisory agencies are generally lacking; in the case of Morocco, the banking law requires that the authorities in the country of origin be consulted when foreign banks submit licensing applications.

24. **The quality of supervision of nonbank financial intermediaries shows considerable cross-country variation**. With the exception of Mauritania, where the central bank is the unified supervisor of all financial services, separate agencies perform supervision of insurance companies and the securities markets. Insurance supervision generally suffers from lack of financial and operational independence (in Morocco and Tunisia, it is performed by a department within the ministry of finance) and limited financial and human resources, reflected in nonsystematic enforcement of prudential regulations and infrequent on-site inspections. The regulatory and supervisory framework for the securities markets has been modernized in Morocco and Tunisia, although their human resources could be further increased. Supervision of nonbank financial intermediaries in Algeria, Libya, and Mauritania is at an embryonic stage due to the underdevelopment of these sectors.

25. **Progress with strengthening financial discipline and increasing transparency has been uneven**. Some countries in the region—notably Morocco and Tunisia—have modernized accounting rules and brought them more closely in line with international principles. International accounting standards have been adopted, and rules have been tightened on the external auditing of financial and nonfinancial firms. In Morocco, credit institutions are expected to be in compliance with international accounting standards by 2008. In other countries, local accounting norms and regulations remain vague and financial statements fail to give an accurate view of company performance. For instance, Algerian

accounting standards do not set out the accounting treatment for a number of important transactions and events.[9] Algeria is actively preparing to implement international accounting standards.

26. **Since the early 1990s, considerable progress has been made in the region on the legal and judicial front**. Most countries have embarked upon a wide-ranging and creditable modernization of laws and regulations governing financial intermediation. Nevertheless, most of them do not compare favorably with the world average for regulatory quality, rule of law, and control of corruption.[10]

27. **Legal inefficiencies continue to impose major costs on financial intermediation**. The degree to which rights of shareholders and creditors are protected varies across countries. Court proceedings remain lengthy, magistrates and attorneys often lack training in commerce and finance, decisions are costly to enforce, and extra-judicial arbitration is underutilized. In addition, some of the countries lack a modern bankruptcy framework—notably Algeria, Libya, and Mauritania. Morocco and Tunisia have made the most progress at modernizing the framework, including with the establishment of commercial courts and, in Tunisia, with the recent introduction of accelerated procedures for auctioning foreclosed real estate collateral.

28. **Countries in the Maghreb offer limited information on credit risk to potential lenders**. Although Algeria, Mauritania, Morocco, and Tunisia have a public credit registry, there are no private credit bureaus in agencies in the Maghreb countries. However, in Morocco, the central bank is expected to launch a bid to put its new credit risk database under private management before end-2006. In most countries, the scope, access, and quality of information remains limited.

29. **Payment systems in the Maghreb are predominantly cash based**. In most countries, manual procedures and paper-based checks mar the systems, contributing to the slow-down of financial flows and, thus, increasing intermediation costs. Clearance of checks may take from six days up to several weeks for inter-regional transactions. In some countries (Libya and Mauritania), informal channels of payment are ubiquitous and the juridical and technical frameworks are inadequate to sustain a modern payment system.

30. **All five countries have made important efforts to modernize their payment infrastructure**. Algeria launched its real-time gross settlement systems (RTGS) in February 2006 and its automated clearing house for retail payments in May 2006. Morocco has set up an RTGS system effective September 2006 to reduce the settlement risk on transactions,

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[9] Indeed, the authorities have had to commission various ad hoc special audits of public banks to ascertain their true financial condition.

[10] See Kaufmann and others (2005).

ensure their security, shorten the lag time for fund transfers and facilitate the implementation of monetary policy. New RTGS systems are being introduced in Libya and Tunisia. The new systems are intended to meet best practice requirements, including settlement finality, fully collateralized intraday central bank advances, and optimization procedures for queues.

III. Ongoing Reforms and Remaining Challenges

A. Ongoing Reforms

31. **All five Maghreb countries are well aware of the importance of modernizing their financial sectors and the authorities in all the countries have been implementing reforms.** These reforms aim at establishing modern, market-based financial systems. Many of the reforms are also necessary for a possible financial integration in the region (see Section IV). The starting point of these efforts varies for different countries. Morocco and Tunisia have taken the lead and started upgrading their financial sectors early in the last decade. Algeria and Mauritania began undertaking financial sector reforms in the second half of the 1990s, and Libya followed more recently. As a result, the Maghreb countries find themselves at present in different stages of reform.

32. **Reforms in Morocco have for the most part focused on overhauling the legal and regulatory framework**, including the promulgation in 2006 of a new banking law and of a new central bank charter. The former law reinforces the supervisory authority of Bank Al-Maghrib (BAM) over the activities of credit institutions, while the new BAM charter strengthens the central bank's monetary policy autonomy and clarifies its functions and powers with respect to exchange policy and the security of payment instruments. BAM has also relinquished its management role and sold its remaining capital shares in all the credit institutions in which it previously participated. In addition, the government has sold its share in one public bank and has committed itself to ensure full compliance of the two previously exempted public banks with prudential regulations by 2007.

33. **In Tunisia, recent reforms have focused on reducing NPLs, improving bank governance, increasing transparency and accountability, and strengthening the regulatory framework**. Following the promulgation of a new banking law in May 2006, measures are being put in place to strengthen banks' credit policies, and banks have been required to increase provisioning for NPLs. In this connection, the tax deductibility of provisions for NPLs was increased and legal reforms were introduced to accelerate the sale of collateral. Two public banks have been privatized and a number of private banks were recapitalized. Finally, the new law for the *Banque Centrale de Tunisie* (BCT), also promulgated in May 2006, gives the BCT new authority in the area of advisory assistance, monitoring, transparency, supervision, and publication of economic and financial information. As for monetary policy, this new law emphasizes that price stability is the main objective of the central bank with the policy interest rate as the main instrument.

34. **Algeria has taken steps to modernize its financial system in recent years**. After modernizing the regulatory framework, the privatization of a first public bank is on track for completion in early 2007 and the sale of a second public bank is scheduled to follow soon thereafter. The authorities have also taken steps to improve the governance of remaining public banks by strengthening the performance contracts with their managers and by submitting all public banks to external audits. The government is in the process of repurchasing the loans of problem public banks and replacing them with budget subsidies which are to be accompanied by enterprise restructuring plans. Efforts are also underway to strengthen banking supervision, including by increasing the number of inspectors. Progress has also been made in improving the payments system with the inauguration of a RTGS system in early 2006 and a new retail payments system in May 2006.

35. **The modernization of the financial sector in Mauritania is at an early stage** and access to financial services remains limited and costly. Although all but one public bank were privatized in the mid-1990s, most banks belong to business conglomerates to which they have large exposures. Since 2005, tightened banking supervision, particularly through on-site inspections in all banks, has led to better provisioning for NPLs. The Mauritanian authorities have launched a major reform program primarily of the legal and regulatory framework of the financial and microfinance sectors, the foreign exchange market, and the money market. The payments system is also being modernized with the imminent start of an interbank electronic payments system.

36. **The Libyan authorities have recently begun preparing to reform the predominantly state-owned financial system**. In particular, they are aware that a more market-oriented banking system is needed to increase the overall efficiency of the economy. A new central bank law was passed in 2005. The first privatization of a public bank was launched in the same year and three other public banks were recapitalized. Efforts to improve banking supervision and arrange workouts of NPLs have been stepped up, while new guidelines on bank risk management have been issued. In addition, a new RTGS payments system is being introduced.

37. **Looking ahead, the authorities in the five Maghreb countries have clearly indicated their continued commitment to further reform**. The remainder of this section will focus on the challenges ahead, focusing on the key areas of strengthening the financial system, promoting competition in banking; deepening financial markets; improving financial sector oversight; and upgrading financial sector infrastructure.

B. Remaining Challenges

a) Ensuring a Sound Banking System

38. **A critical step in increasing the soundness of banking systems in the Maghreb countries is the significant reduction of NPLs**. This will require a combination of actions, including additional provisioning, upfront cash injections by owners, improved procedures

for loan workouts, and (partial) write-offs accompanied by measures to limit moral hazard. The timely recognition of loan losses and the strict implementation of provisioning requirements would enable supervisory agencies to agree with the banks concerned on the required actions to restore solvency and profitability.

39. **The steadfast implementation of prudential rules is also a priority**. The supervisory agencies need strong independence *de jure* and *de facto*, clear and public support of the government, and acknowledged proficiency of their staff in financial contracts and the business practices of financial institutions (see also subsection d below). Although the regulatory framework is reasonably well-established in most Maghreb countries, there is still room to improve the predictability and speed of enforcement of prudential rules, including for public banks.

b) Strengthening Competition in Banking

40. **Strengthening competition in banking in the Maghreb countries is key to promoting economic development**. A higher degree of competition and efficiency in the banking system would contribute to greater financial stability, product innovation, and access by households and firms to financial services, which in turn can improve the prospects for economic growth. A specific concern in this respect is that bank ownership structures in most of the countries in the region—notably extensive state participation, ownership links between banks and their borrowers, and restrictions to foreign bank entry—stifle competition and financial deepening.[11] It is therefore important to identify the reforms that would be needed to remove remaining barriers to competition. Other key elements of a strategy to strengthen competition and bank efficiency—notably, strong regulatory oversight and the development of nonbank sources of finance—are covered elsewhere in this section.

41. **Countries in the region are well aware of the need to modernize their public banking systems** including by privatizing more public banks, improving their governance, and leveling the playing field between private and public banks. The macroeconomic and political stability achieved in recent years provides a unique opportunity to pursue these strategies aggressively. While no standard methodology exists for reforming public banks, there are issues common to each strategy and lessons to be learned from experiences in other countries, including from the region (see, for instance, Box 2).

- Privatization of public banks is a difficult undertaking, particularly when these banks have poor-quality assets and are overstaffed, overbranched, and undercapitalized—as it is the case for several public banks in the region. As it is unlikely that new investors

[11] It should be noted that the ownership structure of the Tunisian banking system has been radically changed over the last five years. The foreign share of total bank capital rose from 16 percent in 2001 to 34 percent in 2005. In Morocco the foreign share of total assets represented 21.5 percent in 2005. In Algeria, the banking sector has been open to local and foreign private investors since 1990.

Box 2. Reforming Public Banks: The Case of Algeria

Most of the banking sector in Algeria is in public hands. At end-2004, the six public banks accounted for 84 percent of bank deposits and 86 percent of bank credits. The authorities' reform strategy consists of privatizing two banks and strengthening governance and management in the other four, including by clarifying their relationship with borrowing public enterprises.

- Preparations for the first privatization are well advanced. The authorities intend to sell a majority stake in *Crédit Populaire d'Algerie* to a strategic investor—possibly a large reputable international bank. Interest among investors is reportedly high. An investment bank is being hired to assist in the privatization process.

- The banks not slated for privatization are being financially and operationally restructured. The banks are to be recapitalized (by replacing nonperforming loans with government bonds carrying market interest rates) based on the result of external audits conducted by reputable auditing firms. Operational restructuring would include strengthening risk management as well as accounting and reporting systems. In addition, new performance contracts have been signed between the State—as shareholder—and the chief executive officer of each of those banks, setting clear objectives in terms of profitability and internal controls.

will be willing to pay the cost of cleaning up a public bank, these banks will need to be both operationally and financially restructured before they can be privatized.[12] The privatization strategy should be based on a thorough diagnostic of the conditions of the public banks and also include which banks to privatize, when, and in what order. Assistance from outside experts (typically, investment banks), with adequate oversight by the authorities, can be useful in conducting a privatization.

- Banks destined to remain public require stronger governance arrangements: the state must become a modern, active owner. This would be particularly important for public banks that cannot diversify by charter, such as agriculture, housing, or small business banks. Performance contracts with public banks' managers—along the lines of those recently signed in Algeria—could be used also in other countries. Any directed lending by the government through these banks—if not discontinued—should be explicitly funded through the budget, including any associated contingent liability in the event of nonpayment. Any such lending should be channeled on an arms-length basis, be based on clear, objective, and easily monitorable criteria, and be fully transparent.

- Countries in the region should aim at eliminating any remaining differences in the regulatory, supervisory, and tax treatment of public and private banks. Although the prudential framework is reasonably well-established in most Maghreb countries, supervisors may find it difficult to enforce rules on public banks, especially as regards

[12] In Libya, private sector response to the privatization of Sahara Bank was lukewarm largely because the privatization was launched without any restructuring of the bank or proper valuation of its balance sheet.

corrective action. In addition to prudential regulation, strengthened transparency, disclosure, and corporate governance standards (see below) should apply to private and public banks alike.

42. **Heightened competition is also needed to address inefficiencies in systems dominated by mixed (financial and nonfinancial) groups**. For example, in Mauritania most banks have direct ownership links with local, family-owned conglomerates and largely operate as the financial arm of the group. This could adversely affect the safety, soundness, and reputation of the system—as related-party lending is pervasive and often extended at preferential terms—and severely restricts access to financial services by creditworthy borrowers outside of the group. The Algerian banking law prohibits lending to shareholders and persons and entities related to them. Gradually opening up the financial system to competition, along with tighter prudential, disclosure, and governance requirements, is necessary if the system is to support broad-based economic growth.

43. **The removal of remaining barriers to entry of reputable foreign banks would strengthen incumbents' competitive behavior**. The benefits of foreign bank entry are well documented. Entry improves the efficiency, and by extension stability, of domestic banking systems through changes in the industry's competitive structure, new financial products, and more modern banking practices. While foreign banks have been operating in the region for some time, their market share remains generally small. Recent progress in attracting foreign banks is encouraging. For instance, a recent privatization in Tunisia increased foreign banks' share to one-third of that system's assets; in Morocco, the already large share of foreign capital in the banking system further increased in 2006 with the entry of a foreign group;[13] two foreign banks entered the Mauritanian market in 2006; and in Algeria, public bank privatizations and the expansion plans of existing foreign banks are expected to transform the system's ownership structure. In Mauritania, the authorities intend to increase the minimum capital for banks to open up the system to new partners and bank mergers. Increased competition from foreign banks may have short-term costs—notably in terms of lower profitability for less efficient domestic banks—but overall benefits for the system and the economy as a whole. Accordingly, public policy should focus on liberalizing entry while continuing to strengthen risk management practices in the local banking systems.

c) Deepening Financial Markets

Capital markets

44. **There is a need to enhance the depth and liquidity of Maghreb capital markets**. Capital markets in the region are concentrated on government issuance while corporate bond and equity markets have developed unevenly or are simply nonexistent. Well-functioning

[13] At the same time, the penetration of Moroccan banks the region and, more generally, in Africa, has increased in recent years.

capital markets facilitate financial intermediation and risk management and, over the medium term, will facilitate cross-border capital flows. The agenda in this area should include steps to strengthen regulation and supervision of securities markets, establish a government yield curve, broaden the investor base, and enhance transparency to promote participation.

- Reforms aimed at strengthening the legal, regulatory, and institutional framework governing the securities markets would have a profound impact on the development of these markets. Efforts in this area should concentrate on adopting international standards and good practices, such as those contained in the International Organization of Securities Commissions (IOSCO*) Objectives and Principles of Securities Regulation*.

- Governments can play a catalytic role in developing capital markets by supporting a deeper market for government debt and facilitating the emergence of a yield-curve upon which other assets can be priced. For this, governments should issue paper of standard maturities on a regular basis and at market rates. In Algeria, Morocco, and Tunisia, government issuance policies have become more conducive to the emergence of a yield curve—for instance, with the number of government securities in Morocco steadily declining from the several hundred different types that existed until 2003. A sovereign yield curve was established in Algeria in 2002 and in Tunisia more recently.

- Diverse participants should be encouraged to enter capital markets on the buy-side. Strengthening or developing an institutional investor industry—notably pension funds and insurance companies—in particular, would have a positive impact on capital markets' depth and liquidity. Steps in this direction—aside from macroeconomic stability—would include tax treatment that supports long-term savings products, a level playing field with banks in attracting long-term savings, as well as the ability of foreign institutions to enter domestic markets.

- Gradually reexamining limits on pension funds' and life insurers' investments would also support diversification. Most countries in the region have imposed quantitative limits on investment allocations by these institutions as opposed to "prudent man" rules.[14] Large investors, such as state-owned retirement or insurance funds, are often captive buyers of government securities. Minimum investment limits and impediments to adequate diversification, including internationally, should be avoided. Greater investment flexibility would allow institutional investors to differentiate themselves and cater to a larger variety of small investor profiles. Legislation passed

[14] Under prudent man rules, trustees are not subject to quantitative limits and may invest in a security if it is one that would be bought by a prudent man of discretion and intelligence, who is seeking a reasonable income while preserving investors' capital.

in Morocco in 2004 allowing insurance companies to invest up to 5 percent of their funds abroad represents a step in the right direction. A gradual move toward prudent man rules could be pursued over the medium term, along with steps to ensure adequate risk management in these institutions as well as appropriate oversight.

- Enhanced transparency would promote market participation on the sell-side. Since deep and well-functioning capital markets rely on the participation of a large number of small investors, an institutional framework with clear rules and where investor rights are well protected is a necessary condition for the development of capital markets. A relevant example in this area is the legislation passed in 2004 in Morocco that clarified and standardized the rules governing IPOs, including the guidelines for issuing a prospectus. In the Maghreb, there is also a need to promote a change in corporate culture, as a large number of family-owned companies in the Maghreb are reluctant to disclose information and/or relinquish control by publicly issuing shares.[15]

- Maghreb governments, as owners of large corporate entities, could hasten the movement to replace bank loans with domestic bonds. Because of their longer-term cash-flows, public utilities and housing finance intermediaries could become typical issuers on the local bond markets in the Maghreb. In Algeria, large public enterprises and utilities began to replace bank debt with corporate bonds in 2004 and were followed by a first private corporate issuance in January 2006. By contrast, the corporate debt market in Morocco is relatively large, even though it has not yet reached it desired growth potential.

Money and foreign exchange markets

45. **Reducing the liquidity of banking systems in the Maghreb is needed to deepen financial markets**. Remittances from expatriate Moroccans, privatization receipts in Tunisia, or hydrocarbon revenues in Algeria, Libya, and Mauritania are large autonomous factors that can boost financial system liquidity over extended periods of time, impeding efficient pricing on financial markets. In particular, fewer banks will need short-term funding from the interbank market, thereby depleting bank treasurers' skills for assessing counterparties and valuing collateral. Structural surpluses can also depress interest rates, which may push banks toward riskier uses of customer deposits. Finally, structural surpluses can lead to the atrophy of the fixed-income community as buy-and-hold behaviors take hold.

46. **Financial market deepening requires closer coordination between Treasuries and central banks in designing and calibrating instruments of monetary policy**. Whenever structural liquidity surpluses from autonomous factors are highly persistent over

[15] In Tunisia for instance, private securities are largely issued by finance companies that are owned by banks. These securities are in turn mainly bought by mutual funds owned by the same banks.

time, instruments of corresponding maturity may need to be deployed. Long maturity instruments typically comprise the outright sale by central banks of government securities, remunerated reserve requirements, or special liabilities of the central bank. Central bank sales of government securities can occur when the Treasury's issues are over and above its financing requirements. The cost for carrying this public debt would be similar to the reduction in central bank dividends from higher reserve requirements or special central bank deposits; both should pay market interest rates to ensure their neutrality for bank margins. Special liabilities of the central bank, such as deposit auctions as in Algeria, can carry maturities that match more closely long-term system liquidity. Central bank bills can play a role, but it is limited by small volumes and short maturities.

47. **A less accommodative access to central bank liquidity facilities would support the development of more liquid interbank money markets in the Maghreb**. The interest rate corridor at which central banks operate these standing facilities should be sufficiently wide so as to encourage interbank transactions as a first resort and support the development of cash management skills in banks. In addition, the frequency of liquidity operations that the central bank conducts at its own initiative may need to be relatively low. Otherwise, frequent operations in the middle of the interest rate corridor, particularly at the end of the day as in Tunisia, can reward ineffective cash management at individual banks in the same way as a narrow corridor on standing facilities.

48. **Further actions are also needed to deepen foreign exchange markets**. Mauritania's elimination of the foreign exchange rationing system in October 2006 and its phasing out of the partial surrender requirements on fish export proceeds in order to create a sound basis for the successful introduction of foreign exchange auctions is welcome (Box 3). Relaxation of requirements to sell foreign exchange to the central bank, as was done by Tunisia in 2005, would encourage banks that exceed foreign exchange position limits to sell foreign exchange to other banks, thereby supporting the development of an interbank market in foreign currency.[16] Relaxation of constraints on banks providing forward foreign exchange contracts, including the requirement for banks to deposit their foreign exchange balances at the central bank at overnight rates, would better enable businesses to hedge foreign exchange risk. The authorities may also consider eliminating government-imposed fees on foreign exchange transactions. In that regard, in 2004, Morocco authorized banks to freely invest a portion of their foreign exchange abroad to hedge the exchange risks they need to manage. Finally, central bank market-making in the foreign exchange market should be discontinued, with central banks requesting firm buy-sell rates from dealers when in need to transact. The pace of such a liberalization of foreign exchange markets will depend on country

[16] More than 90 percent of Algeria's and Libya's exports are in the hydrocarbon sector. The legal requirement to surrender the related export proceeds will delay the development of foreign exchange markets in these countries until non-hydrocarbon exports expand sufficiently.

circumstances and reflect broader considerations, such as the pace of capital account liberalization and the development and appropriate oversight of risk management capabilities in banks.

Box 3. Reforming Foreign Exchange and Money Markets: The Case of Mauritania

Foreign exchange market reform

The Mauritanian authorities intend to develop a more flexible exchange rate policy to better manage the impact of a possible appreciation of the real exchange rate and external shocks related to the increase in oil sector activity, by adopting the following measures:

- removal of any remaining restrictions on current transaction payments;
- abolition of the requirement to surrender a portion of fisheries export revenue to the BCM;
- introduction of a foreign exchange auction system managed by the central bank.

Money market reform

The BCM will introduce the following measures to improve liquidity management, bearing in mind the expected increase in government foreign exchange revenue and the reduction of government debt to the banking system:

- adoption of new regulations to promote the development of an interbank market;
- introduction of a new liquidity management instrument (BCM deposit certificates);
- restructuring and securitization of a portion of BCM claims on the government to be used in open market operations.

d) Strengthening Financial Sector Oversight

49. The authorities of the various Maghreb countries have made commendable progress in strengthening financial system regulation and supervision (see, for instance, Box 4), but more needs to be done. Despite the significant wave of reforms during the last decade, there is a need to enhance the effectiveness of prudential controls in Maghreb countries—judging by their compliance with the Basel Core Principles. Common elements of an action plan to address the remaining shortcomings in the prudential area would be centered on steps to strengthen the operational and financial autonomy of regulatory agencies, and to increase the effectiveness of financial sector supervision. Further progress with divesting from state ownership of financial institutions will also address the intrinsic conflict of interest between the government as owner and as supervisor of these institutions.

Box 4. Reforming Bank Oversight: The Cases of Morocco and Tunisia

Since 2001, the Tunisian and Moroccan authorities have taken important steps to improve the prudential oversight, legal environment, and infrastructure of each country's financial system. This box briefly describes some of the major steps taken to illustrate possible stepping stones that other countries in the region could follow.

Morocco

In 2001, a new Chart of Accounts for Credit Institutions was adopted. The new chart of accounts facilitated the supervision of banking groups on a consolidated basis. The same year, a central bank circular was issued, granting the central bank (BAM) the ability to impose penalties on regulated entities for not complying with key prudential provisions. In a similar vein, revisions were made to the banking law to equip the BAM with a broader set of tools for action. In order to improve the efficacy of the supervisory structure in place, other important logistical improvements were made, such as the computerization of the Credit Institutions Supervision Directorate (DCEC), and the reorganization of on-site and off-site inspection procedures.

In February 2006, a new Central Bank Law and a new Banking Law were promulgated. These laws significantly strengthen the supervisory powers of the BAM and grant it more autonomy from the ministry of finance. The Banking Law also envisages the possibility for the central bank to sign accords with the supervisory agencies of the home countries of foreign banks established in Morocco. These accords would also facilitate the sharing of information regarding banking groups, in accordance with Basel II principles. Finally, in an effort to reduce possible conflicts of interest regarding its supervisory functions, the central bank has relinquished its management role and sold its remaining capital shares in all the credit institutions in which it was previously involved.

Tunisia

In July 2002, Tunisia adopted a new banking law to strengthen the supervisory powers of the central bank (BCT). Currently, the BCT is able to monitor banks closely through on-site inspections (some of which are carried out by external auditors), in-depth analysis of prudential reporting, and periodic meetings with banks managers (semiannual for the largest banks and annual for the others). New regulations also broaden the compilation of financial information by banks on borrowers, and require commercial borrowers to submit audited financial statements when their bank indebtedness exceeds a given threshold. The new banking law also tightens the rules on bank licensing, capital requirements, allowable investments, and limits on credit concentration, connected lending and investment, and equity participations. A revision of this law in May 2006 requires banks to establish an executive credit committee reporting to the board of directors, and to emplace a compliance control system also under board supervision. The BCT has also refined its analytical approach to supervision, developed and enhanced the expertise of its inspectors, improved consolidated supervision, and reinforced the monitoring of credit risk. The new central bank law also promulgated in May 2006, strengthens the central bank's authority in the areas of supervision, regulation, transparency, and publication of economic and financial information.

In order to develop a framework that provides incentives for the adequate treatment of NPLs by financial institutions, several tax measures have been recently adopted. In particular, the ceilings for the tax deductibility of provisions were raised to 85 percent in 2005, and to 100 percent in 2006. Additionally, the scope of provisions related to connected lending has been significantly broadened.

Strengthening the autonomy of supervisors

50. **To help identify risks at an early stage, ensure healthy competition, protect consumers, and shore up public trust in the financial system, there is a need for independent oversight bodies equipped with adequate resources and authority**. This independence should be accompanied by mechanisms of increased accountability. Fuller autonomy of supervisory agencies should be sought on three key fronts: (a) better defining legal grounds for the dismissal of heads and board members of the agencies; (b) ensuring that the role of ministries of finance in the licensing and regulation of financial intermediaries does not undermine the authority of supervisors; and (c) lifting resource constraints to the hiring, retention, and training of qualified staff.

- In most countries in the region, amendments to the law to clearly define the grounds for the dismissal of governors and board members of central banks—which typically have responsibility for banking supervision—are needed to strengthen central bank autonomy. Government representation on the central bank board should be phased out where it still exists. Steps should also be taken to enhance the financial and operational independence of securities and insurance regulators.

- A clarification of the respective roles of supervisory agencies and ministries of finance would reinforce the independence of the supervisors and their ability to apply their powers without interference. Ministries of finance throughout the region often retain extensive powers over licensing, regulation, and sanctioning of financial intermediaries. There is a need to ensure that the fact that supervisory agencies are not responsible for licensing decisions does not undermine their authority—notably by ensuring that they have a decisive input in licensing decisions. If that is not possible, consideration should be given to moving licensing authority to the supervisory agencies.[17]

- There is a need to ensure that supervisory agencies have sufficient financial resources to hire, retain, and train staff. Operationally, effective supervision requires staffing increases and staff quality improvements across agencies in the region. In particular, agencies need to be able to offer competitive salaries to well-trained accountants, financial analysts, and actuaries. Lack of qualified staff has resulted in infrequent and limited-in-scope on-site inspections. Some countries have relied extensively on external auditors to overcome the staff shortages—for instance, Libya and Mauritania—for banking supervision. However, there are risks to outsourcing on-site work, and for this strategy to be successful, supervisors at a minimum need sufficient capacity to verify the quality of external auditors' work, including through auditor certification and joint on-site inspections.

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[17] In Morocco, the 2004 amendment of the law governing the *Conseil Déontologique des Valeurs Mobilières* (CDVM) is an interesting example of strengthening the powers of the supervisory authority.

Improving the efficacy of prudential regulation

51. **The supervisory bodies need to increase their effectiveness by developing a more risk-based approach to supervision, and by establishing greater coordination among domestic supervisory agencies**.

- In most countries in the region, banking supervision is mostly rules-based. Supervisors need to go beyond a compliance or "checklist" approach to supervision to one that requires a thorough understanding of an institution's activities and its risks. Adopting a more risk-based approach to supervision, where the focus is on banks' internal risk management policies and procedures, is needed to help supervisors detect difficulties before they arise and take remedial action at an early stage. Moving toward risk-based supervision is also a key precondition to effective implementation of the Basel II framework.[18]

- There is substantial scope to improve coordination among domestic supervisory agencies. All countries in the region have separate supervisory agencies for banking (usually, the central bank), insurance (the ministry of finance or of commerce), and the securities markets (a separate agency). While informal channels of communication exist among domestic agencies, there are few formal agreements on exchange of information and other prudential matters. In a rapidly changing financial environment—where banks are increasingly involved in insurance and capital markets, and financial groups are becoming important—achieving greater coordination or integration among domestic supervisory agencies should be a key policy priority.[19]

e) Upgrading Financial Sector Infrastructure

52. **The development and stability of financial systems can be fostered through the creation of infrastructure that is supportive of financial activities**. To that effect, the authorities in the Maghreb countries need to extend efforts already underway in the legal and judicial areas, the accounting and auditing framework, and the payment and securities settlement systems. Furthermore, the creation or expansion of credit bureaus with information on debtors would foster financial intermediation by facilitating banks' risk assessment.

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[18] Given its complexities and substantial resource implications, Basel II may not be the first priority for countries with relatively less advanced regulatory and banking systems. A supervisory focus on meeting the requirements of Basel II, with the associated reallocation of resources, may distract supervisors from more immediate concerns, such as building a strong system for day-to-day risk-based supervision. Even for countries that are in a position to migrate to Basel II, the speed of implementation should not take precedence over quality.

[19] In Morocco, the new banking law provides for the establishment of a coordinating commission of financial sector supervisory agencies.

Legal and judicial framework

53. **While considerable progress has been made on the legal front, a number of challenges remain**. Across the region, there remains considerable room to improve bankruptcy and foreclosure proceedings. Only a few countries (such as Morocco) have adopted a modern approach to bankruptcy that gives priority to corporate restructuring efforts. Even in those cases, there is a need to expedite court proceedings, reduce the cost of enforcing decisions, and train magistrates and officials in commercial matters. Commercial courts need to be established across the region (currently, they only exist in Algeria and Morocco), along with a framework for arbitration, which could play an important role in easing the burden of disputes before the commercial courts.

54. **Upgrading the laws governing loan guarantees would facilitate the mobilization and recovery of loans throughout the region**. In Algeria, the legislation applicable to guarantees was toughened. This could be done, in Morocco, by incorporating new instruments and allowing for the use of movable assets as collateral. In Mauritania and Tunisia, modernizing the registration of land tenure titles would enhance mortgage lending.

Corporate governance

55. **Strengthened corporate governance is essential for deep and liquid financial markets**. As investors become increasingly demanding and selective, strong practices in these areas create an attractive investment climate. Corporate governance in the Maghreb has generally improved in recent years. In particular, Morocco and Tunisia stand today as the two countries in the region with higher standards in managerial accountability and shareholders' rights. However, all the barriers to effective application of these laws have not been lifted and the powers of the securities regulators to address wider corporate governance issues remain limited. All countries in the region would benefit from the development and application of codes of best practices regarding corporate governance.

56. **Corporate governance standards in the banking sector require special attention**. Shortcomings in the governance of banks not only lower returns to shareholders but can also destabilize the financial system. Particular attention needs to focus on family- and corporation-owned banks—the latter prominent in Mauritania—to ensure that related-party lending between the bank and its owners occurs in a manner that is consistent with prudential rules. For state-owned banks, there is also a need to ensure that management is under a proper set of incentives—for instance, by using performance contracts, as done in Algeria—and there is no government interference in the commercial activities of these banks.

Transparency and disclosure

57. **Increased transparency and accountability through moving to international standards in financial reporting is another key reform**. This will facilitate the access of companies to domestic and, increasingly, external sources of financing. In most countries in

the region, the accounting and auditing frameworks are inspired by international standards—the International Financial Reporting Standards (IFRS) and the International Standards on Auditing (ISA)—and a number of reforms have been undertaken to strengthen transparency and disclosure (see, for instance, Box 5). Additional efforts, however, are needed to improve enforcement, add certain standards, and clarify some regulations. A number of shortcomings also need to be addressed in disclosure standards—notably in Algeria, Libya, and Mauritania—which result in opaque financial information and hamper investors' ability to make informed decisions. Generally, training in the fields of accounting and auditing is still limited. Fuller adoption and enforcement of international standards would improve the transparency, accuracy, and reliability of financial information to convey an accurate and fair view of companies' performance. In Morocco, credit institutions are expected to be in compliance with international accounting norms (IFRS) by 2008 and Algeria is also actively preparing to implement these standards. National supervisory bodies that ensure the quality and consistency of the auditors' work could also increase public confidence in the transparency and quality of financial information.

Box 5. Improving Transparency and Disclosure:
The Cases of Morocco and Tunisia

In Morocco, the banking law promulgated in 2006 is aimed primarily at strengthening financial transparency by requiring the publication of a report on bank supervision. Two annual reports covering the 2004 and 2005 fiscal years have already been published. These reports take stock of changes made in banking regulations and actions taken to supervise lending institutions (banks, consumer loan, and leasing companies), and describe the activities and performance of these institutions during the fiscal year. There have also been considerable improvements in financial market transparency through the continued convergence of Moroccan financial regulation norms with international standards, as defined by the International Organization of Securities Commissions (IOSCO).

In Tunisia, new transparency requirements on companies have been introduced with the 2005 Law on Financial Transparency. In particular:

a. all stock corporations and all commercial companies with balance sheets exceeding a given threshold must appoint external auditors (with a term limit of three years);

b. all companies raising funds publicly are subject now to more strict informational requirements;

c. external auditors must submit their reports to the central bank when companies raise funds publicly and when their bank borrowing exceeds a certain limit;

d. companies with consolidated accounts and with total balance sheets exceeding a threshold must have two external auditors; and

e. permanent internal audit committees must be instituted in all stock market listed companies and in those unlisted companies with a balance sheet exceeding a given threshold.

58. **Countries in the Maghreb should support the development of borrowers' credit information**. Private credit bureaus and public credit registries (the latter, to the extent that the information is not used solely for the purpose of banking supervision) are useful to strengthen banks' risk management and expand lending to new market segments. Public credit registries should be established where they do not exist (e.g., Libya), and the accessibility and quality of the information should be improved throughout the region, along with appropriate safeguards in terms of consumer and data protection. The development of private credit registries could also be encouraged. A good step in that direction is the decision by the central bank in Morocco to put its new credit information database under private management in 2007.

Payment systems

59. **In recent years, central banks in most Maghreb countries have played a very active role in the reform of national payment systems**. Important efforts have been completed and others are ongoing. In some countries, reform programs have already removed payment system inefficiencies—such as poor integration between the central bank and banks, and long settlement lags. Acknowledging these important achievements, central banks across the region need to finalize the reform effort. Elements of a reform program should encompass improvements in the legal, regulatory, and oversight frameworks, compliance with international standards, full integration of all systems, and introduction of new and efficient payment instruments. A comprehensive approach to payment systems reform is paramount to achieve these objectives.

60. **In some countries, important projects, such as an RTGS system, have already been launched or are in the pipeline**. For instance, efforts in this direction are already well advanced in Algeria and Tunisia, and underway in Libya (Box 6). Algeria started to use the RTGS in February 2006 and an automated clearinghouse for large volume payments in May 2006. In Morocco, the RTGS system became effective in September 2006. In Tunisia, high-value automated clearinghouses are being tested and will come on stream shortly. Plans to introduce such a system as part of the ongoing comprehensive modernization of the payment systems should be initiated in Mauritania as a matter of priority.

IV. Toward Regional Financial Integration

A. Background

61. **What is financial integration?** It is the process through which financial markets of several countries remove restrictions on cross-border financial flows and on foreign entry into the domestic financial system so that all potential participants, local and foreign, in a market are subject to the same rules and have equal access. Financial integration in this sense can be seen as the absence of location-based discrimination in accessing financial markets.

Box 6. Reforming the Payment System: The Case of Libya

A strategy has been defined for the reform of the payment system in Libya and implementation is underway. The Central Bank of Libya (CBL) has signed a contract with a consortium of reputable international companies to cover all the various components of the reform.

a. *Real Time Gross Settlement (RTGS) system*. Settlement across accounts with the CBL will be final and irrevocable, and the system is expected to be compliant with international best practices. This system will replace the current mutual interbank payments system. Progress on the technical and infrastructural front is tangible and the RTGS is expected to be functioning in the near future.

b. *Automated Clearing House (ACH)* for the clearing of electronic files of direct debit and direct credit instructions between banks and their customers. The ACH would cover high-volume, low-value fund transfers such as salaries, utility bills, dividend payments, insurance premia and claims, and loan repayments, reducing thereby the use of checks and cash. The net balances from the clearing would be settled through the RTGS. Once established, the ACH will also be used to clear the output from the Automated Check Processing (ACP) system (see below) and other low-value electronic payments generated by banks and will be capable of accepting additional future modules comprising payment/receipt instructions to banks generated by other parties (stock exchange for instance).

c. *ATM/POS Switch*. The Switch would interconnect a shared financial network within Libya for all Automated Teller Machines (ATMs) and Electronic Funds Transfer/Point of Sale (EFT/POS) devices. Initially, the Switch will have a direct interface to either the RTGS system or a manual interface at the General Ledger (G/L), depending on the CBL's preference. At a later stage, it will interface with the RTGS via the ACH.

d. *Automated Check Processing (ACP) system*. A standard ACP system will be in place to address the current inefficiencies of the manual paper-based system, improve customer service, and reduce current costs. As with the ATM/POS Switch, initially, this system will interface, depending on the CBL's preference, either manually to the G/L or directly with the RTGS system; later, it will interface with the RTGS via the ACH.

The payment system reform project is to be fully implemented within a period of about three years.

62. **Regional financial integration would pool resources available for investment and trade, promote the development of domestic financial systems, enhance risk sharing, and lead ultimately to faster-growing and more resilient economies**. It would achieve this by increasing efficiency through enhanced competition and greater scope for economies of scale. It could also help create a virtuous growth-boosting cycle in which further financial integration facilitates rapid expansion in regional trade and vice versa. Looking ahead, a Maghreb region where goods, services, and capital can flow relatively freely would be a very attractive market for domestic and foreign investors. In particular, a well-integrated Maghreb region could take greater advantage of the potential of the EU Association Agreements and the Wider European Neighborhood. It could also become an attractive destination to investors from other regions, including oil-exporting countries in the Middle East. Finally, regional financial integration could play a catalyst role to broader financial integration with the rest of the world by providing a new impetus to financial sector reforms necessary to prepare regional financial systems for broader competition while minimizing the risks of financial instability.

63. **The vision of a fully integrated Maghreb economy is not a novel one**. It has been floated in policy circles since the independence of the member countries and was formalized in the Treaty of the *Union du Maghreb Arab*e (UMA) that was signed in 1989 by the five Maghreb countries. The treaty aimed at achieving gradual integration of goods, services, capital, and labor markets. Early on, the treaty envisaged the establishment of the *Maghreb Bank for Investment and Foreign Trade* (BMICE) to spearhead financial integration and promote trade and investment within the region. The agreement was signed in 1991 but it took another 15 years before this agreement bore fruit. The Maghreb Ministerial Commission for Finance finally approved the draft statute of the BMICE in March 2006. It will be headquartered in Tunisia with an equally subscribed capital of $500 million. This is a modest achievement when compared to the original objective of a common market by 2000.

64. **The region is well aware of the challenges and opportunities of integrating domestic markets into regional and global financial markets**. Measurable progress has been achieved by all Maghreb countries toward strengthening domestic financial markets and promoting their global integration by gradually lifting restrictions on cross-border capital flows and foreign ownership. In fact, Tunisia has set the goal of achieving full capital convertibility with a freely floating exchange rate over the next few years, and Morocco is preparing a gradual transition to a flexible exchange rate. However, the focus has been more on global rather than regional integration. Given the synergies between regional and global financial integration, progress on both fronts would be beneficial.

B. Lessons from Other Regional Financial Integration Experiences

65. **This section will distill the most relevant lessons for the Maghreb region from the ongoing financial integration processes within the EU and the Gulf Cooperation Council (GCC) countries as well as from the experience of European transition economies with capital account liberalization**. The EU experience, widely regarded as a model of economic integration around the world, is particularly relevant for the Maghreb region because of the importance of the economic relationship between the two regions. It offers a comprehensive framework for financial sector reform and harmonization efforts necessary for advancing financial integration. Similarly, the financial integration effort and progress toward a monetary union in the GCC countries offers interesting insights from the perspective of an important region that shares a similar culture and faces some similar challenges. Finally, the experience of European transition economies with capital account liberalization offers useful lessons to the Maghreb countries, which have started to gradually liberalize their capital accounts.

66. **The EU experience shows that, despite significant economic and regulatory heterogeneity among member countries, a gradual process of financial integration can succeed**. Financial integration in the EU has been based on consensus building for the spread of best practices. This gradual approach is underpinned by the Financial Services Action Plan and the Lamfalussy process (Box 7). Under this model, countries work together to define

Box 7. EU's Experience with the Financial Services Action Plan and Lamfalussy Process

Financial Services Action Plan

The EU commission initiated the five-year Financial Services Action Plan (the Plan) in May 1999 to remove regulatory and market barriers that limit the cross-border provision of financial services and the free flow of capital within the EU. Underlying the plan was the recognition that financial services were increasingly becoming an international market and that any European rule would have to be compatible with those used globally.

The Plan is a multi-faceted approach that addresses the major issues of financial market organization, seeking to create a level playing field among market participants and to support the integration of European financial markets. The Plan and the additional measures that have been agreed in response to market developments are the pillars of the future architecture of European financial markets. The distinctive feature of the plan was that the rules were to be tight and restrictive enough to ensure legal certainty and confidence, but also loose and malleable enough to allow institutions to act and adjust on an international level.

The plan comprised 42 measures to harmonize the member states' rules on securities, banking, insurance, mortgages, pensions, and all other forms of financial transactions. By its 2004 deadline, 39 of 42 measures were adopted. Among the 21 directives contained in the action plan, the average timeframe for adoption by the European parliament and council was just short of 22 months, which was a significant success for a program of this scale. The plan has been successful not only in harmonizing rules for the financial sector but also in fostering an atmosphere of cooperation between the European institutions and market participants.

The Lamfalussy Process

The so-called Lamfalussy process is the major vehicle for the design and the implementation of the Plan's regulatory work. Its objective is to speed up the legislative process, deliver more uniform and better technical regulation, and facilitate supervisory convergence. Initially limited to the securities markets, the Lamfalussy process was extended in November 2003 to the banking, insurance, and pension sectors as well as to the mutual funds industry. It is organized in four layers.

The core principles of legislation take the form of directives and regulations adopted by the political bodies, the European Council and the Parliament (Level 1), on the basis of proposals prepared by the Commission.

Technical implementation of framework directives and regulations is done by the European Commission, on the basis of recommendations made by high-level regulatory committees (Level 2), in consultation with Level 3 committees, and users and experts from the industry.

The implementation of EU legislation at the national level is the task of expert committees composed of national regulators and central banks (Level 3). Level 3 committees are responsible for supporting a consistent day-to-day implementation of EU legislation, by issuing guidelines and reviewing national regulatory practices.

Compliance with and enforcement of legislation by member countries is mainly the responsibility of the European Commission (Level 4).

1/ See European Union Website: http://europa.eu/scadplus/leg/en/lvb/l24210.htm common objectives, set regional guidelines based on qualitative and quantitative benchmarks against best practices, translate these regional guidelines into national policies by adopting specific policies tailored to national circumstances, and set specific timetables for meeting those objectives.

67. **The establishment of the European Economic Community—with free movement of capital, labor, and goods—has been a major force in the transformation of financial markets in Europe**. Integration should allow access to the entire market without the need for establishing local presences and complying with different sets of rules. These are essential conditions for the development of cross-border flows and an efficient functioning of financial markets. The Financial Services Action Plan and the Lamfalussy process seek to reinforce this process by building a common regulatory framework for financial service providers and securities markets and by seeking the convergence of supervisory practices.

68. **Survey and simulation results show that the benefits of financial integration in the EU could be substantial**. The ongoing integration is leading to profound changes in the structure and operation of the financial services sector throughout the continent. A number of benefits are expected for both investors and the corporate sector from a more open and effective European financial market. Investors will benefit from higher risk-adjusted returns on savings, through enhanced opportunities for portfolio diversification and more liquid and competitive capital markets. The corporate sector will benefit from generally easier access to financing capital. Competition in the financial intermediation sector will offer corporations a wider range of financial products at attractive prices. The economy-wide improved allocation of financial resources should increase real GDP growth. Simulation results in a study for the European Commission find that the cost of equity and bond financing could fall across Europe by about 50 basis points each.

69. **However, the progress with respect to integration has been uneven**. Integration of wholesale financial markets has proceeded at a much faster pace than integration of retail-oriented financial services, which remain relatively fragmented. In general, unsecured markets (e.g., the interbank money market) exhibit a much higher level of integration than securities and collateralized markets. Among securities markets, bond markets appear more integrated than equity markets. Finally, it is worth mentioning that the integration of wholesale markets has helped the integration of retail markets, highlighting the complementarity between financial markets.

70. **The experience of European transition countries highlights the challenges associated with increased capital flows as capital account restrictions are lifted** (Box 8). Large and volatile capital inflows, particularly interest rate-sensitive inflows, could complicate the conduct of monetary and exchange rate policies. To preserve macroeconomic and financial stability, it is crucial to maintain highly coordinated and disciplined economic

Box 8. Lessons from Capital Account Liberalization in European Transition Countries

On May 1, 2004 the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia (EU8) joined the EU. One of the requirements for membership was full capital account liberalization. The Czech Republic and the Baltic countries (Estonia, Latvia, and Lithuania) liberalized their capital accounts relatively quickly, with most transactions already unrestricted by 1995. In contrast, Hungary, Poland, the Slovak Republic, and Slovenia took a more cautious approach, achieving full liberalization between 2001 and 2004. Different starting conditions—including relatively high external debt in Hungary and Poland—help explain the speed of liberalization.

Regarding sequencing, the EU8 liberalized FDI before financial credit and portfolio flows, inflows before outflows, and long-term before short-term flows. Early in the transition, the authorities feared that high inflation and depreciating currencies might trigger capital flight. But the relatively fast macroeconomic stabilization achieved in most of the countries dispelled this fear, and, from the second half of the 1990s onward, it proved more difficult to manage capital inflows than potential outflows.

As for the composition of flows, FDI was the largest component during 1995–2003, followed by other investment (financial credit) and portfolio investments. More than FDI flows, other investment and interest rate-sensitive portfolio flows posed considerable difficulties to monetary authorities. As these inflows contributed to credit booms and exchange rate appreciation pressures, monetary authorities strived to find a balance among furthering disinflation, minimizing sterilization costs, and maintaining external competitiveness.

Policy Response to Increased Capital Flows

The EU8 countries responded in a variety of ways, depending on the nature of the inflows and the country's macroeconomic position. Monetary and exchange rate policies were not an option initially for the Baltic countries, which had currency board and hard peg arrangements, but was the most common response in the Central European countries with flexible exchange rates. The latter relied heavily on sterilized intervention and cautious interest rate cuts as disinflation progressed.

As capital flows intensified, countries moved to more flexible exchange rate arrangements, allowing the monetary authorities to better calibrate their policy response to the nature of the inflows. In the Czech and Slovak Republics, where inflows were dominated by FDI, the authorities continued to react mostly with sterilized intervention. In contrast, in Poland and Hungary, which attracted large amounts of interest rate-sensitive inflows in addition to sizable FDI inflows, the authorities abandoned sterilized intervention and allowed significant appreciations of their currencies. Meanwhile, interest rate policy became more active in the Czech Republic, Hungary, and Poland, which had introduced formal inflation-targeting regimes.

Experience with fiscal policy as a response to capital inflows was mixed. In Estonia, Latvia, Lithuania, and Slovenia, tight fiscal policy generally helped to offset the effect of capital inflows. In the larger Central European countries, a looser fiscal stance exacerbated the difficulties caused by the inflows by slowing the disinflation process in Hungary and in the Slovak Republic and by contributing to large current account deficits in the Czech and Slovak Republics and Hungary. Loose fiscal policy placed most of the burden of disinflation on monetary and exchange rate policies, especially in Poland and Hungary.

Other policy responses to capital inflows included capital controls in Slovenia and early repayment of external debt in Hungary, Poland, and the Slovak Republic. Banking regulation and supervision continuously improved during the transition period, helping countries monitor and reduce the risks related to heavy capital flows, although measures directly responding to capital flows—such as the tightening of the reserve requirements on foreign liabilities by Latvian authorities—were rare.

1/ See Arvai Zsofia, 2005.

policies, with a larger role for fiscal policy in managing domestic demand given that monetary policy has limited effectiveness in an environment of excess liquidity in the financial system.

71. **The ongoing financial and monetary integration within the GCC countries underscores the fact that the benefits of financial integration can also be significant between countries with relatively similar endowments and economic structures** (Box 9). Progress toward monetary union has spurred the development of more liquid and deeper financial markets, facilitated non-oil trade between GCC member states and thereby furthered the objective of policymakers in the region to diversify their economies, and has been a catalyst for the design and implementation of sound macroeconomic frameworks that maintain monetary stability, enhance fiscal discipline, and promote growth.

72. **The GCC experience also stresses the importance of political commitment to the economic integration process**. Policy consensus is crucial to avoid tensions once the single currency has been introduced and underpin the credibility and sustainability of the monetary union. The political commitment to the process has to be strong and unambiguous at the highest level in order to overcome obstacles or gridlocks on the way to monetary union. At the same time, the political commitment has to be an informed one that fully takes into account the implications of monetary union. In particular, monetary union ultimately results in the transfer of sovereignty from the national to the supranational level of monetary policy as well as in a reduction in the room of maneuver in fiscal policy.

C. Steps Toward Financial Integration

73. **While there is no blueprint on how to achieve regional integration**, several important lessons can be distilled from the EU and the GCC experiences:

- **A gradual approach to financial integration would be appropriate for the Maghreb region**. It is crucial, however, that integration efforts be sustained resulting in continuous and tangible progress. Indeed, examples abound of failed attempts at regional financial integration due largely to lack of commitment, including past attempts in the Maghreb region. With the globalization wave engulfing the world economy, the authorities recognize that the region has no choice other than to embrace it or risk being marginalized.

- **One way forward in the integration process is to conduct diagnostic assessments in each country against global standards and best practices to identify existing gaps**. This could be followed by agreement on regional guidelines for practices and rules, which countries could gradually adopt. In this endeavor, Maghreb countries should share best practices, including in banking reform, tax reform, and capital account liberalization.

Box 9. Financial Integration within the GCC Countries

Established in 1981, the Gulf Cooperation Council (GCC) had politically and economically united the six Persian Gulf oil-producing states of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. In addition to a general commitment to strengthen economic relations between the member states, it specifically sought to coordinate their financial, monetary, and banking policies in order to establish a monetary union. However, following the agreement little individual or collective action was taken toward these goals. Regional integration efforts have recently gained momentum. By 2003, the GCC countries developed into a customs union and all states officially pegged their currencies to the US dollar, with the aim of achieving a common market by 2007 and a monetary union by 2010.

Introducing a single currency in the GCC member states is an objective that is supported by the region's common history and language, the relative homogeneity of its political systems and traditions and the similarity of members' economic structures. Despite differences between member states, these structures remain largely dominated by the hydrocarbon sector. In their endeavor to achieve a single currency, the GCC countries can also build on a considerable degree of monetary convergence over the past decade—reflected in a high degree of exchange rate stability, generally low inflation rates, and co-moving interest rates.

In addition to progress on monetary convergence, the GCC countries aim at integrating their stock markets in the next few years. Two options are considered. The first is to merge all the stock markets into a regional bourse. The second is to connect them and set unified rules and regulations to be followed by each of the six stock exchanges, which will make it possible for the citizens of each country to trade in stocks under the same rules. This is a challenging goal in view of differences in trading systems and regulatory and supervisory frameworks.

Some key issues still need to be addressed by the GCC countries in order to lay the groundwork for a credible and sustainable monetary union.

Steadfast implementation of the integration agenda. While the agenda set by the GCC countries seems to be comprehensive and well-sequenced, its effective and smooth implementation will be key to underpinning a monetary union. Furthermore, supranational institutions must be strengthened given that the integration process requires not only the coordination of national policies, but also the pursuit of common policies.

Design of convergence criteria. Prior to monetary union, the GCC faces the challenge of designing an appropriate set of convergence criteria. While monetary convergence is well advanced, fiscal convergence is not. Therefore, fiscal criteria—based on a sound public finance framework and taking into account the specific economic structure of the region—would be crucial in fostering fiscal convergence among member states.

Increased transparency and data standardization. Quality and timely statistical data is key to a meaningful monitoring and assessment of convergence criteria and more generally to the formulation of economic policy.

Establish a regional central bank. As the monetary union requires a single monetary and exchange rate policy, the GCC countries have to establish a supranational monetary institution to formulate and conduct such a policy. While different models could be envisaged for the division of labor between the supranational and the national central banks, decision-making on monetary and exchange rate policy has to be centralized at the new institution, requiring the supranational central bank to also command sufficient analytical resources. Such a central bank has to be fully operational from day one of the monetary union.

1/ See Michael Sturm and Nikolaus Siegfried, 2005.

- **Achieving and maximizing the benefits of regional and global integration requires**: (a) consolidating macroeconomic stability and appropriately adapting the macroeconomic framework to increased cross-border capital flows; (b) minimizing risks to financial stability; (c) enhancing and harmonizing market infrastructure; (d) relaxing gradually and selectively restrictions on cross-border flows taking into account the level of preparedness of domestic financial markets; and (e) improving regional coordination. Each of these aspects is discussed in detail below.

a) Consolidating Macroeconomic Stability and Adapting the Macroeconomic Framework

74. **While Maghreb countries have generally achieved a stable macroeconomic environment, continued discipline in fiscal and monetary policies will be needed to preserve it**. Most countries in the region have achieved relatively low inflation and sustainable fiscal and external positions. Continued fiscal discipline and steadfast implementation of fiscal reform agendas are crucial for maintaining macroeconomic stability.

75. **The macroeconomic framework would also need to be adapted to deal with an increase in the level and volatility of capital flows**. Recent episodes of financial crises highlight the danger of combining fixed exchange rates with an open capital account, especially when financial systems are fragile. Therefore, more exchange rate flexibility should precede the removal of capital account restrictions, particularly those on short-term flows. This raises the issue of finding an alternative nominal anchor. Morocco and Tunisia, for example, have decided to gradually move to an inflation targeting framework. Regardless of the framework chosen, a transitional period may be needed to complete the move toward indirect monetary policy instruments and sufficiently develop money markets so as to establish an efficient monetary policy transmission channel.

76. **Financial integration increases the efficiency of monetary policy but requires greater vigilance and discipline in the conduct of macroeconomic and financial policies**. Financial integration along with financial development have an impact on the pass-through of monetary policy changes. In general, the higher the degree of financial integration, the faster the transmission process of monetary policy. At the same time, extracting signals regarding risks to price stability stemming from monetary developments becomes a more challenging task at an advanced stage of integration. As noted in the case of the capital account liberalization of European transition economies, large and volatile capital inflows could complicate the conduct of monetary policy. Therefore, carefully coordinated monetary and fiscal policies will be essential for maintaining macroeconomic stability. Furthermore, as capital market-based financing grows, so will the importance of asset prices. Although the objective of monetary authorities is not to target asset prices—their primary objective is to maintain price stability—asset price dynamics need to be closely monitored.

b) Minimizing Risks to Financial Stability

77. **A fundamental determinant of successful financial integration, be it regional or global, is a healthy financial system**. Hence, efforts at strengthening bank balance sheets—including by resolving the relatively high level of NPLs—ought to be stepped up. The integration process can take place while the financial system is being strengthened as long as the weaknesses are not of a systemic nature.

78. **While regional and global financial integration holds promise for supporting economic development in the region, it will also present increased vulnerabilities and risks, especially as institutions and individuals invest in new markets and instruments**. In particular, the authorities will face challenges in supervising cross-border banking, discouraging regulatory arbitrage, and containing the risk of regional contagion. How should such risks be managed? A strong framework for prudential regulation and supervision is necessary to ensure that risks arising from integration are being assessed and managed well while at the same time making regional financial intermediation more efficient. This will involve a move toward risk-based supervision, changes in prudential regulation and supervisory oversight to address cross-sectoral and cross-border activities, and increased harmonization of countries' oversight frameworks and financial system infrastructures (see below).

79. **Promoting financial market development is also key to financial integration**. An important factor of success is market depth, particularly in the *bond and foreign exchange markets*. A well-functioning bond market facilitates financial intermediation and risk management. An important lesson from previous regional financial integration is that financial depth and financial integration tend to reinforce each other. The existence of a relatively deep *currency swap market* also facilitates financial integration by encouraging foreign issuers to tap and foreign investors to invest in the domestic market, while it allows domestic issuers to tap the overseas market and domestic investors to hedge their overseas investments. Barring regulatory or other impediments, these markets will naturally develop as Maghreb financial systems mature. Regional integration could spur the development of these markets and prepare the region for global financial integration.

c) Harmonizing Market Infrastructure

80. **Financial infrastructure is the set of institutions that enables effective operation of financial markets.** The harmonization of the regulatory and supervisory frameworks, of the payment systems, and of financial information and financial contracts—key elements of market infrastructure—are crucial to strengthening financial stability.

Harmonizing Regulatory and Supervisory Frameworks

81. **Financial oversight frameworks need to be harmonized to maximize the benefits of a gradual opening to the rest of the region, while avoiding regulatory arbitrage**.

- Regional financial integration will bring about vulnerabilities from cross-border financial flows. In particular, the authorities will face challenges in discouraging regulatory arbitrage, supervising cross-border banking, and containing the risk of regional contagion. Increased harmonization of oversight frameworks—notably, with a view to full compliance with the Basel Core Principles for Effective Banking Supervision—would reduce these risks while making regional financial intermediation more efficient.

- Regulatory authorities in the Maghreb countries also need to work together to build the capacity to implement more risk-sensitive prudential frameworks—such as Basel II—that are more suitable for increased capital flows. In the context of regional and global financial integration, Basel II raises several issues including: (a) capacity to supervise banks on a risk basis; (b) home-host information sharing and coordination; and (c) competitive inequalities and the need to upgrade domestic banks.

Harmonizing payment systems

82. **Reforming national payment systems and eliminating remaining barriers to cross-border payments are preconditions to successful harmonization among the different payment systems in the region**. By adopting international standards and good practices, such as those developed by the BIS-based Committee on Payment and Settlement Systems (CPSS), each country in the region will count on a set of payment arrangements, services, and circuits able to serve the needs of all users in the economy. Converging toward those standards will also create the conditions for further harmonization within the region. A significant volume of cross-border payments will allow for the benefits of harmonization to outweigh its costs for both the authorities and the markets.

83. **Harmonization can be accomplished at several levels**.

- *Harmonization of private rules and procedures*, such as market conventions, self-regulations and contractual arrangements for producing, pricing, delivering, and acquiring the various payment instruments and services.

- *Harmonization of laws and regulations* set by legislators and regulators that define and govern the mechanics of the payment transfer process.

- *Harmonization of technical standards*, network arrangements for transacting and clearing payment instruments, processing and communicating payment information, and transferring funds between institutions, and payment instruments (e.g., direct debit and credit cards).

84. **The creation of a payment system forum among regional central banks could be useful in supporting discussions of common payment system issues, including steps**

toward further harmonization. The work of the forum should be guided by detailed assessments of the volumes and values of cross-border payment transactions, of the private and statutory rules covering these transactions, and of the existing technical arrangements, and should aim at preparing minimum common features and a realistic timetable for reform.

Harmonization of Financial Information and Financial Contracts

85. **The harmonization of financial information and financial contracts could facilitate financial integration and enhance efficiency**. Increased transparency and accountability through moving to a common financial reporting and accounting framework—the International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS)—and the standardization of borrower financial information and financial contracts will facilitate regional and global financial integration. Furthermore, a common accounting framework can reduce the costs for maintaining multiple accounting frameworks for companies operating in, or obtaining financing from, different jurisdictions.

d) Gradual Liberalization of the Capital Account

86. **The gradual removal of capital and exchange controls, while maintaining appropriate prudential safeguards, could increase competition and enable investors and firms to tap regional and international markets**. Cross-border capital flows in the region remain highly restricted. However, Morocco and Tunisia have made significant progress toward capital account liberalization in the past decade—Tunisia aims to fully liberalize the capital account and to float the exchange rate in the next few years, and Morocco intends to prepare a possible transition to a more flexible exchange rate (Box 10). A gradual liberalization of the capital account should go hand-in-hand with a gradual liberalization of cross-border trade in goods and services, particularly financial services.

87. **The sequencing strategy for capital account liberalization will vary from country to country, depending on starting conditions and economic objectives**. Box 10 provides a brief description of Tunisia's three-step strategy for the liberalization of the capital account. Although certain rules about sequencing capital account liberalization—for example, liberalizing long-term flows before short-term flows, and foreign direct investment before portfolio investment—have the appeal of simplicity, the fungibility of capital makes their practical application difficult. The maintenance of restrictions on certain types of capital transactions may serve primarily to buy time for the more fundamental restructuring of financial markets, the adoption of appropriate prudential standards and supervisory arrangements, and the development of the necessary indirect monetary instruments.

88. **Measures could also stimulate regional integration of domestic equity markets**. These include information and technology sharing and encouragement of crosslistings and cross-border investment. Giving a greater role to the stock exchange in carrying out privatization could open a platform for privatizing large corporations by providing a market

Box 10. Capital Account Liberalization: The Case of Tunisia and Morocco

The Tunisian authorities have developed a three-phase plan to liberalize the capital account:[20]

- The **first phase**—which is almost complete—consists of reforms aimed at liberalizing medium to long-term flows such as nonresident direct investments and long-term loans to listed firms, limited nonresident investments in local currency government securities, and other measures to enhance the overall effectiveness of financial intermediation and diversify the balance of payments financing sources.
- The **second phase** involves liberalizing direct investment by Tunisians abroad, allowing overseas portfolio investments by institutional investors, and portfolio investments by nonresidents in debt instruments. This stage includes a transition to a floating exchange rate, a deepening of the foreign exchange market, and a banking system that is sufficiently strong to withstand international competition. Progress would also be needed in the development of government securities markets to increase market liquidity.
- The **third phase** involves full currency convertibility. It entails liberalizing domestic portfolio investment abroad and loans by residents to nonresidents. Moving to this stage would require a robust financial sector and a resilient balance of payments position.

Morocco has also taken important steps to liberalize capital account transactions:

- **All restrictions on capital account transactions by non-residents have been lifted.** In particular, there are no restrictions on inward foreign direct investment. In 2005, the International Finance Corporation issued dirham-denominated bonds on the Casablanca Stock Exchange, the first domestic bond offering by a supranational in Africa and the Middle East.
- **Since 2002, banks are allowed to open accounts with foreign counterparts and to invest in securities of governments or multilateral institutions**. These operations take place within existing prudential regulations on foreign currency positions.
- Since 2007, insurance and reinsurance companies are allowed to deposit or invest abroad the equivalent of 5 percent of their total assets.

for share issues that cannot be absorbed on a strictly national basis. Furthermore, divesting at least some shares via the stock exchange could improve the efficiency and transparency of the privatization process. These mutually beneficial linkages could help to overcome the disadvantages of small size, illiquidity, and inadequate market infrastructure. This would enhance access of regional firms to equity capital by increasing the attractiveness of local markets to regional and global investors. Deeper reforms toward possibly the ultimate objective of a fully integrated regional exchange—such as the harmonization of regulations,

[20] For a more detailed discussion, see Bouhga-Hagbe, Selected Issues Paper for the 2006 Article IV Consultation.

including those governing listing, trading, settlement, accounting, and auditing, as well as taxation of capital market activities—will take more time to implement.

e) Improving Regional Coordination

89. **For the kind of economic policies described above to take root throughout the Maghreb region, a growing spirit of collaboration and regional solidarity will be needed**. Throughout Europe's voyage toward unity, it was propelled by a strong political commitment to cooperate, transcending the purely economic aspects of the union. It is very encouraging to see how the Maghreb region has stepped up lately its regional dialogue. The European experience highlights how the establishment of a network of regional institutions and fora for discussion and policy coordination gradually spun an interlocking web of collaboration and dialogue that eventually became an invaluable engine of convergence and coherence—economic, cultural, and political.

90. **With deeper cross-border linkages, enhanced information exchange with foreign supervisors, both within the region and elsewhere, is also increasingly important**. Supervisory agencies from Maghreb countries typically lack formal arrangements with foreign counterparts, although in practice, prudential information is occasionally exchanged with them, particularly in the processing of licensing applications. With increasing integration, the need for more formalized and continuous exchange of information with other supervisory agencies will become more pressing. In some cases, there is also a need to remove legal restrictions to such an information exchange, such as secrecy provisions (as in Mauritania) or the requirement for bilateral international conventions (as in Morocco). International experience shows that a regional forum for cooperation in prudential matters can be useful in promoting an exchange of views among regional supervisors on the need for and direction of reform.[21]

91. **Similarly, as integration proceeds, consolidated supervision of cross-border financial activities will become increasingly important**. Many supervisors in the region do not carry out globally consolidated supervision, even when they are legally empowered to do so, largely because domestic banks' operations with the rest of the world, as well as their offices abroad, are very limited. In some countries, the legal framework needs to be adapted to allow for consolidated supervision, by giving supervisors the authority to supervise foreign branches and subsidiaries of domestic banks as well as local branches and subsidiaries of foreign banks. In all cases, effective implementation of the existing or a new legal framework will be a challenge.

92. **The necessary cross-country coordination effort over the medium-term could be achieved by strengthening existing mechanisms**. The process of integration will require

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[21] See P. Brenner, 2006.

strong efforts and the political will to coordinate economic, institutional, and legal reforms within the region so as to ensure appropriate financial market supervision, payment systems, corporate governance standards, harmonization of taxation and accounting rules, rules governing foreign investment, and data standards and transparency. This could be achieved for instance by strengthening the secretariat of the Arab Maghreb Union and its regional cooperation mechanisms. The Wider European Neighborhood also provides a forum for harmonizing the Maghreb's institutions and legal frameworks with European standards.

D. Measures in the Near Term

93. The analysis below focuses on steps toward regional integration that are potentially highly beneficial for the region, that could be implemented in the near future, and serve as a catalyst to deeper financial integration:

- **Short-term measures are needed to address the financial barriers to intra-Maghreb trade, including through the streamlining of administrative requirements for trade-related banking operations and the reduction of the cost and availability of facilities to finance trade**. The discussions on trade facilitation among Maghreb countries highlighted important synergies between regional trade integration and regional financial integration. More specifically, it showed how overregulated cross-border financial transactions coupled with relatively inefficient payments systems increase the cost of, and impose long delays on, regional trade flows in goods and services. In this context, eliminating barriers for Maghreb banks to set up cross-border branches or subsidiaries could substantially reduce transaction costs. While the process of regional integration has already started—as evidenced by Tunisia's partial sale of *Banque du Sud* to a consortium comprising the Moroccan *Attijariwafa* Bank and the recent announcement by *Banque Internationale Arabe de Tunisie* to open branches in Algeria, Libya, and Morocco—it needs to be accelerated.

- **Proceeding with the establishment of the Maghreb Bank for Investment and Foreign Trade (BMICE)**. The BMICE could serve as a catalyst to financial integration and promote trade and investment within the region.

- **Ensuring close coordination between central banks**. As stressed earlier, increased central bank coordination will be needed to ensure macroeconomic and financial stability as financial integration deepens, to promote the development of money and foreign exchange markets, and to guide the harmonization process of domestic financial market infrastructures.

- **Reforming and harmonizing the payment systems**. The creation of a payment system forum among regional central banks could be useful in supporting discussions of common payment system issues, including steps toward further harmonization. In particular, the forum could focus in the short-term eliminating the remaining barriers to cross-border payments, increasing the efficiency of network arrangements for transacting and clearing payment instruments, processing and communicating payment information, and transferring funds between institutions. It would also be useful to create permanent institutions for consensus-building and coordination that would monitor the harmonization of payment systems or bank supervision and the implementation of Basel II recommendations.

MAIN RECOMMENDATIONS

A. **Undertake further reforms, where needed, to modernize the financial sectors in the Maghreb countries**:

1. *Ensure banking system soundness*

1.1 Reduce NPLs.
1.2 Ensure adequate loan classification and provisioning.
1.3 Comply with other internationally accepted prudential rules fully and in a timely fashion.

2. *Strengthen banking system competition*

2.1 Privatize some public banks to reputable investors where needed.
2.2 Restructure and strengthen governance in the remaining public banks.
2.3 As needed, level the playing field between public and private banks.
2.4 Gradually lift remaining restrictions to foreign bank entry in some countries.

3. *Deepen financial markets*

3.1 Strengthen regulation and supervision of the securities markets.
3.2 Deepen government bond markets and develop a benchmark yield curve.
3.3 Build a dynamic capital market investor and issuer base.
3.4 Stimulate interbank money markets by making it more expensive for banks to transact with the central bank outside of its regular market operations.
3.5 Further liberalize foreign exchange markets consistent with the pace of capital account liberalization and the development of banks' risk management capabilities.

4. *Strengthen financial oversight*

4.1 Increase the independence of supervisory agencies and clearly define the legal grounds for dismissal of their heads and board members.
4.2 Distinguish clearly the roles of the ministry of finance and of the regulatory authority.
4.3 Provide the supervisory agencies with adequate financial resources to hire, retain, and train qualified staff.
4.4 Continue upgrading prudential regulation toward international standards, including by adopting a more risk-based approach to supervision and improving the coordination between supervisory agencies.

5. *Upgrade financial sector infrastructure*

5.1 Improve bankruptcy and foreclosure proceedings by establishing commercial courts and upgrading laws on loan guarantees.
5.2 Strengthen corporate governance, including in the banking sector.
5.3 Move to international standards in financial reporting and auditing.
5.4 Set up public credit registries and facilitate the development of private credit bureaus.
5.5 Accelerate the ongoing reform of the payment systems.

B. Key steps toward regional financial integration

1. *Steps that can be taken in the near term*

1.1 Eliminate financial barriers to intra-Maghreb trade, including by allowing Maghreb banks to set up cross-border branches or subsidiaries.
1.2 Proceed with the establishment of the Maghreb Bank for Investment and Foreign Trade.
1.3 Ensure close coordination between central banks.
1.4 Continue upgrading the payment systems with a view to their harmonization.

2. *Steps to be taken over the medium-term*

2.1 Continue consolidating macroeconomic stability in each country and adapting macroeconomic frameworks to deal with an increase in the level and volatility of capital flows.
2.2 Minimize risks to financial stability, including by strengthening bank balance sheets.
2.3 Harmonize market infrastructure, including regulatory and supervisory frameworks, payment systems, and financial information and financial contracts.
2.4 Gradually liberalize the capital account.
2.5 Stimulate regional integration of domestic equity markets by sharing information and technology, encouraging crosslistings and cross-border investment, and giving a greater role to the stock exchange in carrying out privatization.
2.6 Improve regional coordination and cooperation.

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