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ABSTRACT OF AN M.A. SUBMISSION  
"FINANCIAL FLOWS WITHIN AND  
BETWEEN SELECTED ARAB STATES"  
PRESENTED BY A.M. UNDERWOOD FOR  
AN M.A. DEGREE SEPTEMBER, 1974.

As a result of oil revenues accruing to certain Arab States over the last decade, it has become apparent that all capital needs to meet development plans can be met from internal sources.

A number of inter-Arab development institutions have been established in the region since 1960. These include the Kuwait Fund For Arab Economic Development, The Arab Fund For Economic and Social Development and the Inter-Arab Investment Guarantee Corporation. The Kuwait Fund has been in operation for twelve years and has successfully disbursed funds and technical assistance to a number of poorer Arab States. The Arab Fund and the Guarantee Corporation only recently begun operations.

The commercial banking sectors of the major Arab oil states have grown rapidly over recent years. Despite this growth the banks have still to play a major role in the process of regional economic development. Advances to vital growth sectors such as industry, agriculture and communications have been small. Banks have preferred to finance trade, mostly imported consumer goods, and to invest outside the Arab area.

## II

A number of specialised financial institutions such as agricultural and industrial banks operate in the region. These institutions have as a primary function the provision of medium and long term capital for particular sectors. To date they have not made a decisive impact on economic development within the region. Activities of the specialised institutions have been too restricted by financial, practical, and political barriers.

The existence of a certain amount of capital does not itself ensure economic development. A vehicle for mobilising and distributing capital in accordance with real growth objectives must necessarily be established. Despite rapid growth of financial institutions within the Arab region, the financial superstructure remains inadequate to meet these objectives.

III

FINANCIAL FLOWS WITHIN AND BETWEEN SELECTED

ARAB STATES

ANTHONY MALCOLM UNDERWOOD B.A.

SUBMITTED AS AN M.A. THESIS

TO DURHAM UNIVERSITY

1974.

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INTRODUCTION

The Arab region is made up of a few countries which have a strong capital balance and numerous countries which have a capital shortage. Over the period 1960 to 1970 certain oil rich states namely Kuwait and Saudi Arabia have developed immense capital surpluses amounting to more than \$3.2 billion. Certain non-oil countries, however, namely Egypt, Jordan, Lebanon and Syria have had to supplement their resources by capital inflows amounting to more than \$3 million.<sup>1</sup> Moreover, projections over the next decade estimate that the surplus countries will generate more than \$70 billion in capital surpluses.<sup>2</sup> Although this projection is based on somewhat questionable assumptions concerning G.N.P. and price levels, it does serve as a general indicator highlighting the degree of capital unbalance that can be expected to develop in the region over the next ten years.

Despite the fact that an overall regional surplus exists, only part of the capital inflow to the deficit countries originates in the surplus countries. In some cases Arab capital is invested locally through foreign financial institutions and thus giving the benefits of interest differentials to those institutions rather than to Arab investors themselves.

1. United Nations Economic and Social Office in Beirut.
2. Abdlatif Y. Al-Hamad, Arab Capital and International Finance, (Kuwait Fund For Arab Economic Development Nov. 1973, P.6).

Why is it advantageous to both surplus and deficit countries to promote the flow of funds both between and within Arab States? For the non-oil states it means a sharing out of regional prosperity and subsequent improvements in living standards. In as much as regional disparities constitute an obstacle to stability and peace in the region it benefits all states to foster mutual development. For oil-rich countries the advantages of increasing regional economic and social ties are perhaps less obvious.

Growth in the oil states has to date been tied to a depleting source of wealth, crude oil. It is of benefit to the oil states to utilise this dwindling source of capital to ensure that their economies can sustain themselves when the oil runs out. Firstly, capital can be used to achieve greater factoral balance by developing the lagging factors of land, labour and management. This is slowly being achieved in Kuwait through the importing of labour and through education programmes. In fact, a ceiling on migrants now operates in that country. Moreover, to encourage industrial and agricultural expansion, markets of sufficient size must be found. Local domestic markets in the oil rich states themselves will not allow goods to be produced on an economically large enough scale. The price of Western goods would be lower at almost all possible levels of output. However, if living standards and therefore the demand for goods and services were to rise in the region as a whole, Arab markets capable of supporting industrial and agricultural expansion may be found.

Here one can see a link between the oil states lending funds for the development of non-oil states and their own future development. By encouraging development of poorer states they may capture export markets. This would allow these countries to diversify and secure a more balanced economic structure not so dependent on oil revenues.

Flows of capital between and within states may take one of a number of forms. They may be in the form of private transfers, direct private investments or official grants and loans. This study is primarily concerned with flows of capital originating from financial development institutions, commercial banks and specialised banks. Emphasis is placed on the role that financial institutions are playing, and may play in the future, in the process of economic development of the countries concerned and within the region as a whole.

Four countries of the region, namely Saudi Arabia, Libya, Kuwait and Lebanon are considered in this study. There are two main reasons for this choice of countries.

1. They are financially the most important in the Arab world.
2. The availability of data limits the choice of countries to these major ones.

Chapter I is devoted to an examination of the Kuwait Fund For Arab Economic Development. In Chapter II other inter-Arab development schemes are discussed. In Chapter III the commercial banking sectors of the above mentioned Arab states are examined. This is followed by a comparative study of these banking sectors in Chapter IV. In Chapter V some specialised institutions in the four countries are examined.

CHAPTER I

THE KUWAIT FUND FOR ARAB ECONOMIC DEVELOPMENT

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A. FUNCTIONS AND CAPITAL

The Kuwait Fund For Arab Economic Development (K.F.A.E.D.) was founded in 1961. Although technically a government agency, in the words of the Director General, Latifal Hamad, it has been granted complete independence not only in its' finances and organisational set up, but also and more importantly in forming its' policies and the conduct of its' relationship with borrowers. The question of how far is the K.F.A.E.D. really free from political considerations is discussed in sub-section C.

The objective of the Fund is to contribute to the economic development of the region through the extension of loans for infra-structural projects such as power, transport and irrigation, directly productive undertakings in industry, as well as technical assistance operations. The statutory capital of the Fund is K.D. 200 million, but for a number of reasons its' growth to this level has been frustrated. Firstly, the K.F.A.E.D. is not the only institution channelling funds out of the area. The General Authority for the South and Arabian Gulf disburses of an annual budget of K.D. 2 million. Secondly, the authorities have been directly granting around K.D. 60 million per annum to other states since the 1967 war.

On top of the capital paid in by the authorities the K.F.A.E.D. can raise funds by borrowing or issuing bonds up to the value of twice its' paid in capital, plus reserves. Since reserves are intended to be twenty per cent of capital i.e. K.D. 200 million,

This would give it a legal limit of K.D. 680 million. However, this source which may eventually enable the Fund to channel huge resources from domestic and foreign markets towards the economic development of the Arab World has remained to date relatively untapped. One interprets domestic markets to mean Arab money markets and foreign markets to mean predominantly European and American money markets. The Director General of the Fund defends this policy on the grounds that during the past decade the Fund has still been learning and consolidating. While gaining experience and establishing sound relationships with its client countries and with other international agencies, it has given priority to caution, prudence and sufficient preparation. It is also true that raising funds by the issue of bonds would not be economical. For interest paid to bond holders would, if they are to be competitive in the market, be higher than interest received on Fund loans.

Despite these limitations, the Fund has been able to grow at a reasonably regular pace. Its total assets rose from nearly K.D. 80 million in 1966 to 1967 to well over K.D. 100 million in 1971 to 1972. Table 1 shows the balance sheet of the Fund in the above two periods.

BALANCE SHEET OF K.F.A.E.D. AS OF MARCH, 1967 AND 1972.

TABLE 1

Liabilities	1967	1972	Assets	1967	1972
<u>Statutory Capital</u>			<u>Cash in Hand and in Banks</u>		
K.D. 200,000,000	200,000,000	200,000,000	144,116	2,792,399	
<u>Paid in Capital</u>			<u>Bank Deposits &amp; Securities</u>		
K.D. 68,000,000	78,250,000	78,250,000	46,779,484	45,060,960	
<u>General Reserve</u>			<u>Loans</u>		
K.D. 11,194,003	29,168,695	29,168,695	56,550,000	94,068,523	
K.D. 79,194,003	107,418,695	107,418,695	<u>Capital Paid in to A.F.E.S.D.</u>		
			-	6,000,000	
			<u>Accrued Interest</u>		
			2,324,102	1,617,287	
			<u>Sundry Debtors</u>		
			12,327	13,106	
			105,810,029	149,552,275	
			'Less'		
			<u>Loans Undisbursed</u>		
			25,805,739	27,572,156	
			<u>Loans Repayments</u>		
			744,800	14,301,215	
			<u>Sundry Credit Balances</u>		
			65,487	260,209	
			K.D. 26,616,026	42,133,580	
			K.D. 79,194,003	107,418,695	

SOURCE: Annual report of The Kuwait Fund For Arab Economic Development, 1967 and 1972.

LIABILITIES

Over the period March, 1967 to 1972 authorised capital remained at K.D. 200 million while paid in capital rose from K.D. 68 million to K.D. 78.2 million. The first K.D. 100 million is to be provided out of government savings i.e. reserves, while the additional hundred will be covered by means of annual budgetary appropriations. This modest rate of increase in paid up capital is largely explained by political factors; these are discussed in sub-section C.

General reserves consist of funds transferred from yearly operating income of the Fund i.e. interest from investments and loans minus expenditures. Reserves are classified as liabilities, because by-statute reserves must be twenty per cent of authorised capital. Furthermore as the Fund is a state owned institution, and profits of the Fund should accrue to the Government, reserves as defined above represent Government deposits and thus liabilities. General reserves over the period rose from K.D. 11 million to K.D. 29 million. Although the Fund can make loans from its reserves it has to date kept its actual disbursements below the level of paid in capital. In 1967 disbursements were less than 50 per cent of paid in capital, by 1972 they reached 90 per cent of paid in capital. The Fund has not yet made use of its power to borrow, or issue bonds.

ASSETS

The Funds' financial operations include loan disbursements and investment of unutilised funds.

The Funds' liquid assets consist in the first instance of cash on hand and on the banks, and secondly bank deposits and securities. Information concerning the nature and location of the Funds' investment portfolio is not readily available. However, it is known that the Fund holdings are spread over a number of currencies, countries and institutions. These funds, in seeking low risk and high returns, are most likely to be found outside the Arab region. Over the period the total value of assets held in the above form have not altered significantly. High income earnings of the Fund over the years, as shown by the increase in reserve holdings, suggests that changes in the portfolio mix may have taken place i.e. a greater proportion of foreign assets are held in securities than in deposits and longer maturity holdings.

Total loan commitments have risen from K.D. 56.5 million in 1967 to K.D. 94 million in 1972. In 1967, 55 per cent of total loan commitments had been disbursed, by 1972 this figure had risen to 71 per cent. It is in this category of assets that the Fund has registered its greatest increase in activity - as would be expected of an institution primarily concerned with making development loans. Loan repayments reached K.D. 744,800 in 1967; by March 1972 total loan repayments had reached K.D. 14 million. This not only reflects an increase in loan activity but the end of grace periods on earlier loans.

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Capital participating in A.F.E.S.D. refers to capital paid to the Arab Fund For Economic and Social Development of which Kuwait is a member.<sup>1</sup>

It is significant that the Fund receives approximately 60 per cent of its income from its investments and only 36 to 50 per cent of its income from loans. This does indicate that interest rates on loans are of a very low and non commercial nature. In real terms losses are likely to be incurred at such low rates.

1. See Chapter II, P. 32 to 38.

B. LENDING POLICY AND TERMS OF LOANS

The Director General of the Fund has outlined the lending policy of the K.F.A.E.D. under four principles.

1. The principle of political and social neutrality.  
This shall be discussed in the next sub-section.
2. The Fund does not seek to effect the priority of projects, but does, however, require projects to be intrinsically sound, and show significant impact on the economic development of the recipient country. One interprets intrinsically sound to mean that the project was capable of paying off the loan and becoming self supporting. The Fund does anticipate that the projects it supports will be profit making. However, most of the projects it supports are of a nature which makes calculations of earning capacity over a period of time difficult i.e. transport, agriculture, power.
3. To show flexibility in its' lending policy. That is the Fund will make loans to Governments, public entities and on some occasions to semi-private enterprises. In practice, however, there are a number of reasons why its' loans have mostly been for projects in the public sector. Firstly, the majority of Arab States now have at least partly socialised economies, especially in the field in industry and utilities, thus the main impetus for development comes from governments. Secondly, the kind

of infrastructure projects - in transport, electric power and irrigation - that the Fund has so far mainly financed, are by their nature nearly all under public ownership control.

4. The Fund will act as a development bank in its approach to loans. The Fund will ensure that not only the financial soundness of a project is assured, but that the project has a direct development impact as measured by contribution to national income, the improvement of the foreign exchange situation, on the increase in employment, and other factors of similar significance. In practice it is the recipient countries which have determined which of the above criteria actually carries more weight; for most of the K.F.A.E.D. loans have fitted into the recipients national development plan. Loans have mostly been for capital intensive schemes and so the direct employment impact is evidently given less weighting than the direct impact on foreign exchange earnings or the impact on national income. One can identify two loans made by the Fund in which the impact on employment was the most important consideration. The first was for an irrigation project in Central Morocco where the increase of jobs in a depressed area was a stronger argument in favour of aid than any other. Secondly, the effect on employment rates was considered of prime importance when a loan was given for an irrigation project in Sudan.

The scheme was aimed at re-settling 50,000 people who were displaced from the Egyptian border by the building of the Aswan High Dam.

The direct impact on G.D.P. was given strong weighting in many of the loans granted by the Fund. For example in Tunisia and Sudan, where a high proportion of people are engaged in agriculture, loans for agricultural schemes were expected to have a strong impact on income levels.

The direct impact of loans on the foreign exchange position of countries was also given strong weighting. This was certainly the case when the Fund granted a loan to Egypt for the Suez Canal project and a loan to Jordan for a tourist project.

It is of course somewhat artificial to isolate the impact of projects on employment, G.D.P. and foreign exchange levels. In fact, a project will directly and indirectly effect all three to varying degrees. Two targets may even be incompatible e.g. capital intensive projects and lowering unemployment rates.

It is a characteristic of the Fund that its loans are all for specific projects and not for general aid to development programmes, for filling gaps in budgets, or for balance of payments deficits. The Director General of the Fund believes that planning and evolution of future needs in the Arab economies is still too vague and embryonic for 'programme aid' to be fully effective.<sup>1</sup>

1. Abdlatif, Y.A., Bilateral Development Aid, The View of the Fund (Kuwait Fund For Arab Economic Development, November, 1971).

However, it is perhaps true that by the financing of large visual projects, the Fund and the state acquire a certain amount of prestige.

Loans are normally given to meet foreign exchange costs of projects, but in certain cases local currency costs are also covered in part. The Funds loans are always made for productive rather than social welfare projects such as education, health and housing. This more direct and orthodox approach to aid is a result of the Funds' belief that it is eventually on productive projects that a higher level of social welfare expenditure will depend. Moreover, the Fund is aware that other agencies are active in the social welfare field including the Kuwait Governments' aid agency for the Gulf and South Arabia.

The terms of loans made by the Fund are determined in the light of each individual project and the overall economic situation of the country concerned. Interest rates normally follow a simple pattern, 3 per cent for agricultural loans and 4 per cent for other infra-structural or industrial projects. These above mentioned rates, of course, represent very low non-commercial rates.

As there is little gain for the Fund on economic grounds at such low rates, it is perhaps evident that the Fund is consciously aware of the advantages to Kuwait of fostering mutual development in the region.<sup>1</sup>

1. See introduction, P.1 to 2

The weighted average maturity of loans has been to date about 23 years in agriculture, 15 years in transport, 15 in power, and 13 years in industry, the overall average being 17 years. Grace periods for payments have varied from four and a half years in agriculture to two and a half years in industry. Al Hamad, The Director General, estimates that the "aid component" measured as the grant element in Fund loans due to reduced interest rates, varies from 25 per cent to 88 per cent. It averages 50 per cent for loans for agriculture, 35 per cent for transport and 30 per cent for industrial and power projects.<sup>1</sup>

There are certain statutory limits on the amounts the Fund can lend. The Fund cannot lend more than 10 per cent of its' authorised capital for any one project. This means K.D. 20 million for any one project at this present time.

The Funds' standard loan agreement calls for certain assurances and guarantees from the receiving country. The borrower has to provide necessary information, allow inspection of the project by the Fund staff, and guarantee the Funds' assets and income from nationalisation. There is a clause concerning the efficient administration of the project. The borrower promises that the project management shall have powers necessary for the dilligent and efficient carrying out and operation of the project and undertakes to consult with the Fund on any management charges. Another clause in Fund loan agreements provides that no other external debt shall

1. Robert Stephens, The Arabs' New Frontier, (Temple Smith September, 1973, P.62).

have priority over a Fund loan. This is an important stipulation given that many of the recipient countries such as Egypt and Syria are likely to already be heavily in debt. Problems, however, may arise out of this stipulation where other institutions with similar safeguards are operating in the same countries or where the Fund plans to jointly finance a project.

The Fund, in its' activities, has been aware of the necessity to provide not only financial assistance to the Arab World but also technical assistance. The Fund appreciates that in order to encourage a more optimal use of capital and to raise absorptive capacity of the Arab States, one must foster the use of greater expertise and also the development of expertise at a local level. Assistance may range between merely helping in the preparation of a project and on the other extreme supporting some connected activity on which the degree of success of the enterprise depends. The staff of the Fund, within their capabilities, are available for consultation. A number of pre-investment studies have also received financial assistance from the Fund. The K.F.A.E.D. is also in the process of setting up advance research and training schemes. The K.F.A.E.D. plans to set up a Law and Development Centre to train Arab Lawyers in the rudiments of international law and an Arab Economic Integration Research Institute to co-ordinate Arab economic policies.

C. POLITICAL STATUS

The Kuwait Fund, as mentioned in the first sub-section, has been granted a great deal of political independence. However, for several reasons the Fund could not be regarded as a completely independent body. Firstly, the Minister of Finance is the Chairman of its' governing board. Secondly, the government provides all its' capital. One example of a political factor in operation came to the forefront following the 1967 war. After the 1967 war, the Kuwait government gave direct aid to those countries involved, and as a result the Funds' allocations of capital have stayed below what they might otherwise have been.

In its' lending policy, however, the Fund has succeeded in avoiding two main kinds of political pressure.

1. The allocations or reduction of aid according to political priorities or ideological preferences.
2. Tied aid, the linking of aid to the supply of goods from the donor country.

This degree of autonomy has been gained by a number of test cases. The first was in 1963 when the Kuwait government was in a hurry to lend money to the newly independent Algeria. The Fund, however, was reluctant to commit funds on any grounds other than social or economic. The conflict resulted in a compromise whereby £10 million loan was agreed in principle but the exact projects to be financed were to be decided over time by the Fund.

More recently, after the civil war in Jordan in 1970 to 1971 in which King Hussein's army crushed the Palestinian guerilla forces, the Kuwait government suspended the subsidy it had been paying to Jordan since the 1967 Khartoum agreement. The Kuwait Fund, despite this, continued its' operations in Jordan and was helping the Jordan government to work out a new project which might be financed jointly by the Fund and the World Bank.

Furthermore many of the Arab States have republican regimes and at least partly socialist economies, ideologically different from those of Kuwait; this has not barred them from Fund aid. For example the Fund has granted loans for projects in Syria and Iraq, where the Baathist regimes were for a long time critical of the rulers of the Arabian oil states. The Fund was also approached by the revolutionary socialist regime of the South Yemen for help when it was in desperate financial straits after achieving independence. An agreement was signed with South Yemen on the very day that the Kuwait regime was being denounced as being one of the "imperialist stooges" in demonstrations in the streets of Aden.

Here the Fund could perhaps be accused of buying friends. However, given the small amount of funds that flow through the K.F.A.E.D. as compared to official political loans, this seems unlikely. Furthermore the reputation that the Fund has developed internationally as an independent body, gives a certain amount of prestige to Kuwait and the politicians themselves.

Thus while the capital made available to the Fund is subject to political winds, it seems that in the disbursement of paid in capital the Fund does receive a level of autonomy, which would compare favourably with other multi-national aid agencies such as the World Bank.

D. THE KUWAIT FUND AND ITS' ACTUAL ACTIVITIES

The political nature of the K.F.A.E.D. has allowed it to give loans to a wide range of countries. Table 2 shows the distribution of loans by country up to March, 1972.

TABLE 2

Country	Amount (K.D. Millions)	Number of Projects
Algeria	10.0	2
Bahrain	2.0	3
Egypt	13.3	2
Iraq	6.8	2
Jordan	10.2	7
Lebanon	2.8	2
Morocco	10.9	3
North Yemen	1.0	2
South Yemen	0.3	1
Sudan	14.9	4
Syria	7.0	1
Tunisia	14.5	5

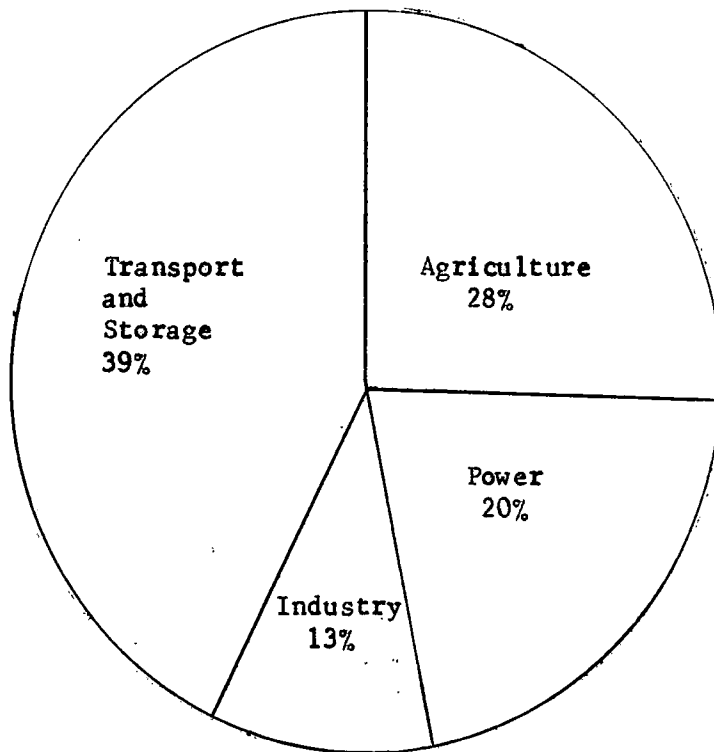
SOURCE: Annual Report of Kuwait Fund For Arab Economic Development, 1972.

Looking at the distribution of loans by country, it is noticeable that Sudan, Tunisia, and Egypt have received considerable higher sums than other countries. Sudan itself received over the period K.D. 14.9 million while South Yemen received a comparatively small amount of aid K.D. 0.3 million. In general these large differences, other than any political factors, arise because some states have a higher absorptive capacity for capital than others. The Fund does not believe in penalising those countries which are better able to absorb available funds. More specifically, countries like Tunisia, Egypt and Sudan have particular characteristics which have enabled them to secure a high proportion of K.F.A.E.D. aid. All three countries have a strong administrative background which in the case of Tunisia dates back to French influence and in the case of Sudan and Egypt dates back to the period of U.K. involvement. This is a big advantage in preparing and presenting proposals to the Fund and in ensuring proper use of loans. The Director General has identified the low standard of loan applications as a serious problem to the Funds' operation.

The Sudan, moreover, has extensive land and water resources in its' Northern region which have naturally attracted capital. Infrastructural loans were also needed to link together the countries widely dispersed regions with the ports and main towns. Egypt, while not so well endowed with natural resources, has to some extent been able to attract foreign aid as a result of its' political status in the area.

Given Bahrain is an oil producing state, it is perhaps difficult to understand why it has been granted aid. This can be explained by a number of factors. Firstly, Bahrain's oil production and revenues have never been on the spectacular scale of those of the other Arabian oil producers. Secondly, Bahrain was the first beneficiary of the Gulf oil boom, and the first to realise the need for diversification i.e. the move away from the dependency on oil. It has undertaken major industrial ventures which have required the importation of foreign capital e.g. £62 million aluminium smelting plant.

Below is a diagram showing K.F.A.E.D. loans distributed by sector up until March, 1973.



SOURCE: Annual report of Kuwait Fund For Arab Economic Development, 1972.

From the sector chart above one can see the concentration of aid that has gone for infrastructural development. Aid has been, in this section, mostly for power, transport and storage, which together account for nearly 60 per cent of total K.F.A.E.D. commitments. The emphasis is caused by a number of factors. Firstly, public utility requirements of capital are substantial and have to be obtained at relatively low cost and easy terms. Also, power and transport are recurrent bottlenecks in most Arab economies. Among Arab states which lack major oil and natural gas resources, expanding hydro-electric power becomes a prerequisite for industrialisation and development.

Agriculture has taken up about 28 per cent of K.F.A.E.D. loans as shown above. This proportion shows the appreciation the Fund has of the importance of this sector in developing countries. Agricultural development is important in areas of over population and shortage of foods. In some areas, Sudan for example, regions are ripe for agricultural development, but a shortage of capital exists. Also the agricultural sector in most of these states accounts for a high percentage of the working population and for a high proportion of exports and foreign exchange savings.

The funds going to industry, 13 per cent of the total, are small in quantity and perhaps inadequate. However, the Fund deals mostly in loans and not in equity capital. Furthermore the Fund has tended to leave the financing of smaller industrial projects to other sources.

By a closer examination of the Funds' activities over the last two years one may gain some idea of the types of loans, the conditions of loans, and the amount of technical assistance all advanced during these years. Tables 3 and 4 show new loans advanced by the Fund over the periods 1971 to 1972 and 1972 to 1973.

Nine project loans were made in 1971 to 1972 totalling K.D. 18.5 million. The largest loan commitment was to Syria K.D. 7 million, for a grain silos project. The smallest commitment K.D. 135,000, went to North Yemen on irrigation projects. Interest rates followed a pattern of 4 per cent for industrial projects, 3 per cent for agricultural loans and a minimal 0.5 per cent for pre-investment studies. The period of payment and grace was generally higher in agriculture than in industrial and extraction industries. This reflects the importance the Fund attaches to the development of the agricultural sector. Low interest rates for non industrial sectors are perhaps necessary as the returns on projects may be hard to measure and accrue indirectly over a long period of time e.g. irrigation projects. By March, 1973 total loans committed by the Fund reached K.D. 94.3 million.

NEW LOANS 1971 to 1972.

TABLE 3

Country	Project	(K.D.I.,000) Amount	Date	Period and Grace (Years)	Interest %
Jordan	Zarga River Project	4,600	14.3.72.	25.5 - 4.5	3
	Phosphate Mines Development Project	230	14.3.72.	2.5 - 5.5	4
Sudan	Mechanised Dry Farming	1,600	14.3.72.	24.2 - 4.2	3
Iraq	Cement Production	3,800	4.8.71.	13.1 - 2.1	4
Morocco	Sugar Factory	860	2.2.72.	9.7 - 1.7	4
South Yemen	Agriculture Survey and Wadi A Byan Development Project	330	17.4.71.	49.1 - 9.1	0.5
North Yemen	Project 2 Wadi Zabid Project	115	2.1.72.	44.5 - 5.5	0.5
	Wadi Mawr	20	14.3.72.	44.3 - 5.3	0.5
Syria	Grain Silos Project	7,000	13.9.71.	15.5 - 3.5	3.5

SOURCE: Annual report of Kuwait Fund For Arab Economic Development, 1972.

NEW LOANS 1972 to 1973.

TABLE 4

Country	Projects	(K.D.1,000) Amount	Date	Period and Grace (Years)	Interest %
Bahrain	Power and Water Plant	7,350	24.7.72.	18 - 4	4
North Yemen	Salif Salt Mines (2)	1,200	14.8.72.	28 - 4	2
North Yemen	Highway Project	284	14.8.72.	49 -10	0.5

SOURCE: Annual report Kuwait Fund For Arab Economic Development, 1973.

Three project loans were made in 1972 to 1973 totalling K.D. 8.8 million. The most significant loan was that of K.D. 7 million to Bahrain for a power and water plant. As is immediately noticable, the Funds' activities during 1972 to 1973 were less than half that of the previous year. This does not, however, mean the Fund is being abandoned. Its' activities in 1973 to 1974 have already exceeded the previous years level. During 1972 to 1973 the Kuwait assembly were increasingly aware of the depletion of oil reserves and so were adding more to oil or financial reserves and giving less to development over this period. Also during this period the quality of loan submissions was low and subsequently the numbers of new loans was low. By March, 1973 total loan committments by the Fund had reached K.D. 102.9 million.

From the above data one can see that loans for pre-investment studies and surveys form only a small fraction of loans that the Fund distributes. Over the period 1971 to 1973 less than K.D. 1 million was loaned out for pre-investment purposes. In view of the criticism the Fund has made about the standard of loan applications, it would seem that more aid could usefully be channelled for such purposes as pre-investment studies and surveys.

Recognising the shortage of technical 'know-how' in developing areas, the Fund has made several grants for pre-investment studies. This marks an attempt by the Fund to ensure a more optimal allocation of capital and to take a more activist part in its' approach to loans. Tables 5 and 6 show the distribution of technical aid grants in 1971 to 1972 and 1972 to 1973. The grants are mostly for pre-investment studies.

The total amount given in grants during the period March, 1971 to March, 1973 was K.D. 761,000; K.D. 411,000 was given in 1971 to 1972 and K.D. 350,000 in 1972 to 1973. Several points emerge from the above data. Firstly, in the light of poor loan submissions referred to by the Director General, total technical grants are small. Secondly, only a few countries have received technical grants. Over the two years Sudan, South and North Yemens acquired virtually all the grant allocations. It should be noted, however, that the technical assistance component is likely to be underestimated across the board as technical aid is incorporated as part of many loans.

TECHNICAL ASSISTANCE GRANTS 1971 to 1972.

TABLE 5

Recipient	Purpose	Amount (K.D.1,000)
Sudan	Technological - Economic Studies for a Sugar Plant Project	100
	Technological - Economic Studies Livestock Development	50
South Yemen	Fish Meal and Fish Oil Pre- investment Study	50
North Yemen	Salif Rock Salt Geological Survey	85
	Resident Technical Assistance Mission	71.4
	Technical Economic Study Textile Industry	25
Ideas	Technical - Economic Study - Arab Petro- chemical Corporation	30

SOURCE: Annual report of Kuwait Fund For Arab Economic  
Development, 1972.

TECHNICAL ASSISTANCE GRANTS 1972 to 1973.

TABLE 6

Recipient	Purpose	Amount (K.D. 1,000)
Sudan	Transport Study	250
South Yemen	Fish Meal and Oil Plant	50
North Yemen	Tihama Agriculture Project	50

SOURCE: Annual report of Kuwait Fund For Arab Economic Development, 1973.

Technical experts, financed by the Fund, normally come from outside Kuwait. For example, a Hungarian firm carried out the survey of the Wadi Zabid project in the Yemen, a Swedish firm was brought in to carry out a pre-investment survey in Bahrain. However, experts from the Arab states have also been hired. Two studies in the Yemen were to be carried out by an Arab firm of consulting engineers. As the Fund has only recently been active in granting assistance for pre-investment studies and surveys it is too early to see if these studies are followed by project implementation.

Besides pre-investment studies, the Fund has been aware of the necessity of encouraging the supply of skill and management capable of completing and servicing projects. In this context the repatriation and training of local talent is extremely important.

CHAPTER II

THE K.F.A.E.D. AND OTHER INTER-ARAB  
DEVELOPMENT SCHEMES

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A. THE ARAB FUND FOR ECONOMIC AND SOCIAL DEVELOPMENT  
(A.F.E.S.D.)

The A.F.E.S.D. was approved by the Arab Economic Council in 1968 and started its' operations in 1972. It is expected that the Fund will act as co-operation bank for the Arab region. In its' lending policy the Fund will favour the financing of joint Arab economic projects. <sup>1</sup>

The A.F.E.S.D. shall contribute to financing projects for economic and social development in the Arab states by:

1. Financing, for investment, easy term loans to government, private, and public institutions and bodies, giving priority to projects vital to Arab entities and joint Arab countries.
2. Encourage, by direct and indirect means, investment of private and public funds so as to foster growth and development of the Arab World.
3. Providing technical expertise and assistance in the various aspects of economic development.

In its' present form, the A.F.E.S.D. was drafted by the Kuwait Fund and put forward by the Kuwait Government during the Khartoum Arab Summit meeting in September, 1967.

Participation is extended to members of the League of Arab States plus any other Arab state that has subscribed to the capital

1. Arab Fund For Economic and Social Development, Agreement Establishing The Arab Fund For Economic and Social Development, (1968).

of the Fund before July 1st, 1968. Admission can take place after this date if approved by the board. The Fund has authorised capital of K.D. 100 million which is completely convertible. Subscription is according to the wealth of each country. The Board of Governors may approve any increase in capital paid in by a member or any change in authorised capital.

Similar to the Kuwait Fund, the A.F.E.S.D. can obtain added resources by issuing bonds or obtaining credit from private and public institutions, individuals, and international institutions. Unless otherwise approved by the board, the Fund can not raise funds greater than twice its' capital plus reserves ( $2(K+R)$ ).

The main organ of the Fund is the Board of Governors with two representatives from each member country. There is also a Board of Directors which is elected by the Governors and consists of four persons. This body is responsible for directing the general operations of the Fund and exercises all the powers delegated to it by the Governors. There is also a loans committee whose function will be to study project and loan applications.

It should be realised that the A.F.E.S.D. is not simply an extension of the Kuwait Fund. Although it is, in being, a development bank for the Arab countries, necessarily similar in many ways.

It is anticipated that the A.F.E.S.D. will operate in a number of ways dissimilar from the K.F.A.E.D.<sup>1</sup>

1. United Nations Economic and Social Office in Beirut, The Arab Fund for Economic and Social Development, (ESOB/pp-Conf. 1/72).

1. The Arab Fund by virtue of its' multi-national nature will embody a regional ethos in its' formulation of policies. It is hoped that the A.F.E.S.D. will favour regional schemes involving more than one country in a project. The Kuwait Fund has primarily been concerned with bilateral agreements.
  
2. It is anticipated the new Fund will give aid for social development such as health, education and housing, as well as to directly productive economic projects. The Kuwait Fund has concentrated on the latter.<sup>1</sup> The Arab Fund will be supporting a high proportion of projects whose returns are low and require loans at very low non-commercial rates. This could represent a considerable extension to the type of non-commercial financing activity that the Kuwait Fund is already involved in, in the region.

Given the Arab Funds broad aims, it is suggested that its' specific objectives may be as follows.<sup>2</sup>

1. Supplement and not supplant financial resources available to member countries.
  
2. Increase each member countrys' capacity to make efficient use of local and external capital.

1. See Chapter I, P. 14  
2. United Nations Economic and Social Office in Beirut, The Arab Fund for Economic and Social Development, (ESOB/pp.-Conf.1/72).

3. Promote regional economic co-operation and integration and help to reduce disparities in levels of living.
4. Assist members to effect the type of economic, social, and technological transformation which would enable them to control their own resources, and to achieve the degree of economic independence and power warranted by the magnitude and nature of these resources.

Alternative policy approaches that could be used by the Fund to achieve its objectives differ according to the degree of activism which the Fund is prepared to exercise. A passive approach of simply selecting from among loan applications by member countries may be criticised on several grounds.

1. Initiation of projects by member countries is mostly guided by local and particularist considerations and rarely takes into account multi-national interests.
2. Application for external loans by member countries is often a substitute for a more effective effort at domestic resource mobilisation.
3. Economic planning and programming in most member countries is still in its' infancy, and so project initiation is not likely to lead to optimal solutions.
4. The project identification process in most member countries is constrained by low levels of development of the public administration, and/or private entrepreneurship, leading again to poor project selection.

It can be argued then that the Arab Fund, in order to reach or go part of the way in reaching its' objectives, should adopt an active approach. Here it would take initiative in conducting the necessary research and pre-investment studies to conceive projects of direct impact on the achievements of its' targets, and to promote the finances and entrepreneurship, public or private, required for their implementation.

However, for a number of reasons the Arab Fund may not be able, or feel it desirable to pursue a highly active approach. Firstly, the Funds' activities will ultimately be constrained by the statutes it operates under and the capital it is supplied with. A conservative interpretation of the clauses of the agreement may preclude some of the activities of the Fund. Secondly, a more active approach requires a more complex organisation to administer it. Given the shortage of skilled management in the region this may not be possible. Thirdly, an active approach may be thought undesirable as intervention by the Fund in the regions development, necessarily gives less control to individual governments over their own future. This may be a potential source of conflict. It is perhaps worth noting that the K.F.A.E.D. has adopted a role less active in nature than is being advocated for the new Arab Fund.

#### THE A.F.E.S.D. AND ITS' FIRST YEAR IN OPERATION

The year 1973 witnessed the beginning of lending operations by the Fund. During the year three projects were submitted to the Board for financing and in February, 1974 they were approved. The

loans totalling K.D. 7.2 million, relate to projects in three member countries.

1. Tunisia received a loan of K.D. 2 million for the construction of an electrical generating plant South of Tunisia. Included in the loan is the cost of preparation of design and the supervision of construction.
2. The People's Democratic Republic of Yemen received a loan of K.D. 3.2 million for a multi-purpose project at Mokalla. The project includes the construction of a fish meal and fish oil processing line, a modern fishing fleet, a harbour at Khalf and the expansion of the electric power station at Mokalla. Part of the loan is for study and training missions abroad.
3. Syria received a loan of K.D. 2 million for the construction of underground reservoirs for oil projects.

Based on only one year of operation, it would be presumptuous to come to any firm conclusions about the nature of the Funds' activities. However, a number of significant points emerge after only such a short period of time. The Arab Fund has seemingly adopted a number of the characteristics associated with the lending policy of the K.F.A.E.D.<sup>1</sup>

1. See Chapter I P. 12 to 14 and P. 33 to 34.

1. It has granted loans for national and not joint Arab projects.
2. It has granted loans for directly productive projects and not social projects.

There are indications, however, that the Arab Fund will in the future move onto a more activist approach and satisfy some of its' objectives.<sup>1</sup>

1. The Fund has already financed a multi-purpose project.
2. The Fund has been keenly active in providing technical assistance in both preparing and servicing projects.
3. The Fund is at the moment considering three joint Arab projects which are:

Pan Arab Shipping Company

Navigation Aid Inspection Unit

Highway link between the Y.A.R. and the P.D.R.Y.

1. See P. 34 to 35.

B. THE INTER-ARAB INVESTMENT GUARANTEE CORPORATION  
(I.A.I.G.C.)

Estimates suggest that there exists, in the sphere of private funds, a potential for mobilising local capital in amounts far greater than anything yet offered in the way of official aid. For example during 1965 to 1970 Kuwait alone saved an average of 50 per cent of her G.N.P. Of this, some 40 per cent was invested or spent outside Kuwait, 13 per cent of which went to various Arab countries in the form of official aid. The remaining 27 per cent went outside Kuwait in private and government investments. This outflow was estimated at K.D. 80 million in 1969 to 1970 and K.D. 60 million 1970 to 1971.<sup>1</sup> With the recent rise in the price of oil one would expect savings and foreign investment to expand in the future.

Part of these private investments from Kuwait as well as from other oil countries in the Gulf have gone to other Arab countries. Exact figures of private capital flows between the Arab countries are not readily available, but it is generally believed that such flows are usually directed towards property development in the tourist areas such as Jordan and the Lebanon and towards bank deposits in financial centres such as Beirut. Private loans and direct investments are thought to account for little of the total flows between the Arab countries.

1. Stephens, R., The Arabs' New Frontier, (Temple Smith, 1973, P.70).

The total might, however, have been far greater, but for the political risks faced by investors in some of the countries - risks of nationalisation or expropriation or of stringent exchange control blocking the recovery of profits. If Arab private investors are to put more of their money into Arab countries, they will need assurances against such risks as mentioned above.

With this in mind the Kuwait Fund submitted the I.A.I.G.C. scheme to the conference of Arab Industrial Development in 1966. It has now been signed by fourteen of the Arab League states and ratified by eleven.

The basic idea behind the scheme is to create a kind of joint arrangement in which Arab countries, whether capital exporting or capital importing, would participate on equal status. The corporation was to recognise that from the viewpoint of overall development in the area, the scheme should seek to protect investments other than just those flowing from rich to poor countries. Flows of capital may move from rich countries to poorer states or in some cases from poor to rich countries. Normally one would not think it desirable to encourage flows of capital out of a poorer country, but in some instances this need not be the case e.g. if no opportunity exists for investment in a region where pockets of surplus capital exist.

Although the basic idea was to accept and reject applications according to the merits of each case, the corporation gives priority to three categories of investment.

1. Those which promote Arab economic co-operation,
2. Those which build up the productive capacity of the host countries.
3. Those for which the writing of an insurance is an essential incentive factor i.e. otherwise no investment would take place.

Membership is extended to all Arab governments or any public organisation within a country on behalf of that country. The idea behind this alternative is to shelter the corporation from undue political pressures. However, it seems doubtful whether this option is going to be taken, or even if it was, that the corporation would necessarily be of an apolitical nature.

The capital of the Corporation paid in by the members, is to K.D. 10 million - a sum smaller than was originally envisaged. The agreement provides for the capital of the Corporation to be open-ended, that is allowing for an increase in capital supplied by a member and by accession of new members. Originally, paid in capital by each member was to be encouraged by the provision that each member could have amounts insured in respect of investments not exceeding twice the share of its' capital. This provision has since been dropped as a result the activities of the corporation may be somewhat less than could otherwise have been expected. The adoption of the provision, however, may have unfairly benefited these states with large capital surpluses i.e. most capable of paying in capital to the corporation.

There is an extensive list of categories eligible under the scheme. Four main types can be listed.

1. Direct investment - ownership of firms and branches.
2. Portfolio investment - stocks and bonds.
3. Loans of greater than three years maturity.
4. In exceptional cases shorter loans are also eligible.

Initiators of the scheme were reluctant to include short term loans, for the scheme was meant to consider only long term investments. It was not in any way intended that guarantees should be offered for short term monetary flows.

No distinction is made in the agreement as to who is lending and who is borrowing. Private, mixed, or public property is eligible providing the public operate on a commercial basis. This provision, however, evokes two criticisms. Firstly, the Corporation was primarily intended to protect private investment flows, but now flows from government or public entities can seek protection for investments. This in itself is not necessarily undesirable, but the founding principle behind the scheme may be undermined if guarantees to public flows are given at the expense of private flows. Secondly, the qualification that public or mixed enterprise investments are eligible if they operate in a commercial way may be unsatisfactory on social grounds. For example, is it better to guarantee an investment loan for a commercial concern, than to guarantee an investment for a necessary public utility?

One can see that by stepping outside the original boundaries of the scheme additional ambiguities and problems arise.

As the scheme is for the Arab countries, rules about nationality have been formulated. For a single investor he must be a citizen of one of the member countries. In the case of a corporate entity, it must be substantially owned by citizens of the contracting parties or by one of those parties.

Broadly speaking the Corporation guarantees against three types of non-commercial risks.

1. Political risks, these refer to action by the host country which deprives the investor of substantial rights over his investments such as expropriation and nationalisation.
2. Transfer risks, these refer to risk of non-convertibility and non-transferability of income, interest, or principle out of the host country.
3. The Corporation may guarantee losses due to acts of war, riots and revolutions.

Given the Corporations limited resources, only a small percentage of possible investment flows between the Arab states could be guaranteed against the above. It is here that the adoption of an Arab investment code becomes an important complementary factor.<sup>1</sup>

1. See P. 46.

The institutional structure of the Corporation is fairly simple in nature. The Council is the governing body and includes a representative from each member. The management of the Corporation is vested in one person the Director General who is responsible for the conduct of operations within the limits drawn by the Councils decision. There is also a supervisory committee made up of these members, one from industry, and the other two from the Council. Its' function is to check and advise the other two organs.

The Corporation is limited in its' operations in several ways. Firstly, its' total written guarantees shall not be greater than five times its' capital plus reserves ( $5(K+R)$ ). Secondly, no one guarantee shall exceed 10 per cent of capital projects, so as to avoid over exposure in any one country. Also compensation paid on a policy should not exceed losses or the value covered in the guarantee, which ever is the less.

The I.A.I.G.C. has only recently begun its' operations and so to evaluate its' activities at this date would be premature if not impossible. The Corporation will first be tested when some country defaults on repayment of a guaranteed investment. One can say, however, that if the Corporation is successful in its' objectives, local capital will be made more readily for local investments. In a regional context this is important in as much as closer political and economic ties may emerge. The success of the Corporation in mobilising private capital will of course depend

ultimately on returns obtainable. Capital may not be forthcoming unless returns are sufficiently high, even with guarantees as outlined above. There may be other markets offering similar guarantees and at the same time offering higher rates of return.

C. TOWARDS AN INTER-ARAB INVESTMENT CODE

Complementary to the I.A.I.G.C. the Kuwait Fund has supported a move towards the adoption of a common Arab investment code. A preliminary draft of the Code worked out by the K.F.A.E.D. was adopted with only slight alterations by the Council of the Arab Economic Union at Damascus in August, 1970.

The Code will apply only to Arab investments in Arab countries. Arab investors are considered absolved from the accusations of neo-colonialism or exploitation liable to be levelled against other foreign investors especially the more powerful international firms. In the outline so far agreed the Code recognises the right of Arab countries to nationalise private firms providing such action is in the national interest and that the investor gets fair and effective compensation - provisos similar to those generally laid down in international law. This first proviso is nebulous in nature. National interest is not something easily definable and may in some instances be little more than particular governmental prejudice. Furthermore it is difficult to ensure that fair and effective compensation is paid, even if one can overcome the problems of arriving at such a figure. The Code also accepts the right of Arab governments to control the conditions of ownership and operations of foreign investments and the employment of foreign nationals.

The Code lays down principles of behaviour aimed at safeguarding investors interests.

1. Arab investors should enjoy adequate security and protection with treatment at least as good as local nationals and no less favourable than other foreign investors. The difficulties of ensuring fair treatment have been mentioned above.
2. Investors should have the right to transfer profits, debts, and compensation out of the country and repatriate their principle within the limits compatible with the economic situation of the country.

One of the major determining reasons why an investor may choose to enter one foreign market rather than another is whether he feels he can repatriate freely his earnings on investments from one and not the other. Thus if investors are to be encouraged into foreign markets it is necessary to make it clear under what condition the repatriation of income is not allowed, if any. This second principle fails to do this, 'compatible with the economic situation of the country' could be interpreted to mean almost anything. The latitude given by the wording in principle two could well extend the rights of governments and not the investor over capital transfers i.e. justify stringent controls on capital transfers.

The adoption of an investment code, by the Arab states, based on multilateral support and recognition of the interests of both investor and host country, is certainly desirable. In practice the existence of such a code could play an important part in regional development by encouraging a greater volume of inter-Arab capital

flows. However, the adoption of the Code outlined above, may for several reasons already mentioned, fall short of achieving these objectives.

CHAPTER III

THE ROLE OF COMMERCIAL BANKING IN THE ARAB OIL STATES

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Arab oil states especially Saudi Arabia, Kuwait, and Libya have over recent years acquired large capital surpluses. Arab banking has an important role to play in channelling this surplus for the purpose of local and regional economic development. Through the net-work of bank branches, the banking sector represents the most effective mechanism for mobilising savings. How far the commercial banks have developed to meet this challenge is the subject of this Chapter. The commercial banking systems of Saudi Arabia, Kuwait, Libya and Lebanon are examined.<sup>1</sup>

A. KUWAIT

There are five commercial banks operating in Kuwait.

1. The Kuwait National Bank.
2. The Kuwait Commercial Bank.
3. The Gulf Bank.
4. The Ahli Bank of Kuwait.
5. The Bank of Kuwait and the Middle East.

All of them are privately owned and must have a 100 per cent Kuwaiti shareholding. There are seventy six branches now in existence.

1. See Introduction, P.3.

As one can see from Table 7 the assets and liabilities position of the commercial banks has undergone remarkable change over the last few years. The combined assets of the banking sector increased from K.D. 293 million in 1965 to K.D. 790 million in 1972. This is not surprising in view of the countries rapid economic growth, in which oil revenues are the main source of income. This rapid economic growth has meant an increase in demand for financial assets.

The table shows how the relative importance of foreign assets to local advances has increased over the 1965 to 1972 period. The value of foreign assets increased by 250 per cent over the seven years, and that of advances and discounts to local residents by 230 per cent. The banking sector is evidently finding it more profitable to invest abroad than at home.

Table 8 shows in more detail the combined balance sheets of the banking sector over the period 1970 to 1973.

#### LIABILITIES

The bulk of liabilities accounts have been to local residents. In 1972 they constituted about 73 per cent of total liabilities. Liabilities to foreigners in the same year only amounted to about 10 per cent of the total. This small percentage is a reflection of two factors. Firstly, the existence of an ample supply of local funds makes it unnecessary for Kuwaiti banks to attract foreign deposits. Secondly, the advantages inherent in the Lebanese banking system make it more attractive to foreign deposits than Kuwaiti and other Arab banking sectors.

TABLE 7

DEVELOPMENT OF MAIN ASSETS AND  
LIABILITIES OF KUWAITI COMMERCIAL BANKS  
1965 to 1972 (in Million K.D.)

Year 31st March	Total of Balance Sheets	Foreign Assets	Advances and Discounts to Residents	Deposits	
				Public	Private
1965	293.4	173.3	65	35.8	173.9
1966	337.1	193.1	78.7	46.7	189.8
1967	448.3	260.1	94.6	49.9	263.3
1968	467.1	258.3	102.5	43.9	267.6
1969	601.3	323.8	133.5	51.1	344.9
1970	628.7	350.7	128.3	64.6	299.2
1971	713.7	406.6	135	77.7	327.0
1972	789.7	434.0	151.1	82.9	378.0

SOURCE: Third Annual Report of the Central Bank of Kuwait.

TABLE 8

COMBINED BALANCE SHEET OF KUWAIT  
COMMERCIAL BANKS 1970 to 1972.

Assets	1970 (K.D.000's)		1971 (K.D.000's)		1972 (K.D.000's)	
	Amount	%	Amount	%	Amount	%
Foreign Assets	350,701	70	406,599	71.1	433,980	79.0
Advances and Discounts to Residents	128,298	25.6	135,012	23.6	151,099	24.0
Other Assets	22,144	4.4	30,236	5.3	43,507	7.0
<u>TOTAL:</u>	501,143	100	571,847	100	628,586	100
<u>LIABILITIES</u>						
Residents Deposits	363,813	72.6	404,661	70.8	460,836	73.3
Foreign Deposits	59,533	11.6	70,969	12.4	63,790	10.1
Shareholders Liabilities	28,084	5.6	33,429	5.8	38,077	6.1
Other Liabilities	49,713	9.9	62,788	11.0	65,883	10.5
<u>TOTAL:</u>	501,143	100	571,847	100	628,586	100

SOURCE: Third Annual Report of the Central Bank of Kuwait.

In 1972 time or deposit accounts comprised over 50 per cent of total deposits. Saving deposits contributed a little less than a quarter of the total in 1972. Current deposit accounts comprised about a fifth of the total in the same year. Most deposits in Kuwait commercial banks are in Kuwaiti dinars. In 1972 almost 80 per cent of deposits were in the local currency. Recently, moreover, there has been a considerable shift from foreign to local currency. Between 1970 and 1972 deposits in K.D. have increased by 10 per cent whereas deposits in foreign currencies have correspondingly decreased.

The weakening and subsequent devaluation of the Dollar and Sterling over the 1970 to 1972 period imposed losses on deposits dominated in these currencies. Further asset depreciation was avoided by movement into other currencies. Subsequently the demand for deposits has risen and the local currency has moved into a stronger position vis-a-vis other currencies.

#### ASSETS

Foreign assets are the most important item in the banking sectors asset portfolio. They comprise more than two thirds of total assets. This implies two things. Firstly, that Kuwaiti banks are channelling most of their resources outside the country. Secondly, that the bulk of the income they receive derives from overseas. The other major source of income, namely advances and discounts to residents, was earned locally.

Lending rates vary between six and<sup>o</sup> eight per cent. These rates, low in comparison to Western commercial rates, reflect in part the excess liquidity position of the banks. However, this may not be the only explanation of the interest rate level. The authorities do stipulate that a 7 per cent ceiling on lending rates should be adhered to.

In 1972 local credit constituted only a little more than a quarter of the total assets portfolio of commercial banks. In the context of financing local economic development it would appear that the commercial banking sector is playing only a minor role. Table 9 shows the distribution of commercial banks loans by economic sector in 1972.

TABLE 9

Sector	1972 (K.D.Million) 31st March	%
Trade	105.3	70.4
Industry	21.3	14.1
Construction	23.5	15.5
<u>TOTAL:</u>	151.1	100

SOURCE: Third Annual Report of the Central Bank of Kuwait.

The trading sector, as shown above, received 70 per cent of total local credit advanced by the banking sector in 1972. Trade credit is advanced mainly for the importation and distribution of consumer goods e.g. beverages, tobacco, foodstuffs, radios, televisions, and washing machines.

Credit of this kind, however, does not directly encourage self sustaining growth in the economy, just growth of imports.

In contrast, the share of credit allocated to more directly productive sectors was relatively small. The industrial sectors share was only 14.1 per cent in 1972 and the construction sectors was 15.5 per cent in that same year.

This pattern of credit distribution may be explained by a number of factors.

1. There are few investment opportunities in sectors other than trading in Kuwait. Interviews with banking officials in Kuwait have confirmed this as a major explanatory factor.
2. The fact that the banks only lend for short periods and do not normally provide investment capital.
3. The commercial banks are profit making institutions and do not have as an objective, at any cost, the financing of local or regional development.

Data concerning the exact location of foreign assets held by Kuwait commercial banks is not available, but one can gain some idea of the nature of these assets from the data below.

TABLE 10  
MAIN COMPONENTS OF FOREIGN ASSET HOLDINGS  
OF KUWAITI COMMERCIAL BANKS, 1972.

Components	March (K.D. Million)	
	1972	%
Foreign notes and coins and money at call and short notice	30	7
Balances with foreign banks	294	67.7
Certificates of deposits	27	6.3
Foreign bills, bonds and shares	19	4.5
Other foreign investments	11	2.4
Advances to non-residents	53	12.1
<u>TOTAL:</u>	434	100

SOURCE: Fourth Annual Report of the Central Bank of Kuwait.

Balances with foreign banks represents the largest portion of the foreign assets portfolio. In 1972 this represented 67.7 per cent of total foreign holdings. Other important items are advances to non-residents, money at short call and notice, and certificates of deposits. It would appear that the bulk of foreign holdings are in liquid form. Liquid assets, as defined by the Central Bank of Kuwait, are those assets that can be recalled within a one month period. More recently and as a result of uncertainties in international money markets, a movement away from short term liquid assets and towards long term assets has been evident. In 1972 the bills, bonds, and shares item accounted for 4.5 per cent of total foreign assets. By 1973 this figure was 11.6 per cent. Most foreign assets of the banking sector are believed to be held outside of the Arab region. Substantial amounts are held as euro-dollar deposits and in euro-bonds. Part of these funds will flow overseas indirectly through the Lebanese banking system.

Although available data is in many respects inadequate, and therefore conclusions somewhat questionable, what evidence is available suggests that the Kuwaiti banking sector contributes little by way of finance towards economic development of the region.

This is largely explained by reasons outlined above. In addition non-economic risks to investment are high. The fear of expropriation, nationalisation and exchange control may discourage the flow of private capital within the region.

B. SAUDI ARABIA

There are eleven commercial banks operating in Saudi Arabia. Two are national banks, three are Arab banks and six are foreign owned. Out of a total of sixty branches, thirty eight belong to the two national banks. Over the period 1971 to 1972 the national banks accounted for over 80 per cent of total deposits and investments made by all commercial banks.

Table 11 shows the development of some balance sheet components of the commercial banks in Saudi Arabia.

TABLE 11  
COMBINED BALANCE SHEET OF  
SAUDI ARABIAN COMMERCIAL BANKS (MILLION RIYALS)

Mid-Year	Cash in hand and with Sama	Net foreign Assets	Loans and Advances to Private Sector	Total deposits (excluding inter bank deposits)
1966	221	+ 2	1,091	1,045
1967	266	+ 27	1,260	1,236
1968	325	+ 113	1,373	1,361
1969	250	+ 167	1,478	1,476
1970	252	+ 323	1,565	1,616
1971	348	+ 471	1,634	1,881

SOURCE: Annual Report of The Saudi Arabian Monetary Agency, 1971.

The amount of cash in hand and with the Saudi Arabian Monetary Agency (S.A.M.A.) has increased by 57 per cent between 1966 and 1971. Net foreign assets have recorded a spectacular rise over the period concerned. Between 1969 and 1971 they nearly trebled and between 1970 and 1971 they registered a rise of nearly 46 per cent. Loans and advances to the private sector have also recorded a considerable rise, about 50 per cent between 1966 and 1971. According to S.A.M.A. the reason why credit to the private sector has not registered a greater increase was because of excess liquid funds i.e. profits and income being used for investment purposes rather than loans. Concomitantly a substantial increase in foreign holdings has taken place. The availability of bank credit is reflected in the low rate of interest imposed on loans, 3 to 4 per cent. It is interesting to note that although the bulk of commercial bank funds are utilised locally the trend appears to be away from local and towards foreign markets.

Deposits went up by 76 per cent between 1966 and 1971. Between 1969 and 1971 the increase recorded exceeded 27 per cent, while in 1970 to 1971 the figure was 16 per cent. In view of the magnitude of oil revenues accruing to Saudi Arabia, it is not surprising that the banking sector has witnessed such a large increase in activity. In 1971 alone, Saudi Arabia received \$2,146 million in oil revenues. The income generated by oil revenues has brought about an increased demand for income generating

assets such as time and saving deposits. Although returns of 2 to 3 per cent are low, bank deposits represent a less risky and more profitable form of investment than some traditional assets, such as physical assets and money under the bed. The fact that banking activity has not grown at an even faster rate in Saudi Arabia reflects a number of factors.<sup>1</sup>

The main source of funds for Saudi Arabian commercial banks is from within the country. Data giving the share of private and public deposits in total deposits is not available. In Saudi Arabia, where public and private wealth are in many cases indistinguishable, perhaps the distinction is a little artificial. But it is known that in the period 1968 to 1970 demand deposits increased by 18.8 per cent, saving and other deposits by 12.8 per cent.<sup>2</sup> The deposits of government and semi-government institutions were placed with the two national banks, the National Commercial Bank and the Riyal Bank. The National Commercial Bank alone accounted for about 45 per cent of all bank activity conducted in the country in 1971 to 1972. In the period 1961 to 1971 the deposits rose by about 15.2 per cent from S.R.L.S. 345 million to S.R.L.S. 869 million.<sup>3</sup> The implication here is that public deposits have increased substantially over the period 1969 to 1972.

As in many other Arab countries, credit for financing trade accounts for the bulk of loans and advances made by the banking

1. See Chapter I.V, P.77.

2. Annual Report of The Saudi Arabian Monetary Agency, (1971).

3. I,B.I.D.

sector. The most profitable source of income locally was derived from short term credit extended to finance foreign trade dealings. According to Hassan Ahmad, who has made a study of Saudi Arabian banking, about 40 per cent of their funds are used for this purpose.<sup>1</sup> Construction activities account for about 35 per cent of loans and advances. Less profitable sources were funds used for the finance of internal trade and the giving of personal credit.

It would appear that although much of the banking sectors credit is used locally in Saudi Arabia, because of the nature of this credit, the banking system has yet to play a major role in local development. The industrial and agricultural sectors have little financial assistance from the commercial banks. If the banks are to be more active in putting the Saudi economy on a self sustaining growth path, a re-distribution of credit in favour of directly productive sectors is desirable.

Detailed data showing the exact nature and location of foreign assets held by the commercial banking sector are not available. One would expect the foreign assets portfolio to resemble that of the Kuwaiti commercial banks.<sup>2</sup> The Saudi banking sector, it would seem, contributes little to Arab regional development. The capital that flows outside the country is for the most part finding its way into Europe and U.S.A. and not into the poorer Arab States.

1. Arab Economist, Banking in The World, (August, 1973, P.70).
2. See P. 57.

C. LIBYA

There are five commercial banks operating in Libya.

1. The Umma Bank
2. The Cumhouria Bank
3. The National Commercial Bank
4. The Wahdo Bank
5. The Sahara Bank

The first three are public owned while the State has a 51 per cent shareholding in the other two. Where banks are only partially nationalised the remaining shares are all owned by Libyans. The banking sector in Libya has been nationalised since 1963 i.e. before the revolution.

Table 12 shows the consolidated balance sheet of commercial banks in Libya over the period 1969 to 1972.

LIABILITIES

Nearly all the funds of commercial banks in Libya come from within the country. Total deposits account for about 80 per cent of liabilities, demand deposits being over 64 per cent of this figure in 1972. Borrowing from other local banks, foreign institutions and from the Central Bank constituted only a small part of total liabilities.

ASSETS

Table 12 shows that Libyan commercial banks utilise nearly all their funds within the country. Some interesting trends within the assets portfolio have taken place over the period 1969 to 1972.

The ratio of total deposits to total assets amounted to 20 per cent in 1969. This rose to over 41 per cent in less than three years. In contrast, the ratio of the value of loans made to total value of assets exceeded 65 per cent in 1969, but dropped later to less than 50 per cent at the outset of 1972. Thus the relative importance of loans fell in the period concerned while that of deposits with other banks correspondingly has risen. The commercial banks of Libya have redistributed their funds away from loans and towards deposit with other banks. A most probable reason for the shift was the limited absorptive capacity for credit of the Libyan economy.

Overall the total assets or liabilities of the banking sector have registered an increase of over 66 per cent between the end of December, 1969, and January, 1972. From Table 12 one can see that items cash in hand, demand deposits of the commercial banks, and the deposits of with overseas banks have in money terms doubled during the relevant period. Time deposits have recorded a ninefold increase.

It is not surprising, given banking is nationalised in Libya, that the banking sector plays an important role in financing local

TABLE 12

CONSOLIDATED BALANCE SHEET  
OF COMMERCIAL BANKS IN LIBYA  
(M'000 OF LIBYAN DINARS)

Assets	1969	1970	1971	1972
Cash at hand	2,769	4,324	4,300	5,552
Demand deposits with Central Bank	16,136	17,701	66,406	33,819
Demand deposits with other Commercial Banks	884	2,327	328	571
Time deposits with other Commercial Banks	205	1,928	514	514
Time deposits with Central Bank	5,550	5,020	53,777	49,427
Deposits with overseas banks	4,113	6,673	7,830	8,514
Overdrafts, loans, advances, discounts	92,932	96,198	107,605	111,016
Foreign currency assets	270	586	293	447
Fixed assets	3,709	3,987	3,989	4,018
Other assets	8,175	21,245	25,843	10,080
<u>TOTAL</u>	<u>134,743</u>	<u>159,989</u>	<u>270,085</u>	<u>223,958</u>
 <u>LIABILITIES</u>				
Capital and reserves	8,452	9,903	9,913	10,292
Demand Deposits	69,498	91,170	175,521	143,785
Time deposits	19,898	23,156	24,636	22,943
Saving deposits	11,574	15,408	11,931	13,728
Borrowing from the Central Bank	7,195	1,226	5	-
Borrowing from other local banks	9	9	2	-
Borrowing from overseas banks	2,610	1,067	2,060	1,491
Other Liabilities	15,507	17,968	46,183	31,719

SOURCE: Bulletin of Central Bank of Libya, vol. 12 No. 1, 1972.

economic activity. The Central Bank in Libya can control the amount and distribution of credit going to various sectors in the economy. In 1970, loans and advances to local residents accounted for 60 per cent of the total assets portfolio.

More importantly one must examine the nature of banking sector activity. How far does the Central Bank exercise its' power of direction and control to promote local economic development? Table 13 shows the pattern of credit advanced by the banking sector over the period 1969 to 1971.

The development of communication, industry, and agriculture are necessary pre-requisites for sustained economic growth. Data shows that the banking sector has advanced relatively small amounts of credit to these sectors. In 1971 industry received 11 per cent, transport 7 per cent, and agriculture only 2 per cent of total banking credit. In contrast, general commerce received 38 per cent of total banking credit in 1971. Finance was mainly for the importation and distribution of consumer goods not directly promoting economic development.

To conclude, it appears that quantitatively the banking sector in Libya does play an important role in financing local activity. Nationalisation of the system has ensured, through directives, that funds are channelled for local purposes and very little capital is being exported. Qualitatively the banking sector has been less active in promoting economic activity than might at first be apparent. Its' activities are mostly tied up with financing import trade.

TABLE 13

LIBYAN COMMERCIAL BANK CREDIT  
BY SECTOR 1969 to 1971 (000 L.D.)

Sector	1969	1970	1971	% 1971
General Commerce	39,365	35,539	40,813	37.9
Construction	15,562	16,690	18,791	17.5
Transport Services	6,455	8,123	7,091	6.6
Petroleum	4,158	2,279	2,159	2.0
Industry	9,118	12,050	12,034	11.2
Professions and Individuals	4,114	4,131	4,646	4.3
Mortgages on Buildings	5,030	5,385	8,374	7.8
Agriculture	1,640	1,858	2,123	2.0
Hotels and Entertain- ment	2,053	3,449	1,339	1.2
Public Utilities	1,777	2,584	1,689	1.5
Other Items	3,533	3,988	8,545	7.9
<u>TOTAL</u>	92,835	96,196	107,604	100

SOURCE: Bulletin of The Central Bank of Libya,  
vol. 12 No. 1, 1972.

D. LEBANON

Beirut is well established as a Middle East and international financial centre. At the end of 1972 seventy three banks were operating in Lebanon. Twenty six of these are foreign owned. There are seven Arab banks and forty Lebanese banks. The expansion that has taken place in the banking sector since 1945 when only nine banks operated is explained by a number of factors.

Banking law in Lebanon is considered favourable to banking activity in a number of aspects.

1. The exchange of money is free and not restricted by law. Thus the cost and non-economic risks of holding money assets are low.
2. The transfer of capital and profits is unrestricted by law. This may have the effect of encouraging the inflow of foreign capital and so stimulate the banking sector as a result of general economic growth.
3. The banking secrecy law of September, 1956, made it unlawful to reveal the names of deposit holders to anyone other than the holders themselves. This acts as a strong attraction to those who, for a number of reasons may wish to keep secret asset accounts. Lebanese banking laws are similar to Swiss laws in this respect.

4. In Lebanon the joint account law exists by where an account may be used by anyone of two signatures.
5. All deposits in Lebanese currency are guaranteed by the Banks Deposits Guarantees Institution.

Some other influencing factors can be identified. The geographical position of Lebanon between two continents has helped to make it a port to the Arab World and the centre of most foreign transactions. Also capital inflow from Arab oil states has contributed to the growth of the Lebanese banking system.

Table 14 shows the consolidated balance sheet of the Lebanese banking system over the period 1968 to 1972.

#### LIABILITIES

Deposits account for about 70 per cent of commercial bank funds. They accounted for 66 per cent of total liabilities in 1966 and 74 per cent of total liabilities in 1972. For reasons already mentioned above, much of these deposits originate from outside Lebanon especially from Arab oil states and the West. The Lebanese economy does not so much generate deposits internally, but rather acts as host to large sums of refugee funds.

Time or saving deposits are the most important deposit item representing 64 per cent of deposits in 1972. These deposits receive 4 per cent interest. Demand deposits have fallen over the period as a percentage of total liabilities. This figure was

23 per cent in 1968 and 17 per cent in 1972. The foreign liabilities item has also fallen during the 1968 to 1972 period from 23 per cent of total liabilities in 1968 to 17 per cent in 1972.

In absolute terms banking activity, as measured by change in deposits, has increased rapidly from L.L. 3,958 million in 1968 to L.L. 7,046 million in 1972. Over this period demand deposits have risen at a slower rate than time or savings deposits, reflecting the increase in demand for interest bearing assets and a fall in demand for purely money assets.

#### ASSETS

Claims on the private sector represents the most important item. In 1968 this item accounted for 51 per cent of total assets and in 1972 the figure was 45 per cent. This relative fall is most probably a reflection of the limited local absorptive capacity for banking credit on banking terms. The local credit factor was offset over the period by a steady increase in credit to the public sector. In 1968 the public sector acquired 1.7 per cent of total banking assets while in 1972 this figure had risen to 10.0 per cent.

The foreign assets portfolio represents an important item within the banks total assets. In 1968 foreign assets accounted for 40 per cent of total assets by 1972 this figure had risen to 45 per cent. Thus there has been a tendency for Lebanese banks to increase their holdings of foreign assets relative to other assets



over the period. This implies that foreign holdings have been seen, by the banks, as more profitable than investments in the local market.

Table 15 shows banking credit distribution by sector in the economy over the period 1969 to 1971. As in many other Arab countries, the trading sector receives the bulk of finance offered locally by the commercial banks. Those sectors which need to grow if the country is to achieve economic growth and independence are receiving only negligible shares of credit. In 1971 the trading sector received 54 per cent of total credit while the industrial and agricultural sectors received only 16 per cent and 3 per cent respectively.

Concluding it would appear that the Lebanese banking sector has yet to play an important role in the process of economic development of the Lebanese economy. Its' foreign orientated structure may be explained by a number of factors.

1. The economic liberty which the banks enjoy provides them with the opportunity for operating as they do. The Lebanese Central Bank never intervenes in commercial banking policies.
2. Although Lebanese banks outnumber the foreign banks they remain to some extent weak in their organisation. The strong foreign influence may partially explain the foreign

TABLE 15

CREDIT CLASSIFICATION BY SECTORS OF THE ECONOMY  
1969 to 1971  
 (IN MILLIONS OF LEBANESE LIRAS)

Designation	31.12.69.	31.12.70.	31.12.71.	% 70/69	% 71/70	% of total 1970	% of total 1971
1. Credits to Agriculture	92.9	82.8	85.8	89	104	3.97	3.28
2. Credits to Industry	326.6	345.2	435.9	106	126	16.57	16.68
3. Credits to Construction	222.7	242.9	291.3	109	120	11.66	11.14
4. Credits to Trade	1,112.3	1,214.5	1,401.6	109	115	58.27	53.63
- Foreign Trade	(368.4)	(437.8)	(465.9)	(119)	(106)	(21.01)	(17.83)
- Interior Trade	(489.9)	(498.8)	(587.3)	(102)	(118)	(23.93)	(22.47)
- Services	(153.8)	(167.3)	(205.4)	(109)	(123)	( 8.02)	( 7.86)
- Consumer Credits	(100.2)	(110.6)	(143.0)	(110)	(111)	( 5.31)	( 5.47)
5. Credits to Financial Institutions	84.3	70.0	89.1	83	127	3.36	3.41
6. Various Credits	218.6	128.7	310.0	59	241	6.17	11.86
<u>TOTAL</u>	<u>2,057.4</u>	<u>2,084.1</u>	<u>2,613.7</u>	<u>101</u>	<u>125</u>	<u>100.00</u>	<u>100.00</u>

SOURCE: Annual Reports of the Central Bank of Lebanon.

orientated nature of the banking sector. Decisions about banking investments will be made by foreign headquarters and not by local management.

3. Given that credit is normally advanced for only short periods of time the absorptive capacity of the Lebanese economy for credit may be below that level which is available.
4. The precarious political situation that exists in the Arab region may preclude local private investment. Banks may prefer investments outside the area when economic risks are lower and profits are higher.

It should be noted that the banking sector in Lebanon does contribute to the countries invisible exports through its' international activities. In this way the banking sector is related to growth in the Lebanese economy.

CHAPTER IV

A COMPARATIVE STUDY OF SOME ARAB BANKING SECTORS

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A. COMPARATIVE STUDY

Similarities and differences between the banking sectors of Saudi Arabia, Libya, Kuwait, and Lebanon have emerged from the previous chapters. In Chapter IV, with the aid of a comparative table, these differences and similarities are highlighted and discussed.

Table 16 shows that ownership of the banking sector differs from country to country. In Libya the system is nationalised while in Kuwait the system is owned privately and entirely by local Kuwaitians. In Saudi Arabia and Lebanon a mixture of foreign and local ownership is characteristic. Nationalisation of the banking sector rests mainly on the argument that the authorities and not foreign private interest should be able to influence the flow of capital within their own country. The argument may be thought to be particularly strong in the case of developing countries.

The fact that foreign banks are allowed to operate in some countries reflects two main factors. Firstly, the recognition that foreign banks provide additional expertise and so stimulate efficiency in the banking sector. Secondly, the strong influence and control that Western banks have acquired in many Arab States has not yet been replaced by local banking independence. The Kuwait system of private but local ownership represents the compromise between nationalisation and foreign ownership.

It is interesting to note that the size of the Lebanese banking

sector, as measured by total consolidated assets, is almost that of the other three countries combined.<sup>1</sup> This emphasises the importance of Lebanon as a financial centre within the Arab World. The reasons for this were discussed earlier in this paper.<sup>2</sup> Furthermore, it is interesting to note that Saudi Arabia, by far the largest recipient of oil revenues of the three oil States, has a commercial banking system smaller than that of either Kuwait or Libya. This may be explained by a number of factors.

1. The policy of the authorities to distribute oil wealth amongst the people in the country. Income must be acquired before it can be deposited. In Saudi Arabia benefits from oil revenues have not percolated through the economy via government expenditure to the extent that has taken place in Kuwait.
2. The fact that estimates put the population in Saudi Arabia as 7 million. In Kuwait there are under 1 million people and in Libya there are under 2 million people.<sup>3</sup> Thus one would not expect per capital income to be so high and correspondingly deposits will not be so large.

It is also surprising, given that Libya has over the last few years been receiving oil revenues of a greater magnitude than Kuwait,

1. Annual Central Bank reports of Kuwait, Libya, and Lebanon, (1971), and Saudi Arabian Monetary Authority Annual report, (1971).
2. See Chapter III, P. 68 to 69.
3. Arab-Turkish Chambers of Commerce, Economic Facts and Figures, (September, 1973).

TABLE 16

COMPARATIVE INTER-COUNTRY TABLE (1971)

Countries	Kuwait	Saudi Arabia	Libya	Lebanon
Ownership	(All Local) Private	(Mixed, Local & Foreign) Private	Nationalised	(Mixed, Local & Foreign) Private
Total Assets in \$ (Million)	1,600	500	800	2,500
Foreign Assets as a % of total assets	71	24	3	56
Foreign Assets/Local credit ratio	Local credit was 34% of foreign assets	Foreign assets was 29% of local credit	Foreign assets was 7% of local credit	Local credit was 27% of foreign assets
Trading Credit as a % of total local credit	70	40	38	53
Principle source of funds	Local	Local	Local	Outside Lebanon
Principle use of funds	Outside Kuwait	Within Saudi Arabia	Within Libya	Outside Lebanon
Lending rates %	5-6	3-4	4	3-4
Borrowing rates %	6-8	-	7	6

DATA SOURCE: Annual Central Bank Reports of Kuwait, Saudi Arabia, Libya and Lebanon.

that its' banking sector is only half the size. Apart from the two reasons mentioned above perhaps the fact that the system is nationalised provides a partial explanation for this. A shortage of local management skill may result in inefficiency of operations. Thus costs become higher and the returns to investors may be lower. Nationalisation furthermore may reduce effective competition in the banking sector and this may itself bring about inefficient banking operations. Of course nationalisation need not necessarily imply inefficiency in operations. It will depend on how the sector is organised.

Item three of the table shows the percentage of foreign assets to total assets of each of the four banking sectors. The figure indicates how expatriate in nature each of the banking structures are. The Kuwaiti and Lebanese systems appear to be highly foreign orientated while the Saudi Arabian and Libyan banking sectors appear to be engaged primarily in local finance. These contrasting figures reflect two main factors.

1. The absorptive capacity for capital within each country. The opportunity for local investment in Saudi Arabia, by virtue of its' very size, is greater than in either of the other countries. However, this is not always true. The potential for agriculture development in Saudi Arabia relative to its' size, for example, is smaller than that in the Lebanon.
2. Depending on who owns the banking system the behaviour of

that system will be different. In Libya, where the system is nationalised and the authorities have direct control on credit allocations, very little capital flows outside the country. In Lebanon, where foreign banks are predominant, the bulk of banking credit is channelled outside the country.

Item four of the table shows the amount of credit from the banking sector which is being channelled locally in relation to total foreign holdings. Item four differs from item three in that it excludes such other assets holdings as inter-bank deposits. These represent the counterpart, in the Libyan nationalised system, of the foreign deposit holdings made by the private banks in the other three banking systems. That is, the excess liquidity position is shown internally in Libya while in Kuwait, Saudi Arabia, and the Lebanon it is met largely by foreign deposit assets.

From these figures and in the absence of Central Bank directives, one can deduce that Saudi Arabian banks have found it profitable to use their funds locally while in Kuwait and Lebanon banks have preferred overseas investments. As the Libyan system is nationalised it is difficult to say whether the high ratio of local to foreign finance is a result of central authority directives or management preferences. In the light of the other figure it would seem that the authorities have been instrumental in forming commercial banking policy. If the Libyan system was to move into private hands one would expect their holdings of foreign assets to rise considerably.

Item 5 of the comparative table shows trading credit as a percentage of total local credit. Trading credit is defined as the credit advanced by the commercial banks, for the importation and distribution of mainly consumer durable and luxury goods. As trading credit is not directly linked to sustained economic growth, this figure gives us some idea of the direct contribution banks are making to economic development in each of the four countries.

It appears that in all four countries the banking sectors advance relatively large amounts of credit to the trading sector. Kuwaiti banks allocate 70 per cent of local credit to this sector.<sup>1</sup> The Saudi Arabian and Libyan systems advance nearly 40 per cent of local credit to the trading sector.<sup>2</sup> The relatively high figure for Kuwait reflects the fact that Kuwait, while having a very small industrial sector, has one of the highest per-capita income in the world. Kuwaitians have, as have the Lebanese, acquired very Westernised tastes and preferences. This can only be met by the importation of Western goods. The figure for Libya suggests that nationalisation of the banking sector has not been wholly successful in assuring a major role for the banks in local economic development.

Items 6 and 7 show the main sources and uses made of banking sector funds in each of the four countries. Not surprisingly, local deposits form the main source of funds in the oil rich states.

1. Annual Central Bank Report of Kuwait, (1973).
2. Annual Central Bank Report of Libya, (1971), and Saudi Arabian Monetary Authority Annual Report, (1971).

The Lebanese banking sector acquires most of its' funds from abroad for reasons already mentioned.<sup>1</sup> Although relevant data is not available it is believed that the funds come from both Western depositors and depositors from the wealthy Arab States. Commercial banks in both Kuwait and Lebanon utilise most of their capital abroad. Contrastingly commercial banks in Saudi Arabia and Libya use the bulk of their funds for local purposes. The reasons for this have already been discussed.<sup>2</sup>

Lending and borrowing terms of the four banking sectors in question share many common characteristics. None of the banking sectors provide long term credit facilities. Advances are mainly for working and not investment capital. Credit is normally advanced for periods of six months to one year. Although in many instances credit is continuously advanced and so in effect is given for longer periods of time.

Interest paid on savings on time deposits tends towards the 4 per cent level.<sup>3</sup> Bank lending rates tend towards 7 per cent.<sup>4</sup> Rates do vary slightly between countries and between particular types of accounts, but the average tends to approximate the figures outlined above. One may be surprised that rates in what are surplus countries are as high as this. However, when compared to Western rates of interest they appear relatively low. Of course foreign currency deposit rates are similar to those paid abroad and so are currently higher.

1. See Chapter III, P. 68 to 69.
2. See P. 79 to 80.
3. Annual Central Bank Reports of Kuwait, Libya, and Lebanon, (1971), and Saudi Arabian Monetary Authority Annual Report, (1971).
4. I.B.I.D.

B. SOME SHORTCOMINGS OF COMMERCIAL BANKING IN ARAB STATES

Examination of commercial banking systems in Saudi Arabia, Kuwait, Libya, and Lebanon has shown that rapid expansion in banking activity has occurred over the last few years. However, the nature of this expansion has meant that commercial banking have failed to play a more dynamic and active role in local and regional economic development. A number of explanatory factors can be identified.

1. A characteristic of Arab commercial banking is the unbalance which prevails in the distribution of loans and advances as between various economic sectors. Credit is advanced mainly for the importation and distribution of goods. This was evident in Kuwait where the banking sector is in private hands, and in Libya where the system is nationalised. This bias in favour of largely non-productive sectors cannot be in the best interests of local economic development. It seems this pattern of credit distribution has not altered radically over the last few years.
2. Another characteristic of Arab commercial banks is the nature of credit facilities provided. They are mostly and overwhelmingly in the form of short rather than medium and long term credit, though there are some slight differences as between different countries. Loans are

usually made for periods ranging between six months to a year. Short term credit is obviously most useful for short term profit making projects such as import financing. It is not designed to supply investment capital for industrial or agricultural expansion and development. This feature is of course true of many commercial banking systems in developed countries. However, in the more developed countries other institutions exist to augment capital supplies to agricultural and industrial sectors. In the Arab States the financial superstructure is not so broadly based. The banks may therefore have to perform somewhat different function than their counterparts in more developed countries.

3. Thirdly the banking structure in some Arab countries is fragmented, in that too many banks are allowed to operate. This feature is most relevant in Lebanon where over 70 banks are operating. Fragmentation has certain adverse consequences. It makes medium and small sized banks vulnerable, with the result that funds tend to be diverted away from them e.g. the Intra crash in October, 1966. It may interfere with efficiency and render the cost of credit higher than it might otherwise be. Also it makes the costs of automation much higher for the smaller bank. However, some degree of competition in the provision of

banking services may not be necessarily bad. Where competition precludes monopoly power positive gains may be obtained e.g. the cost of services may be lower than might otherwise have been.

4. The fact that foreign banks play such an important part in Arab commercial banking may result in certain disadvantages. The use and disposition of local funds might be determined by foreign headquarters rather than by local management. Therefore funds may not be used in ways conducive to domestic and regional economic development. This is certainly a factor determining the nature of Lebanese and to a less extent Saudi Arabian commercial banking activity. However, the ownership argument does not itself explain the degree of involvement of commercial banks in regional economic development. Firstly, in Kuwait, where all banks are Kuwaiti owned, local management play only a minor role in financing domestic development. Secondly, the Libyan banking sector, which is nationalised, has yet to play an active role in financing local economic development.
5. Given the limited absorptive capacity for capital in the Arab region it is inevitable that commercial banks in the area will look towards the international market. Investments which offer low risk and high return should be sought after. However, it is a feature of banks in the region

that they hold the bulk of their foreign assets as deposits with foreign banks. As a result of recent events in the international money market, substantial losses have been incurred. Kuwait and Saudi Arabian banks in particular lost heavily. It is of interest to the banks to guard against further losses. This could take the form of fixed investment assets abroad. Direct investments and equity purchases are likely to appreciate in value over time. Perhaps an index linked deposit scheme could be operated.<sup>1</sup> This is being seriously discussed by officials in Kuwait at this time. At the same time, and as a result of increasing uncertainties abroad, the banks may look closer at local investment opportunities.

1. For a comprehensive explanation, see Mabro R.E., The Absorptive Capacity of the Arab World and Investment policy, (Seminar on Investment Policies of Arab Oil Producing Countries, Kuwait, February, 1971).

C. COMMERCIAL BANKING AND FUTURE INVOLVEMENT IN LOCAL/  
REGIONAL DEVELOPMENT

Before the banking sector in the Arab world can take a more active role than it has to date in financing Arab economic development a number of pre-requisites must be met.

1. A strengthening and widening of the institutional base is of primary importance. New institutions would take the form of merchant and investment banks, financial companies, and other financial intermediaries. This would make available medium and long term loans on a more substantial scale. Some of the existing commercial banks could become more specialised in the manner suggested above. Individual banks may be given certain sectors of the economy to finance. Where specialised institutions are initiated the commercial banks should become directly involved in their activities by depositing funds with them. Advantages of such specialisation would be many fold. Notably large scale finance could be made available for sectors previously limited to small amounts of capital. Also thorough project appraisal could be carried out and so economically viable projects determined.
2. The development of an active capital market is important. Of all the familiar benefits that are bound to accrue from the development of a capital market one is particularly relevant in connection with the potential role of

Arab banking in the development of the Arab region. The capital market would provide a vehicle for converting short term funds into medium and long term capital for investment purposes. The possibility of floating long term securities in an active primary capital market provides the issuees with a convenient opening for raising long term investment capital. The existence of an active secondary market for such securities would ensure that investors assets are fairly liquid in nature. Commercial banks, as well as other financial institutions, could become important investors in the stock exchange. At present, however, banking regulations in Lebanon and Saudi Arabia prevent commercial banks from investing directly in the industrial, agricultural, or commercial sectors. Banking regulations in Kuwait and Libya differ from the above in that they are allowed to make outside investments.

3. The prospect of active involvement by the banking sector in regional development will depend partially on the implementation and further reinforcement of Arab investment insurance schemes.<sup>1</sup>
4. Another pre-requisite for improving and developing Arab financial systems lies in greater co-operation between

1. See Chapter II, P.39 to45.

Arab banks. Co-operation at present is restricted largely to transfers, collection of bills, and other related operations. The pooling of resources would for instance enable them to undertake large scale banking operations. Some joint banking ventures have taken place, between European and Arab banks. However, they have been at the initiative of foreign banks and ventures were in the consumer rather than producer market. If the potentially large pool of funds made available by joint ventures is to help finance the process of economic development, these funds should be utilised in the productive and vast consumer markets.

5. The movement of commercial banking away from foreign to local ownership may help to induce the system to increase its' holding of local assets and decrease its' holding of foreign assets. However, after comparing those locally owned systems with those mixed ownership systems the argument appears to have little substance.<sup>1</sup> Regardless of whether foreign or locally owned, commercial banks operate in such a way as to maximise returns. With limited low risk and high return investment opportunities at home, banks will naturally look abroad.

1. See P.85,

CHAPTER V

A STUDY OF SOME SPECIALISED FINANCIAL INSTITUTIONS

IN THE ARAB REGION

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All countries of the region have adopted plans for development based on industrial and/or agricultural growth. Subsequently, a number of specialised institutions have been established over the last decade to provide capital and related services to particular sectors. Specialised institutions serve largely the internal capital needs of each country, and have as an objective the promotion of inter-country financial flows.

In this Chapter a brief survey of some specialised institutions in Saudi Arabia, Libya, Kuwait, and Lebanon is made.

Also some suggestions are made as to how they may change in the future to best promote local economic development.

A. SAUDI ARABIA

Agricultural Bank

The Agricultural Bank in Saudi Arabia was initiated by the government in 1964 and currently has five branches within the country. It was set up with the aim of providing short, medium, and long term credit for the agricultural sector. Financial support for this sector is of particular importance in Saudi Arabia where 75 per cent of the population is engaged in agriculture.<sup>1</sup>

Stated objectives of the bank are:

1. Arab-Turkish Chamber of Commerce, Economic Facts and Figures (September, 1973, P.36).

1. To ensure the consumer a good quality of agriculture and animal produce at the cheapest price possible.
2. To attempt to narrow the gap between consumption and local production.

The banks capital has increased by over 400 per cent since its' inception. It was increased from 10 million riyals in the fiscal year 1964 to 1965, to 16 million riyals in 1965 to 1966 and then to 24 million riyals in 1966 to 1967. This figure reached 37 million riyals in 1968 to 1969 and by 1970 it had reached 53 million riyals.

The relative percentage of outstanding loans to capital increased from 38 per cent to 70 per cent over the 1964 to 1969 period. This reflects the increase in loan activity by the bank since its' initiation.

Medium term loans typically have comprised of the major part of the banks activity. In 1966 medium term loans accounted for 91 per cent of all loans, in 1970 the figure was over 80 per cent. The number and type of loans granted by the bank since it began operations until 1970 are tabulated in Table 17.

TABLE 17

Kind of loans	Number of Loans	Value (Riyals)
Short term	3,537	4,726,875
Medium term	9,562	47,649,643
Long term	3	109,700
	<hr/> 13,102	<hr/> 52,486,218

SOURCE: Saudi Arabian Monetary Authority Annual Report, 1970.

Classification of loans by purpose shows that 54.2 per cent of medium term loans were for the purchase of engines, pumps, and pipes, 13.2 per cent for livestock, poultry and fodder, 9.5 per cent for the purchases of trucks, tractors, and spare parts, and the remainder for other purposes. Short term loans were usually granted to farmers to enable them to meet sundry expenditures including wages of seasonal labour, purchase of fuel, seed and fertilizer. Long term loans are avoided by the bank because they are viewed as too risky.

The operations of the bank have undoubtedly helped finance the growth of the agricultural sector. The bank has made more capital available for agriculture over the period of its' operation than would otherwise have been. However, in relation to potential demand for capital, the banks financial base remains rather small.<sup>1</sup>

1. See United Nations Economic and Social Office in Beirut, Financing of Industrial Development of the Middle East, (No. ESOB/PD/72/18 Rev.1, P.60 to 61).

B. KUWAIT

Savings and Credit Bank

The Savings and Credit Bank in Kuwait was initiated in 1957 and is a government agency. Its' capital 120 K.D. million is entirely paid up by the authorities. The main objective of the bank is to grant loans for real estate, industry, and agricultural projects. The Bank is guided primarily by social objectives and only secondarily by ordinary banking principles, i.e. the profit motive.

The maximum period of loans is 10 years, extended for establishing and expanding industrial projects or for building housing facilities for the workers of industry. Credit is normally granted in co-ordination with industrial plans and with the co-operation of the Industrial Development Committee. Once the profitability of the project is ascertained decisions to extend loans are made. It is policy that any one loan should not exceed 30 per cent of total value of the project.

Total loans granted by the bank amounted to K.D. 38 million during 1972 to 1973. On average 80 per cent of its' lending activities were confined mainly to medium-term loans for construction of houses. This is a reflection of the demand for property in Kuwait where surplus funds are increasingly being channelled into real estate. The fact that industry received relatively little credit reflects two main factors.

1. The high risk entailed in long term industrial loans.
2. The lack of viable industrial projects.

The Saving and Credit Bank of Kuwait, one must conclude, has not made a significant contribution to industrial development within the Kuwait economy. Table 18 gives an indication of the relative importance of commercial banks to specialised institutions in Kuwait in terms of industrial credits. Specialised institutions provide relatively little industrial credit and their importance appears to be falling. In 1970 specialised institutions in Kuwait provided 8.8 per cent of total commercial banking industrial credit. By 1971 this figure had fallen to 6.2 per cent.

TABLE 18

(K.D. Millions)	1966	1967	1968	1969	1970	1971
1. Total Industrial Credits of the Banking System	-	-	-	-	17.1	22.7
2. Total Industrial Credits of the Specialised Institutions	1.5	1.6	1.6	1.5	1.5	1.4
Percentage of 2/1	-	-	-	-	8.8	6.2

SOURCE: United Nations Economic and Social Office in Beirut based on data compiled from national sources.

C. LIBYA

National Agricultural Bank

The National Agricultural Bank was initiated by the government on August 18th, 1955. The main aim of the bank is to provide long, medium, and short term loans for agriculture on various soft loan condition. Its' capital is entirely paid by the authorities through budgetary allocations.

The banks capital has increased steadily over the last decade from L.D. 5 million in 1967 to L.D. 6.2 million in 1968 and in 1971 it was raised to L.D. 10 million. This represents a 100 per cent increase over the period 1967 to 1971.

Medium and short term loans have typically comprised of the major part of the banks activities in earlier years. In 1966 to 1967 short term loans constituted 42.6 per cent of total loans, medium constituted 30.8 per cent of total loans, and long term 26.3 per cent. By 1971 the share was 17 per cent, 26 per cent and 57 per cent respectively. Thus a move away from short term and towards long term loans has taken place. There are two main factors explaining this trend.

1. Recognition of the need for long term loans for agriculture.
2. The fact that other institutions, namely commercial banks, are mainly engaged in supplying short term loans.

The interest payable on loans varies according to the precise nature of each loan. Rates are 4.5 per cent for short loans, 3 per cent for medium term loans and 1 to 2 per cent for long term loans. Rates have, however, fluctuated over time and in 1966 to 1967 rates were abolished altogether in order to encourage borrowing in the agricultural sector.

The shortage of relevant data makes it difficult to assess the operations of the bank. However, in terms of capital size it would appear that the bank can only be making a minor impact on the agricultural sector.

#### Industrial and Real Estate Bank

Like the Agricultural Bank, the Industrial Bank was set up by the Libyan authorities and its' capital is paid in by the government. Its' paid in capital reached L.D. 22.2 million in 1971. The aims of the bank are twofold in nature.

1. It aims to extend loans to industry.
2. It aims to alleviate the housing problem that prevails in the country.

Article 6 of the Banks Law explicitly states that funds allocated for industry shall not be invested in building or vice versa except by a decision of the Board of Directors of the Bank and according to specific conditions. Funds of the Bank are to be allocated evenly between the industrial and agricultural sectors.

However, in fact, real estate has received the bulk of bank loans over the period of its' operations. Over the period 1966 to 1967, 80 per cent of its' approved loans were approved for real estate. By the 1970 to 1971 period this figure had risen to 90.5 per cent. A number of explanatory factors have been forwarded to explain the one sided growth of the Bank.<sup>1</sup>

1. Application for loans in real estate are much greater in number than application by industry.
2. The lack of sound study into industrial projects.

Below is a table of industrial loans by sector during the period 1970 to 1971.

TABLE 19

Sectors	(L.D.,000)
Industrial Projects Based on Agricultural Projects	592.6
Building materials industry	66.5
Carpentary workshops	54.6
Other	37.4

SOURCE: Central Bank of Libya Annual Report, 1971.

1. Central Bank of Libya Annual Report, (1971).

It is noteworthy that the bulk of industrial loans go to the food processing industry. Thus growth in the economy based on agricultural industrialisation is being encouraged.

D. LEBANON

Banque de Credit Agricole, Industrial et Foncier

The Banque de Credit Agricole, Industrial et Foncier (B.C.A.I.F.) was established in 1955 as a partly owned government institution, and began operations in 1956. It was the second specialised bank to be set up in the region, the first being the Industrial Bank of Iraq which was set up in 1946.

The B.C.A.I.F. extends credits to projects in agriculture, industry, and real estate. The Bank is purely a credit giving institution and may not participate in industrial enterprises as founders and/or shareholders. This is in contrast to the Savings and Credit Bank of Kuwait which is permitted to do so.

Medium and short term loans are extended to joint stock companies, the paid up capital of which exceeds L.L. 500 thousand. Any one loan should not exceed:

1. 25 per cent of the borrower companys' paid up capital.
2. 15 per cent of funds allocated to industrial credit.
3. 40 per cent of the real value of estates when loans are secured by estates.

4. One million Lebanese liras, or three million Lebanese liras if guaranteed by government, if the loan is of agricultural or industrial origin.

Interest rates are 7.5 per cent to 9 per cent. If a loan is less than L.L. 50 thousand then a 5.5 per cent rate is levied. While they represent 'soft term rates' they are higher than those rates levied by the Kuwaiti Savings and Credit Bank. This difference may be explained by a number of factors.

1. The Kuwaiti Bank is an entirely government owned institution. Thus a stronger subsidy element is likely than in a mixed ownership institution as the (B.C.A.I.F.)
2. The low interest rates in Kuwait reflect the financial position of the country. Lebanon is not an oil State.

The acute shortage of data makes it difficult to assess the contribution and impact of the bank on the Lebanese economy. One can, however, gain some idea of the relative importance of specialised institution and commercial banks in providing industrial credit from Table 20.

It appears that specialised institutions only give a small percentage of that credit given to industry by the banking system. Furthermore the share of specialised institutions credit to industry is falling. In 1965 this reached 16.5 per cent and by 1971 this figure amounted to only 10.4 per cent.

TABLE 20

(L.L. Millions)	1966	1967	1968	1969	1970	1971
1. Total industrial credit of the banking system	293	342	382	382	370	385
2. Total industrial credits of the specialised institutions	49	51	49	44	43	40
Percentage of 2/1	165	15	12.7	11.4	11.8	10.4

SOURCE: United Nations Economic and Social Office in Beirut based on data compiled from national sources.

SPECIALISED INSTITUTIONS AND THEIR FUTURE ROLE IN FINANCING DEVELOPMENT

It would appear that none of the existing specialised institutions have so far played a fundamentally important role in the process of industrial or agricultural finance. Their activities have been limited by their limited financial base. For example in Kuwait in 1972 the relative share of various existing specialised institutions in financing industry was only 1.3 per cent.

The review of the various lending policies of the specialised institutions indicates several lines of action and policy changes which ought to be decided in order to remedy some of the existing deficiencies and enhance the effectiveness of these institutions.

The shortage of financial resources has increasingly become a bottleneck in expansion in the activities of the various specialised institutions. The industrial banks do not have the necessary investment funds to play an important role in the industrial development of the region.

Important steps in the direction of strengthening the financial resources of the specialised institutions would be, first, to pay the whole of the authorised capital and, second, to provide a way for the private sector to join in financing the expansion of the Banks' resources. This could be done by issuing shares or bonds of the banks and making them available to both institutional and individual investors. One weakness of the present institutional structure is that the system is not originally linked to the ultimate source of savings, and depends a little too much on adhoc allocations from the Central Bank or the Treasury. This is particularly true in the case of the Banque de Credit Agricole, Industrial et Foncier of Lebanon. It would be desirable therefore, to establish chosen links between the distributing mechanism and the normal channels of saving so that the distributing mechanism become increasingly capable of autonomous growth along the needs of the economy.

Attracting private capital to specialised institutions, especially a newly established one, is not likely to be easy. The government will have to provide appropriate incentives such as

guaranteed minimum dividends, or tax free dividends, in order to mobilise resources to such institutions. In certain cases, government could also apply various forms of pressure on the existing financial institutions to buy the shares or bonds of specialised institutions.

All specialised institutions place too much emphasis on security and too little on the profitability and earning potential of the enterprise. It is worth mentioning in this context that industrial plant and equipment are considered as poor security in most countries, because it may be difficult to realise their value, even in good times let alone bad. The problem may be more difficult in an under-developed country than in an advanced one, for the former the potential buyers are likely to be fewer especially if the industry concerned is new and unfamiliar.

A shift of concern from too much pre-occupation with security, to interest in the potential earning capacity of the enterprises will naturally lead to a corresponding interest in equity investment. In new enterprises equity participation is probably the most appropriate form of assistance.

Access to managerial advice and modern techniques are sometimes more important to small and medium size enterprises than access to financial resources. Adequate research and technical divisions should be created in the various specialised institutions and wherever they exist they should be strengthened. Furthermore,

industrial banks should be more active in identifying feasible projects rather than in merely waiting for applicants to submit such projects.<sup>1</sup> This is of particular importance in countries still at their early stage of industrial development and where entrepreneurial talent is relatively scarce.

1. See Chapter II, P. 35 to 36.

SUMMARY AND CONCLUSIONS

SUMMARY

Financial institutions in the Arab World have an important role to play in the process of regional economic and social development. Recent changes in the oil industry have ensured that the region has the capacity to self-finance all its' capital requirements. From this study, however, it has become evident that the various institutions are at present having only a minor impact upon development in the region.

REGIONAL INSTITUTIONS

The Kuwait Fund For Arab Economic Development (K.F.A.E.D.) has been operating effectively and efficiently over the last decade supplying capital to poorer Arab States. To date it has allocated over K.D. 100 million in loans to a wide variety of Arab countries. Loans have mainly been advanced for agricultural, communications, and transport sectors. The Fund has provided grants for technical aid. It has also provided technical guidance and expertise from its' own staff.

A number of less tangible achievements of the Fund, of no less importance, may also be identified.

1. The K.F.A.E.D. was the initiator of both the Arab Fund For Economic and Social Development (A.F.E.S.D.) and the Inter-Arab Investment Guarantee Corporation (I.A.I.G.C.). The A.F.E.S.D. was established as a multi-national development body. It began its' operations in 1973 and

has already granted three loans within the region. The I.A.I.G.C. has not yet begun its' operations. The Corporation will guarantee investments both public and private, between Arab States, against non-economic risks and thereby hope to stimulate inter-Arab financial flows.

2. The Kuwait Fund, as a result of its' involvement in the region, has fostered closer social and political ties between the Arab States.
3. The Kuwait Fund has helped in introducing Arab countries to international institutions such as the World Bank.
4. The Kuwait Fund has taught Arab States to accept the rules of the game for international lending.

Despite these formidable achievements, one can levy a number of criticisms at the Fund and identify a number of shortcomings in the way that it operates.

1. The Funds capital resources remain small in relation to the needs of the region, the wealth of Kuwait, and the amount of funds channelled from Kuwait to other Arab States for political reasons.
2. The Fund, as a government agency, can never be entirely free from political influence.

3. The K.F.A.E.D. has not been active in providing finance for industrial projects, social projects, or subscribed to programme aid.
4. Technical aid is only a small part of Fund loans. The Fund, however, has made it clear that the provision of technical assistance to receiving countries may be as fundamentally important as financial aid.

It is in a piecemeal fashion, then, that the Arab States have and are taking steps towards greater regional economic and social co-operation. The development of regional institutions and schemes, as discussed in Chapter I and II is still at an infancy stage. Much scope remains for progress within those institutions and also for the development of new institutions. Priority should be given to increasing the resources at the disposal of these bodies.

#### COMMERCIAL BANKS

The last decade has witnessed a rapid expansion of the banking system in the Arab World. Expansion has followed the massive inflow of oil revenues to the region. Growth in the financial sector is attested by the proliferation of local and foreign banks and their branches.

Despite notable progress achieved, the role that the banks have played in both local and regional economic development has been

limited. Communications, industry, and agriculture have received negligible amounts of banking credit. For example in 1971 industry received an average of only 14 per cent of local credit advanced by commercial banks in Kuwait, Libya, and Lebanon. The figure for agriculture was 1.7 per cent. The figure for credit going to the import sector, however, was 52 per cent. Banks have thus preferred to focus on import financing.

The foreign holdings component of banking assets have increased rapidly over the last decade. These assets tend to be held outside the region in both the American and European money markets. Banks have therefore not been operating in such a way as to encourage the flow of funds between Arab States.

A number of economic implications arise from the above findings.

1. If long term sustained growth is the objective of all Arab States then the development of the industrial,, agricultural,,and communications sectors is important. Banks in the Arab World have not been active in advancing credit to these sectors.
2. The pattern of loans advanced by banks between sectors has meant that the economies of Kuwait, Saudi Arabia, Libya, and Lebanon remain open in nature. This in turn has meant these economies have, over recent years, been hit severely by the problem of imported inflation.

3. The reluctance of banks to lend money for local industrial projects, has meant that economic development along the line of import substitution industries has not taken place to any appreciable extent.
4. The reluctance of banks to invest in other Arab States has done little to encourage economic co-operation within the region.

The general lack of involvement by banks in local and regional development may be explained by a number of factors.

1. There is limited absorptive capacity for capital. In many cases there is a natural constraint such as little or no suitable agricultural land. The major constraint, however, is one of competent manpower. There exists a chronic shortage of technical and management staff. The absorptive capacity of the region is also constrained by political uncertainties and non-economic risks to capital investment.
2. The very nature of commercial banks in the region precludes rapid involvement by them in local and regional development. Only short term credit is made available by the banks. Many banks are foreign owned and so local interest is absent. Also there is little co-operation between the banks.

The degree of future involvement by the Arab banking sector in local and regional development will rest on the implementation of a number of changes.

1. The establishment of a capital market should be encouraged. This would provide a vehicle for turning short term assets into long term liabilities. Commercial banks could invest in the stock exchange and thereby involve themselves in long term capital finance. At present the capital markets in the Arab region are markedly unsophisticated.
2. Commercial banks should give greater consideration to investment opportunities in industrial projects and perhaps lend funds on a longer term basis than at present.
3. Banks could channel funds for development purposes indirectly through specialised financial institutions such as industrial and agricultural banks.
4. The movement of banks from foreign to local hands should be encouraged wherever practical i.e. where competent management is available. This would perhaps encourage greater investment within the region by the banking sector. Local management is more likely to consider local interest than foreign management.

5. Co-operation between banks should be encouraged. The pooling of financial resources may allow larger projects to be financed and the risks of financing these projects would thus be spread.
6. Policies should be implemented which will increase the regions absorptive capacity. For example measures should be taken to alleviate the shortage of skilled manpower in both the short run and in the long run.

#### SPECIALISED INSTITUTIONS

The need for specialised institutions to supply medium and long term capital for the implementation of industrial and agricultural growth plans, has been felt by all countries of the Arab region. Institutions specialising in industrial, agricultural, and real estate have been established in a number of Arab States.

These institutions have as a result of their operations made available a greater amount of credit to particular sectors than would otherwise have been. However, their share in financing development needs has been very small. For example, the commercial banks in Kuwait and Lebanon supply a greater amount of capital to industry in their respective countries than do the industrial banks in those countries.

Whatever the character of the existing specialised institutions it is evident that none of them has so far acquired decisive importance in the process of economic development. There are a number of reasons for this.

1. The shortage of financial resources. The resources of specialised institutions should be substantially increased.
2. The short supply of managerial advice and modern techniques. Steps should be taken to ensure that adequate technical assistance is available where necessary.
3. The fact that specialised institutions place too much emphasis on security and too little on the profitability and earning potential of projects. A shift away from the pre-occupation for security would be desirable.

### CONCLUSIONS

The existence of a certain volume of capital within the Arab region does not by itself ensure economic development. There is a pre-requisite need for a broad financial base capable of not only mobilising funds, but allocating funds according to particular needs of each country and the needs of the region as a whole. The development of the real sector is closely related to development of the financial sector. In the Arab World it is the slowness of the financial sector to adapt and change in accordance with the needs of the region that has restricted a faster rate of growth in the real sector.

While the availability and proper channelling of financial resources are essential for meeting industrial and agricultural investment requirements in the region, other non-financial constraints are also of primary importance.

1. The smallness of the potential market facing a number of Arab States such as Kuwait and Libya precludes investment in large industrial projects. As a result of trade barriers affecting the free flow of trade between Arab States the market for any one country in the short run will come mainly from local demand. Local domestic markets, however, will not allow goods to be produced on an economically large enough scale. The price of Western goods would nearly always be lower at all possible levels of output. For the larger Arab States such as Saudi Arabia the problem is not so acute.

2. The shortage of managerial and technical skills in the region has put limitations on the amount of capital that can be efficiently utilised. Discussions with officials in The Kuwait Fund For Arab Economic Development and in a number of commercial banks in Kuwait showed the administrative and technical gap to be a fundamental barrier to further investment both within and between Arab States. One reason forwarded by the Kuwait Fund for its' reluctance to finance a greater number of projects was the lack of sound project proposals and the shortage of trained staff to service these projects. Commercial bank officials in Kuwait intimated that the added risk of investment in projects where competent management was not apparent has precluded such investment. The standard of investment projects submitted for finance to the banks was also said to be of a low standard.
3. The absence of a favourable investment climate in general within the region has acted as the main barrier to the free flow of funds between Arab States. The unstable nature of a number of governments has left investors with little confidence in fellow Arab countries to manage their economies. The fear of investors is that they may face the political risks of expropriation, nationalisation, and stringent exchange control blocking the recovery of profits. Accordingly investors have preferred to invest outside the region where the political risk are not so high.

Until these non-financial barriers to economic growth are lowered the financial system in the Arab World is unlikely to change rapidly in such a way as to play a major role in the process of local and regional development. The two are complementary factors.

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