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**THE EFFECTS OF
GLOBALISATION OF FINANCIAL SERVICES
ON BANKING INDUSTRY AND STOCK MARKET:
AN ALGERIAN CASE STUDY**

By

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ABSTRACT

Since the mid-1980s, Algeria has embarked on a programme of comprehensive financial liberalisation to establish a market-oriented financial system, and to develop the role of the Algiers Stock Exchange in the mobilisation of financial resources. The transition from a centrally planned to a market-oriented economy meant fewer regulatory barriers towards local and foreign banks. This study demonstrates that financial liberalisation is the main force that drives the globalisation of financial services, followed by financial innovations and the Internet. Globalisation has affected the performance of the two prevalent banking models in Algeria: interest-based (conventional) and non-interest-based (Islamic). The benchmarks used to assess banking performance are: competition, profitability and efficiency. Quantitative and qualitative analyses show a direct link between banking efficiency and the globalisation of financial services. The study concludes that globalisation has more advantages than disadvantages to the Algerian banking sector and the Algiers Stock Exchange. The elimination of regulatory barriers has enabled state-owned banks to improve the quality of their services and to use more advanced information technologies. Private and foreign banks are also involved in the modernisation of the Algerian banking industry by launching innovative financial products and attracting local and foreign capital. However, this project emphasises that the removal of remaining regulatory obstacles would enable banks to benefit fully from the process of financial liberalisation, and to be active institutions in the financial market. Moreover, opening the Algiers Stock Exchange to large domestic and foreign companies would attract capital investments and boost equity trading in Algeria.

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LIST OF ABBREVIATIONS

ABC	:	Arabic Banking Corporation
BAD	:	<i>Banque Algérienne de Développement</i>
BADR	:	<i>Banque de l'Agriculture et de Développement Rural</i>
BCA	:	<i>Banque Centrale d'Algérie</i> (Central Bank of Algeria)
BCIA	:	<i>Banque Commerciale et Industrielle d'Algérie</i>
BDL	:	<i>Banque d'Algérie de Développement</i>
BEA	:	<i>Banque Extérieure d'Algérie</i>
BNA	:	<i>Banque Nationale d'Algérie</i>
CNEP	:	<i>Caisse Nationale d'Épargne et de Prévoyance</i>
CPA	:	<i>Crédit Populaire d'Algérie</i>
EU	:	European Union
GDP	:	Gross Domestic Product
IMF	:	International Monetary Fund
M1	:	Measure of Money Supply. It comprises all coins, notes and personal money in current and deposit accounts
M2	:	Measure of Money Supply. It includes coins, notes and personal money in current and deposit accounts
M/P	:	Money Balance
SGA	:	<i>Société Générale d'Algérie</i>

Chapter 1:

INTRODUCTION

1.1. Scope and background of the study

This research project analyses the implications of globalisation of financial services on the performance of the Algerian banking sector and stock market. This entails determining the main components of globalisation and how banks have responded to them. The study identifies globalisation of financial services as a process, which allows free trading of financial services and enables banks to compete and improve their profitability and efficiency. This, however, is only possible in the presence of financial liberalisation, financial innovations and advances in information technology such those of the Internet. We focus our analyses on the difficulties encountered by conventional (interest) and Islamic (non-interest) banks during the transition from a centrally planned economy to a market-oriented one, and what are the possible solutions to resolve them.

This study is motivated by the recent developments in the Algerian banking industry and stock market since the initiation of financial liberalisation in the 1990s, which contributed to the entry of foreign banks and to the emergence of private banks in the national financial market. Another motivation is the creation of an Islamic bank in Algeria, *El-Baraka* Bank, which operates according to *sharia* principles of lending and borrowing.

We have endorsed the argument that many barriers to domestic and foreign financial institutions are removed under the free market economy, reflecting the phenomenon of globalisation. The restructuring of the national banking sector has accelerated the interaction of supply and demand for financial products among the users of the financial system. Banks become willing to diversify their portfolios and to benefit from the economic liberalisation.

This study defines globalisation of financial services as a phenomenon that allows market forces to replace administrative mechanisms of financial resources mobilisation.¹ The result is a decline in the role of the government and an increase in the autonomy of financial institutions. Taking this definition into account, we have argued that globalisation of financial services is driven by three major forces: (1) financial liberalisation; (2) financial innovations; and (3) the Internet.

The liberalisation of national financial markets dismantles direct governmental control on banks' lending and borrowing. This enables foreign banks to compete with local banks for a market share. Likewise, financial innovations increase the number of financial products that facilitate the penetration of financial markets such as those of Algeria. New financial instruments are used in meeting the demand of domestic and foreign investors. In addition, the Internet has dramatically broadened banking businesses in the past decade. Many banks provide their services through the Internet

¹ There is no single definition that explains exclusively the phenomenon of globalisation. Gurley and Shaw (1960) noted that changes occur in the financial sector when new institutions, products or markets emerge. Anneart (1999) stressed that globalisation of financial markets has mainly been caused by technological advances, by financial liberalisation and by institutionalisation. Walter and Smith (1999) indicated that banking performance appears highly sensitive to globalisation; this makes financial markets unreliable, thanks to the many financial institutions involved in them. Masson (2001) pointed out that globalisation reflects an increase in the mobility of capitals, trade, individuals and information. He also noted that advances in information technology and economic stability facilitate the process of globalisation.

to achieve economies of scale and scope. Therefore, it is believed that financial liberalisation, financial innovations and the Internet are the main cause of globalisation of financial services in Algeria.

We are aware of previous studies on the Algerian financial markets, such as those of Jbili *et al* (1997) and Nashashibi *et al* (1998). In their study, they argued that the slow economic growth in Algeria, Morocco and Tunisia was due to poor mobilisation of financial resources (Jbili *et al*, 1997). Before the financial reforms, banks' funds were mainly used to finance government expenditures and state-owned enterprises. The amount of credit that went to the private sector was very small because of preferential lending rates and restrictions imposed on banking activities. Banking competition was also limited because of the restrictions on foreign banking entry, high specialisation and controls on capital account.

Mckinnon and Shaw (1973) noted that the order of economic liberalisation is a means to improve the mobilisation of financial resources because funds are used to finance high yield investments, and this contributes to a decline in the cost of borrowings. Financial liberalisation also results in an increase in the number of savings instruments and a decline in the risk of holding financial assets due to a rise in market liquidity.

Negative real interest rates and excessive regulations caused a sharp decline in savings and investment rates. Therefore, financial reforms were introduced to set up a market-based financial system. This was achieved by removing constraints on banking lending and borrowing, trade liberalisation and privatisation. Algeria's state-owned banks enjoyed a thirty-year banking monopoly, during which time the government forbade competition from foreign or private banks, but this changed with

the liberalisation of the national financial market. Facing competition from Algerian private banks and foreign banks, state-owned banks have had to adopt new lending policies, develop their information technologies, and improve the speed and the quality of their services to boost confidence with their clients. The growing network of emerged banks forces state-owned banks to improve their management and to develop new financial products. This study analyses the changes in banking activities, organisations and personnel during and after the financial liberalisation. It also examines the performance of the Algiers Stock Exchange, which is part of the financial liberalisation programme initiated by the Algerian government in the 1990s. Non-banking financial institutions are excluded as they are underdeveloped and because they are undersized compared with banking institutions.²

The research uses a single country case study (Algeria) because of its unique approach in liberalising its financial market. “Clearly, there are risks in making generalisations about the growth performance of the region (Middle East and North Africa) as a whole because each of the 24 economies has had its own experience, which in some ways remains unique” (Abed and Davoodi, 2003: 6). Also, at institutional level, a report entitled “*The Emperor Has No Growth*”, produced by a centre for Economic Policy Research claimed that implementing universal rules for capital flows and government reforms is a mistake (Weisbrot, Naiman and Kim, 2000).

² Algeria has four national insurance companies: (1) *Société Algérienne d'Assurance*; (2) *Compagnie Algérienne d'Assurance et de Réassurance*; (3) *Compagnie Centrale de Réassurance* and (4) *Compagnie Algérienne des Assurances Transport*. *Société Algérienne d'Assurance* insures non-industrial activities; *Compagnie Algérienne des Assurance et de Réassurance* concentrates on industrial risk insurance coverage; *Compagnie Centrale de Réassurance* specialises in reinsurance and foreign risk coverage; and *Compagnie Algérienne des Assurances de Transport* holds an exclusive monopoly on maritime, aerial and land insurance (Benhalima, 1998).

As in Armijo (1999), it is expected that financial liberalisation would reduce the role of the state in managing savings and investments.³ Researchers anticipate that as the government withdraws from the financial sector and as foreign players participate in the formerly closed national market, competition among different categories of banks will improve the quality of services offered to their customers.⁴ In particular, new private banks and reputable foreign banks will pressurise state-owned banks to increase the range of their services. Researchers also predict that the stock exchange will eventually play a major role in promoting savings and investments.

Before the financial liberalisation, banks were unable to monitor their borrowers or prevent them from funding poor investments (Thakor, 1998). In Algeria, state-owned banks accumulated a large amount of non-performing loans, which weakened their portfolios significantly. Worse still, loss-making state-owned enterprises became unable to service their debts and many of them went bankrupt. However, researchers expect that recapitalising state-owned banks and privatising state-owned enterprises will enhance their performance and promote their efficiency (McKinnon, 1993). Our study gives a detailed analysis of micro- and macro-level factors that affect banking performance in Algeria. In this study we argue that globalisation of financial services improves banking performance, which is measured using three benchmarks: (1) competition; (2) profitability; and (3) efficiency.

Financial liberalisation is the most important factor behind the rise of globalisation of financial services in Algeria, for four main reasons. First, it removed many

³ “In a globalized world, traditional territorial borders have become so porous that individual governments cannot take actions to regulate businesses, especially those relating to banking and finance” (Arnold and Sikka, 2001: 476).

⁴ In our sample, we divided banks into two categories: interest and non-interest banks. We classified banks according to their ownership and their mode of financing.

regulatory obstacles towards foreign banking entry. Second, it reduced the government's role in the banking sector through the elimination of various obstacles on state-owned banks' lending and borrowing. Third, it contributed to the emergence of new private banks. Four, it facilitated capital movements and allowed local banks to operate on both domestic and international levels.

How a country emerges into the global market depends on its distinctive economic, social, cultural and geographic features. In Algeria, oil exports remain the main source of government revenue, at about a quarter of GDP.⁵ Foreign debts have declined from USD33.421 billion in 1996 to USD28.014 billion in 1999 (Callier, Abdallah and Joly, 2001).⁶ In 1999, the Algerian population reached 30 million and the reported unemployment rate was 29.2 per cent (Callier, Abdallah and Joly, 2001).⁷ Culturally, Western lifestyles greatly influence Algerians' behaviour, notably in urban areas (Encyclopaedia of the Orient Online, 2003). Geographically, Algeria is the gateway between Europe, Africa and the Arabic world (Arab Banking Corporation Annual Report, 1999). Although political risks during the 1990s caused a decline in foreign direct investments, the government has since embarked upon a programme of political and economic reform, (including economic liberalisation with the guidance from the International Monetary Fund), to attract foreign capital and to improve the social environment (Nashashibi *et al*, 1998). Results have been positive, especially in the banking sector, where many new private and foreign players have entered the market.

⁵ Industry is the largest economic sector, at 39 per cent, followed by transport at 21 per cent and housing at 20 per cent. The service industry accounts for only 9 per cent (Callier, Abdallah and Joly, 2001).

⁶ The debt services increased from 30.3 per cent of exports in 1997 to 39.5 per cent in 1999.

This chapter has three sections. The first section examined the background and motivation to the study. The concept of globalisation is defined in the context of financial liberalisation and advances in information technology. The second section explains the study's rationale. The final section identifies the study's implications.

1.2. Rationale of the study

In this study, we argue that globalisation has changed the banking industry both structurally and technologically.⁸ Policy makers no longer entirely determine the shape of the banking industry; financial deregulation has removed inhibiting obstacles to free trade; and information technology, having accelerated the speed of economic integration, continues to impact the structure and activity of financial institutions. So sweeping are these changes that researchers have found it difficult to fully comprehend them.

Before the financial reforms, the state had entire control of what is called 'strategic' sectors, which were receiving generous subsidisation. Preferential lending rates and excessive control on commerce and foreign exchange were also the norm before the reforms. This made the public sector grow at a faster rate than the private sector. State-owned enterprises were forced to achieve a given level of outputs to receive financial support from the government. The tools used by authorities to reduce the effects of open inflation were price control, subsidisation and foreign exchange control.

⁷ 50 per cent of the population are under 20 years old and the growth rate is 2.1 per cent.

⁸ "For economists, the global economy has emerged from business decisions and strategies" (Filipović, 1997: 2).

Administrative interest rates and large intervention by the government in credit allocation were typically used to ensure the stability of the financial system. Preferred interest rates and direct credit were applied to make funds available to priority sectors. Direct credit and banking refinancing were also adopted by the central bank because of the absence of a money market. The result is high segmentation within the banking industry and very limited competition between the state-owned banks.

The role of the financial sector was to collect public savings at low cost and to use the funds raised in financing government expenditure and projects by state-owned enterprises. The bond and equity market were non-existent and a development bank was created to meet the financial needs of medium- and long-term investments.

After the introduction of financial liberalisation in the 1990s, Algerian banking regulations have changed in three main ways. First, private and foreign players have been allowed to enter the national financial market. Second, state-owned banks have gained extensive operational autonomy since the initiation of financial liberalisation. Third, new financial products have emerged in the domestic market immediately after the entry of foreign banks and the set up of private banks. This study examines how these factors have affected the structure of each banking group: (1) state-owned banks; (2) foreign banks; (3) private banks; and (4) the Islamic bank.

Eliminating economic, social, political and technological obstacles has allowed foreign banks to set up and operate in Algeria.⁹ These trends have both positive and negative implications: “going global” has helped banks diversify their portfolios and increase their market share, but the entry of foreign players into the national financial market has also raised fears about the future of local banks. Because of this,

policymakers have introduced structural and institutional reforms to improve the financial position of state-owned banks. This research will examine the three most important parts of financial liberalisation: (i) interest rates; (ii) recapitalisation; and (iii) privatisation.¹⁰

Scholars agree that foreign banks benefit the financial markets of developing countries (Bonin and Leven, 1996).¹¹ The advantages they bring include capital, experience, skills and advanced management. By providing innovative products, encouraging consolidation, and developing services, foreign banks strengthen the local financial market and motivate local banks to become more healthy institutions. In addition, foreign banks transfer knowledge and technology to the host country, which helps cut the costs of conducting financial transactions. However, the competitive advantage of foreign banks over local banks can cause market instability because depositors and borrowers move to foreign banks (Knight, 1998). Local banks often need a long time to improve their financial conditions; this is due to management problems and risks associated with their financial instruments.¹²

The impact of structural reforms and fiscal sustainability on the process of reforms is addressed in this study. Stable macroeconomic conditions encourage policymakers to reform the financial sector. Sustainable fiscal balances and low inflation rates are mechanisms to avoid negative real interest rates and to reduce the risk of holding

⁹ A thorough analysis on the characteristics of global financial markets is presented in Chapter 2.

¹⁰ McKinnon (1973) pointed out that privatisation is one of the major reasons for the breakdown in financial restructuring. Many scholars, such as Bonin and Leven (1996) and Doukas, Murinde and Wihlborg (1998) endorse this argument.

¹¹ See for instance, Abarbanell and Bonin (1997), Bonin and Leven (1996) and Fink *et al* (1998).

¹² Azzam (1999) argued that local banks can become stronger through consolidation or mergers. Consolidations reduce operating costs and therefore improve organisational efficiency.

financial assets. The study examines the relationship between macroeconomic variables and the process of financial reforms.

This study also considers the impact of globalisation on the performance of the non-interest bank (*El-Baraka* Bank) as it forms part of the banking sector in Algeria.¹³ Under the rules of Islamic finance, banks cannot pay interest on deposits; this is different to conventional banking practice, in which banks use interest rates to attract savings and to manage their funds. However, the ultimate objective of both interest and non-interest banks is to increase societal wealth. Globalisation allows non-interest banks to improve their business and to penetrate financial markets such those of Algeria.¹⁴

The thesis is organised as follows:

- Chapter 2 provides a literature review, presenting influential papers that explore how globalisation of financial services has changed the structure of the banking industry. Topics covered include financial liberalisation, financial innovation and the Internet. This chapter also incorporates scholarly analyses of non-interest banks lending and borrowing mechanisms.
- Chapter 3 traces the history of Algeria's financial system from independence to the present day, comparing the organisation of the Algerian banking system before and after financial liberalisation. We pay special attention to the past

¹³ We divided banks into interest and non-interest types to compare the two banking models. We explain the characteristics of non-interest banks in detail in Chapter 4.

¹⁴ In the past decade many non-interest banks opened representatives and subsidiaries in large financial centres such as London, New York and Frankfurt.

decade. This chapter covers all measures implemented by the Algerian government to liberalise the national financial market.

- Chapter 4 provides a detailed analysis of the two prevalent modes of Algerian banking, namely interest and non-interest. We also discuss the effects of globalisation of financial services on their profitability, and examine the competition between the two banking models.
- Chapter 5 deals with the research methodology. It discusses the qualitative and quantitative methods used in this study as well as research limitations. Problems encountered during the research field and in gathering primary data are also presented in this chapter.
- Chapter 6 is the core part of the study. It examines how each banking category has responded to financial liberalisation and to the emergence of new financial products. The correlation between the macroeconomic framework and the process of reforms is discussed, and the role of the Internet in the development of the national market is analysed. Also, the impact of financial reforms on banking competition and profitability is discussed. Finally, the performance of the Algiers Stock Exchange is assessed as part of the financial liberalisation process.
- Chapter 7 addresses the study's concluding remarks and policy recommendations. First, it states the applications of the study to the Algerian banking industry and stock exchange. Second, it shows what is learned from this study. Finally, it identifies proposals for further research.

1.3. Implications of the study

This study makes a contribution to the literature on the banking industry and stock market developments in Algeria. Previous studies, such as those of Jbili *et al* (1997) pre-dated the opening of the Algiers Stock Exchange for trading in 1999. Besides, those studies were on a group of selected countries, such as the *Maghreb* region.¹⁵ In general, little attention has been paid to countries such as Algeria, perhaps because of the lack of data or the high political risk involved in conducting studies there during the 1990s (banks' senior managers, 2002). Given this lack of attention, this study offers an opportunity to highlight the changes that have occurred in the Algerian financial market since the initiation of financial liberalisation in 1990.

Previous studies also hesitated to address the issue of Islamic banking in Algeria. Therefore, this study takes the opportunity to examine the simultaneous effects of globalisation of financial services on conventional and Islamic banks, in terms of competition and profitability. The results show how conventional and Islamic banks are performing to increase their market share and to boost their profitability. This includes an examination of their mode of receiving funds and financing in Chapter 4.

In this study we first ask what are the main forces that drive the globalisation of financial services in Algeria? Second, we ask what are the problems encountered by interest and non-interest banks during the transition from a centrally planned economy to a market-oriented one. Third, we ask what measures could improve the Algerian banking industry and stock market performance. Fourth, and most

¹⁵ There are three countries that form the *Maghreb* region: Algeria, Morocco and Tunisia.

importantly, we ask how banks could survive the pressure of globalisation of financial services.

The findings achieved in this research can be used by policymakers as guidance for further financial reforms in Algeria and by banks to improve their performance. The Algerian financial market is considered to be in transition because Algeria, formerly a socialist country that kept all banks under state ownership, has been engaged since 1990 on a programme of financial liberalisation. In a modern economy, it is also a disadvantage to isolate domestic financial markets from foreign ones. Finally, foreign banks are concerned with developments in Algeria, as a place to diversify their portfolios and to increase their market share.

The next chapter explores the different schools of thought on globalisation and its implications for the financial markets of the former socialist countries. It includes reference to the most influential papers on financial liberalisation, financial innovations, the Internet and the non-interest banking model, and examines how globalisation of financial services impact the banking industries of the former socialist countries in terms of competition and profitability.

Chapter 2:

LITERATURE REVIEW

2.1. Introduction

This chapter examines globalisation of financial services from various scholars' points of view, reviewing papers on a topic-by-topic basis. The benchmark used for the selection of author is the scope of their studies. We analyse the characteristics of a financial system in a centrally planned economy, then study the changes that occurred in the structure of non-interest and interest banks caused by differences between the two banking models. We synthesise the views of these scholars to produce a coherent overall picture.

In the former socialist countries, the government owned all financial institutions and did not allow private ownership of banks. Nationalisation and rigorous control of domestic banking operations made the socialist banking sector highly centralised (Shaw, 1973). These monopoly practices also restricted the integration of financial markets. In the late 1980s and early 1990s, almost all socialist countries introduced financial liberalisation in order to open their financial sector to private and foreign ownership. Programmes of financial liberalisation dismantled the barriers that previously inhibited local and foreign financial institutions (Bonin and Wachtel, 1999), producing increased numbers of private and foreign bank branches,

representatives and subsidiaries. As these programmes went into effect, governmental intervention in the financial sector decreased dramatically.

Banks use innovative financial products to acquire new market share locally and internationally (Harrington, 1992). Three factors enable banks to introduce new financial instruments: technology, money and the institutions' internal organisation. Silber (1975) noted that money is the primary financial instrument used by banks in conducting their daily transactions. Money is also used as a means to create other financial products. Financial innovation produces products that may be traded internally and across international frontiers, and demand for the new instruments assists the process of globalisation. New products also enable banks to lower their running costs (Silber, 1975: 2).¹⁶

The Internet provides both bankers and consumers of financial services with information about banking services. Banks now offer almost all their services through the Internet, allowing customers to make balance inquiries, to pay bills, to transfer money between accounts, and more (Jun and Cai, 2001). Internet banking has been growing rapidly in recent years, notably in developed countries, where it has had enormous influence on banking operations and personnel (Hughes and Stone, 2002). Analysts predict that e-banking will continue to grow and that this growth will drive banks to perform in a more global network (Oxford Analytical Citibank, 1999).

Financial liberalisation, financial innovations, and the Internet permit interest banks to compete in host countries' financial markets and non-interest banks may now also enter European and American markets. The number of foreign banks

¹⁶ On financial innovations see: Copelman (1996) Mullineux (1996) and Quian and Rose (1997)

offering Islamic financial products has also increased dramatically. Because Islamic and conventional banking models use different financial techniques and products, analysts anticipate competition between interest and non-interest banks (El-Ashker, 1987). This competition will add new products to the financial market, products that will affect banks' balance sheets and ultimately market behaviour. Non-interest banks have attempted to modernise their operations by introducing new instruments that meet *sharia* rules. They have also tried to convert Western financial instruments, such as zero coupon bonds, into Islamic instruments by eliminating interest rates and by keeping the bond's nominal value.¹⁷

Islamic banks account for less than one per cent of worldwide assets. Their capacity to penetrate financial markets is limited because of their low capital, and the small number of non-interest banks (176 worldwide) is insufficient to meet the financial needs of more than one billion Muslims. However, researchers anticipate that the removal of regulatory constraints on non-interest banks entry into Western financial markets will help them expand in coming years (Fox, 1996).

The non-interest banking model is based on *sharia* law, in which profit- and risk-sharing are the key concepts of the financial system (Warde, 2000). In the interest banking model, by contrast, banks aim to maximise their shareholders' value by investing in creditworthy projects (Al-Omer and Abdel-Hak, 1996). Some of the few financial products that fit with *sharia* rules are *musharaka* (partnership/joint-venture), *istisna* (manufacturing contract) and *mudaraba* (profit and loss sharing).

¹⁷ Zero coupon bonds are bonds in which there is no interest payment during the life of the bonds. Investors purchase zero coupon bonds at a deep discount from their face value that is the value of a bond at the date of maturity. When the bond becomes due, investors receive their initial investment plus accumulated interest. The issuers may still have to pay interest to local income tax, as in the USA. But, usually zero coupon bonds are exempted from tax. In almost circumstances the maturity of zero coupon bonds exceeds ten years and their price tends to fluctuate in the secondary market.

Most securities are not acceptable because they involve payment or collection of interest (Parigi, 1989). Another difference between the two banking models is that non-interest banks may in certain circumstances work to satisfy social needs, but interest banks operate only to make profit (Warde, 2000).

Scholars offer different interpretations of globalisation's impact on financial markets of countries in transition. Their views are influenced by many factors such as their educational background and the sample chosen for their studies. This literature review tries to cover the most influential papers.

2.2. Financial liberalisation

2.2.1. Centrally planned economies before the financial liberalisation

In developed countries, the process of financial liberalisation started in the 1960s and 1970s when banks in the former socialist countries were still under state control (Morison, 1999). Not until the financial liberalisation programmes of the 1980s and 1990s did those countries develop market-oriented banking systems.

Two factors illustrate financial market concentration in a centrally planned economy. First, the government generally ensured that a few banks hold the majority of financial assets. Second, the government nationalised existing foreign financial institutions and implemented regulations to prevent foreign competitors from entering the national financial market (Knight, 1998: 14).

Consider some weaknesses of the socialist banking model. Centrally planned economic regimes had no capital markets, which meant that governments could not issue sizeable bonds to the public. The banking system was also weakened by ceiling interest rate placed on deposits and loans, and by lack of competition from foreign

financial institutions and from the private sector. McKinnon (1993) noted that to improve the banking sector and to prevent credit from going to non-creditworthy enterprises, governments should stop using monetary instruments to draw money from local banks. The government should continue this practice until it has eliminated all non-performing loans. “Starting off with a highly centralised, but “passive” state-owned banking system, the socialist economies must move vigorously at the outset of liberalization to harden the system of money and credit” (McKinnon, 1993: 6).

McKinnon (1973) and Shaw (1973) stated that capital control and high reserve requirements are the main cause of financial depression in less developed countries. Therefore, it is necessary for those countries to remove all those obstacles, to eliminate all restrictions on capital inflow and outflow, and to open the domestic market to foreign investors.

Administrated interest rates and bad debts have negatively affected state-owned banks’ profitability and efficiency (McKinnon, 1993: 44). McKinnon stressed that interest rates need to be positive on both loans and deposits, and emphasised that banks should promote payment mechanisms to encourage savings and foster banking assets.¹⁸

In the former socialist countries, interest income could not cover interest expenses plus administrative charges.¹⁹ Despite the effects of interest rate regulation, bank managers never requested different financial rules because volatile interest rates

¹⁸ Price-level volatility usually contributes to unstable interest rates and exchange rates, which leads to increased borrowing and lending risks by deposit-taking banks.

¹⁹ Banks should put an end to the credit to the enterprises that do not pay loans and their interest in their maturity date. The default rate on exorbitant loans can be substantial (McKinnon, 1973: 74).

would have negatively affected banking competition and earnings (McKinnon, 1973).

Centrally planned economies also saw poor mobilisation of financial resources (Shaw, 1973). Governments used bank funds to finance their expenditures and state-owned banks were obliged to hold government securities. The result was a high unit cost of state-owned banks' financial assets, a cost exacerbated by the difference between the lending rate and the borrowing rate. Large-scale government intervention in the financial sector ultimately caused a scarcity of capital, an effect contradictory to the financial authorities' putative objective — i.e. providing capitals for investments (Shaw, 1973: 88–9).

Long-term direct finance was non-existent in almost all former socialist countries, which instead financed government projects through the treasury (Shaw, 1973). Some countries had stock exchanges, but their operations were limited to issuing securities by the government and by foreign trade corporations.²⁰ Long-term securities were also hampered by complex accounting and financial legislation.

Mismanaged investments also contributed to the socialist era's poor financial record. Most bank-financed projects were not profitable, meaning that loans were not repaid on time (if at all). Moreover, the scarcity of capital encouraged banks to restrict their lending. Shaw stresses that financial depressions discouraged financial liberalisation because such situations give more monopoly power to national banks (Shaw, 1973: 92).

²⁰ In Algeria the stock exchange was absent and state banks were the dominant in the financial sector.

Capital and inter-bank markets were absent in all former centrally planned economies, and non-financial institutions were not allowed to hold government bonds or to trade private firms' shares. All of these factors caused a misallocation of domestic financial resources.

Socialism's financial authorities seemingly remained convinced that high interest rates, capital scarcity, direct control on investments, and subsidised government projects could ensure national financial success (Shaw, 1973). However, bad economic and social conditions adversely affected savings, investments, and growth; the ceiling interest rate on loans and deposits made return on financial assets for state-owned banks negative; and governmental intervention weakened the financial sector. "Effective low ceiling on real loan rates intensify risk aversion and liquidity preference on the part of intermediaries" (Shaw, 1973: 86).

Governments used bank deposits to finance specific activities, then protected those activities with subsidies. Furthermore, poor credit decisions negatively affected banks' portfolios (McKinnon, 1973: 69). The logic of liberalisation should prevent such *self-finance* and allow banks to fund only profitable investments.

Limitations on lending, consumers' risk-averse preferences, ceiling interest rates and high banking charges seriously impeded competition in the socialist banking sector. The sector did not achieve economies of scale and scope due to the absence of competition among state-owned banks, and no mechanisms existed to determine the lending costs and risk associated with investments. "In the absence of a free market, where credit would have been rationed by price – the price reflecting the cost of funds and the risk of loss – credit was largely rationed by perceived quality" (Morison, 1999: 38).

2.2.2. The process of financial liberalisation

The problems encountered during the centrally planned economy urged financial authorities to introduce the process of financial liberalisation. Abiad and Mody (2003) constructed an index for financial liberalisation. The index was formed using six indicators: (1) directed credit/reserve requirements; (2) interest rate controls; (3) entry barriers and/or lack of pro-competition policies; (4) restrictive operational regulations and/or lack of prudent regulation; (5) the degree of privatisation in the financial sector; and (6) the degree of controls on international financial transactions. They used data of thirty-five countries, from 1973 to 1996. Countries were classified into four groups: fully repressed; partly repressed; largely liberalised; and fully liberalised. Following their analyses, they concluded that countries supporting reforms are benefiting more than those who oppose them. Initial reforms also make further reforms essential to achieve government goals of financial liberalisation. Other factors influencing the decision makers to introduce further reforms are: the sequence of reforms in the neighbouring countries; the International Monetary Fund programme of financial liberalisation; trade openness; balance of payment deficit; and the decline in interest rates.

Drazen and Easterly (2001) found that hyperinflation delays the progress of financial liberalisation and makes policy-makers reluctant to produce a coherent agenda of reforms. Hyperinflation causes microeconomic imbalances such as decline in the value of banks assets. Rajan and Zinglas (2002) noted that trade openness and foreign capital movements are the two main driving forces of financial reforms.

Helleiner (1999) emphasised five aspects of financial liberalisation. First, financial reforms are inevitable in countries where non-performing loans account for a large proportion of bank credit. Second, financial liberalisation must be implemented gradually. Third, financial reforms must abolish direct credit and ceiling interest rates. Fourth, financial liberalisation requires macroeconomic stability. Fifth, reforms should inject liquidity into national banks to alleviate the burden of non-performing assets.

Reformers should set up a time-frame for financial liberalisation, taking into account the degree to which government regulation has inhibited banking networks' growth, and examining how banks' capital adequacy, assets, and liabilities have fluctuated over time. Banks also require effective internal management and attentive external supervision for a successful transition to a free-market environment (Helleiner, 1999).

Financial liberalisation results in a market-based system where the government exercises only modest control over the financial sector. Depending on the national financial system's features, financial authorities can enact financial liberalisation programmes gradually or very quickly. Most countries have preferred a step-by-step approach to financial liberalisation (Oxelheim, 1995: 28), which is usually more successful than introducing reforms overnight (McKinnon, 1993: 4).

Oxelheim (1995) divided financial liberalisation to two categories, internal and external. Internal financial liberalisation necessitates removing four factors: 1) control over local financial institutions' activities; 2) interest ceilings on deposits and credit; 3) government intervention in the financial sector; and 4) taxes on financial institutions. External financial liberalisation focuses on eliminating exchange rates

and capital control, removing restrictions on cross-border financial operations, and abolishing multiple exchange rates and taxes on foreign financial transactions.

Pill and Pradhan (1995) claimed that financial liberalisation requires a non-inflationary environment. Many countries have found that conducting programmes of liberalisation in inflationary economies has negative effects on the banking industry (Pill and Pradhan, 1995). In fact, banks' assets decline steadily during the process of liberalisation in hyperinflationary countries.

Financial liberalisation has five common factors: abolishing foreign exchange control; eliminating credit control; opening domestic financial markets to foreign participation; dissolving barriers inhibiting local financial institutions; and liberalising money and capital markets. All these courses of action allow banks to transfer funds across frontiers and to establish niches in domestic and foreign markets.

Jbili *et al* (1997) assessed the sequence of financial sector reforms in the three *Maghreb* countries: Algeria, Morocco and Tunisia. They stressed that non-financial variables, such as those of structural reforms and fiscal policies affects savings, investments and growth. This argument is based on a study by Gurley and Shaw (1960), in which they pointed out that economic development is a means to increase the availability of capitals in the financial sector.

High inflation rate and fiscal imbalances make economic growth less sensitive to financial sector reforms. A stable macroeconomic environment helps authorities to reform the financial sector with great precaution. Sustainable fiscal balances and low inflation rates are tools to avoid negative real interest rates, to make financial variables more informative and to reduce the risk involved in holding financial

assets. Jbili *et al* (1997) said that financial sector reform needed to be implemented even if the macroeconomic conditions were not in favour of the reforms as this may improve economic stability within the long-term.

Macroeconomic imbalances in the 1980s forced all the three *Maghreb* countries to initiate financial sector reforms (Jbili *et al*, 1997). Financial authorities introduced price controls and posed restrictions on trade and payments to reduce the effects caused by fiscal and current account deficit. This was followed by structural reforms under the support of the International Monetary Fund. However, monetary imbalances were not restored because of the large amount of loans extended to priority sectors in Tunisia and to monetise fiscal deficits in Algeria and Morocco.

Inflation increased dramatically during the early years of the reforms, but did not exceed the annual rate of 15 per cent. Reserves also declined substantially to almost a month of imports in Algeria and Tunisia and to a minimum of a week in Morocco (Jbili *et al*, 1997).

Jbili *et al* (1997) examined the process of financial reforms in Algeria, Morocco and Tunisia from 1970 to 1995. They said that the methods followed in reforming the financial sector were similar in the three countries. This included: (1) liberalising interest rates; (2) removing direct credit; (3) adopting market-based mechanisms in financing the state budget; (4) strengthening the monetary policy; (5) opening new markets and launching new financial instruments; (6) reinforcing banking supervision and financial rules; (7) boosting banking competition; and (8) liberalising capital account. The aims of the reforms were to reduce the role of the government in the financial sector, to improve financial resources mobilisation and to develop market-based monetary policy instruments. Jbili *et al* (1997) noted that

the scope of reforms was less broadened in Algeria than in Morocco and Tunisia, where financial authorities were also involved in the structuring of bond and equity markets.

The sequence of financial sector reforms had been influenced by issues of macroeconomic stabilisation, such as those of fiscal budget (Jbili *et al*, 1997). In Algeria, the substantial amount of fiscal losses generated by state-owned enterprises made commercial banks continue to use preferential credit financing. Fiscal losses also caused negative effects on the liberalisation of interest rates as well as banking competition.

Jbili *et al* (1997) examined the quantitative side of financial reforms by measuring the relationship between financial indicators, which are applicable to the process of reforms and to the non-government saving rates. Their aim was to analyse if the reforms had positive effects on non-government savings rather than evaluating the country saving rate as this was subject to other indicators such as per capita income and demographic aspects.

The financial variables included in Jbili *et al* study are: (1) real interest rate; (2) the ratio of M2 over GDP; (3) credit to the non-government sector in per cent of GDP; and (4) reserve money to deposits. The financial variables were used as indicators of the progress obtained within the financial sector because of the process of reforms. They selected three different periods for their investigation: (i) the entire period (1970–1995); (ii) before the reforms and (iii) after the reforms. Quantitative measures were made before and after the financial reforms to analyse the correlation between non-government savings and main financial variables. Dummy variables related to non-financial factors such as drought and variables that may affect directly

non-government savings such as per capita to GDP were also excluded in their investigation. Per capital and non-government disposable income were presented differently in the regression analyses of Morocco and Tunisia. The regressions found by Jbili *et al* were almost similar to the coefficients of the financial variables. But, they emphasised the impact of financial sector reforms on the savings rate without the inclusion of other factors, which may have had similar effects.

The lack of data influenced the result and scope of Jbili *et al* (1997). Data on credit to the private sector were not fully available, especially for Algeria. Another factor that may cause bias is that banks can be pressurised to meet the financial needs of state-owned enterprises. Private enterprises and households savings, which form part of the non-government saving rates, are not separated; this can cause problems in the quality of the data, because state-owned enterprises savings' trends may differ from those of households. For instance, state-owned enterprises savings may decline because of the increase in their losses after the rise in real interest rates. On the other hand, the increase in real interest rates may escalate household savings because incentive effects are superior to those of income effects. Jbili *et al* (1997) also emphasised the difficulties in identifying suitable financial variables for quantitative assessment of the progress achieved because of the reforms.

Factors affecting banking performance at the micro-level were also not fully discussed in Jbili *et al* (1997), as the main focus was to assess the sequence of reforms on non-government savings rate. They stressed that the volume of intermediation, return on savings and the effectiveness of intermediation increased after the creation of a market-based financial system. But, they did not examine how banks operated after the financial reforms to accelerate their intermediary role

between savers and borrowers, and also how the entry of foreign banking affected the financial markets of the three countries.

2.2.2.1. Liberalisation of interest rates

The first component of financial liberalisation is the elimination of administrative interest rates. Matutes and Vives (2000) and Stiglitz (1994) stated that interest rate ceilings help banks avoid destructive competition. In highly competitive conditions, high-deposit interest rates increase the cost of capital and lower investments. Low interest margins stimulate banks to monitor their borrowers carefully. Researchers therefore conclude that ceiling interest rates prevent many constraints on investments (Stiglitz, 1994).²¹

Sarr (2000) examined the impact of interest margins on the market-oriented banking sector. He found that in an open market banks seem to exploit profit maximisation to cover their service fees.²² Sarr also argued that banks with large deposits could offer attractive lending rates. Economies of scale and non-bank services also drive the marginal cost of deposits by reducing banks' lending and borrowing rates. He concluded that in a liberalised banking sector, deposits do not reflect financial deepening because banks know how interest rate changes affect their deposits. Offering higher interest rates on savings accounts increases banks' operating expenses and thus reduces their profit margin.

Bandiera *et al* (2000) used capital account liberalisation, bank ownership, interest rates, directed credit, reserve requirements, prudential regulation and deregulation of

²¹ Interest margin is the spread between the rate charged on loans and the rate paid on deposits (Demirgüç-Kunt and Huizinga, 1998).

securities markets to form an index for financial liberalisation. The data span from 1970 to 1994. They noted that the relationship between real interest rate and savings is negative and significant in Ghana and Indonesia. The short-term impact of financial liberalisation on savings also varies across countries: positive and significant in Turkey and Ghana, negative and significant in Korea and Mexico.

Bandiera *et al* (2000) confirmed the existence of liquidity constraints, but without emphasising on the role of financial liberalisation in alleviating them. The results of the Euler equation indicated that in most cases the impact of financial liberalisation on credit allocation was small. They concluded that real interest rate has no direct impact on savings and the implications of financial liberalisation vary across countries.

Usually, the liberalisation of interest rates raises costs and lowers profits (Humphery and Pulley, 1997).²³ The borrowing rates increase substantially during financial liberalisation leading to decline in banks' profit margin. Banks react to shifting interest rates by cutting costs (often by reducing the numbers of branches and workers), using floating-rate loans,²⁴ raising fees on deposits, and extending credit to high-risk borrowers. Banks will also shift costs onto their borrowers and may become involved in securities activities as an additional cost-transference measure.²⁵ Banks will also adjust their capital to moderate the effects of interest rate liberalisation (Humphery and Pulley, 1997).

²² Chiappori, Perez-Castrillo and Verdier (1995) noted that profit maximisation boosts the network size, lowering long-term credit rates as a result.

²³ In the 1980s, interest rate deregulation increased costs and lowered profits of many USA banks.

²⁴ Global interest rates are measured either on floating or a fixed-rate basis. Under floating interest rates and variable future costs, the net present value of loans change slightly. Under fixed interest rates and fixed costs, the net present value of loans may raise or decline drastically.

²⁵ Large banks often enjoy high profits because of technological advantages; small banks are more likely to see higher profits as a direct result of improved business conditions.

Oxelheim (1995) noted that banks yield a small amount of earnings in markets with a low interest rate margin. The margin on borrowers' loans fall because of increased liquidity and reduced credit rationing. In a free market economy, most investors pay lower lending rates and depositors receive higher interest rates on their savings than they would in a centrally planned economy (Oxelheim, 1995).

Hanohan (2003) examined the effects of financial liberalisation on money market and bank interest rates (wholesale rates). He found that the process of liberalisation has resulted in an increase in the real and nominal interest rates. Banks spread also escalates as financial liberalisation progresses. The removal of interest rates controls makes rates dependable on market forces, which force deposit rates downwards and lending rates upwards. Theoretically, real interest rates reflect nominal interest rates adjusted by inflation. However, in practice, there are other factors that influence real interest rates including the followings: propensity to save, marginal efficiency of capital, level of risk and country monetary policy.

Jbili *et al* (1997) noted that the adoption of step-by-step interest rate liberalisation in the aftermath of high administrative interest rates was vital for the success of financial reforms in Algeria, Morocco and Tunisia. In 1990, the Algerian financial authorities placed similar lending and borrowing rates on the public and private sectors, and their commercial papers were given the same standards of refinancing. Four years later, limits on banking spread were in place instead of ceilings on lending rates. In December 1995, limits on banking spreads were eliminated. Real interest rates remained negative until 1995 due to a sharp increase in inflation after the liberalisation of price controls. In Morocco, authorities started by raising administrative interest rates and eliminating the subsidisation of interest rates to

priority industries. Liberalisation of interest rates was completed in the first instance. Limits on banking spread were in place instead of ceilings on lending rates. Exclusion was given to credit extended to exports and to small- or medium-size enterprises. The limits imposed on lending and deposit rates were also removed. Exceptions were made for small savings and sight deposits.

Unlike Morocco, Tunisia did not liberalise lending rates to priority sectors in the early part of its financial liberalisation (Jbili *et al*, 1997). Instead, term deposits rates of less than three months were liberalised and special saving accounts rates were linked to the money market rate of the previous month. Spread for lending rates was given up to 3 per cent points above the money market rate (except for credit related to priority sectors). In the second stage, preferential rates for priority sectors were raised, but exceptions were made for the agricultural sector, with just a modest increase. Lending rates for priority sectors were liberalised, albeit limits on deposit rates were fixed at two per cent on sight deposits and two per cent above the money market rate for savings deposits.

Khan and Sunhadji (2000) emphasised that the availability of capital would not necessarily lead to high economic growth. The increase in real interest rates, which accelerates household savings, can lead to over-borrowing and a decline in the quality of credit. Brock and Rojas-Snarez (2000) also found evidence that spreads in Latin America do not fulfil international standards.

Rock and Rojas-Suarez (2000) found evidence of a positive relationship between spreads and non-financial costs such as wages. Another factor with direct impact on spreads is provision for bad debts. Saunders and Schumacher (2000) said that the increase in the capital used by banks as a precaution from risky loans results in high

spreads. The holding of extra capital would make banks pay more taxes. Meeting the expected capital ratios would also force banks widen the spread between the lending and the deposit rate. Finally, Brock and Rojas-Suarez (2000) argued that the absence of accounting standards and unsuitable risky asset classification makes the capital to asset ratio have little influence on spreads.

2.2.2.2. Elimination of lending restrictions

Alleviating constraints on banking lending is the second criterion used in assessing the process of financial liberalisation. Mishkin (2001) noted that financial liberalisation improves accountability and transparency within the banking sector while removing liquidity barriers in financial markets. Bekaert, Harvey and Lundblad (2001) used panel and aggregate data analyses to examine the impact of financial liberalisation on banks' borrowing in Turkey. They found a one per cent increase in output growth rates of domestic banks after liberalisation of financial markets. In their conclusion they emphasised a sound regulatory and supervisory system, using international reporting standards, to benefit fully from the process of economic liberalisation. Johnson (2000) pointed out that it is essential for banks to have adequate information about factors such as consumer behaviour and market risk of the host country. Foreign banks should also understand the host country's economic and political conditions, the size of its local and foreign financial institutions, its policies on financial deregulation, its local business culture and its market length.

Brownbridge and Kirkpatrick (2000) said that alleviating credit controls and liberalising interest rates would encourage banks with moral hazard to invest in risky projects. The new regulations give more autonomy to those banks to engage in

various activities and to take high risk. Therefore, they recommended swift restructuring of the banking system to avoid an escalation in banks' losses.

Financial liberalisation brings capital into the local financial market, encouraging local banks to fund highly risky projects (Sikorski, 1996). This process can continue until moral hazard forces banks to cover their losses with discount credit. Financial authorities normally use discount rates or reserve requirements to reduce the lending rate, but if the discount policy fails, banks will use central bank liquid assets to continue lending (Sikorski, 1996: 178-9).

Sundararajan and Baliño (1991) stressed that a well-managed banking structure avoids concentrating financial power and allows banks to offer competitive lending and borrowing rates.²⁶ Moreover, Parker (1998) stated that in global financial markets, authorities need to separate out control, relationships, market segments and protection, and need to strengthen the relationship between financial institutions, borrowers and depositors.

Demetriades and Fattouh (1999) argued that financial liberalisation generated unproductive credit to countries such as South Korea.²⁷ Local banks used international financial markets to finance domestic investments, but incomplete and unclear information about the financed projects made this credit highly risky in the short-term. Further lending to those projects caused large banking losses and ultimately financial shock to the whole system. Unproductive credit occurs in a soft budget constraint economy where borrowers and lenders expect high return. Long-

²⁶ In a market economy interest rates movements depend on anticipation of foreign interest rates and exchange rates; therefore it is also essential to pay attention to international rates.

²⁷ Unproductive credit means that loans went to unprofitable projects and eventually became non-performing loans.

term changes in economic conditions lead to moral hazard, and increase the number of non-performing loans.

Although local banks may use foreign credit to meet the high demand for loans, currency devaluation during financial liberalisation can aggravate local investors' financial positions, making it difficult for them to service their loans. As a consequence, banks' losses escalate. McKinnon and Pill (1998) noted that market failure seems to be the norm in countries where credit institutions are not well integrated within the domestic financial system. To minimise the possibility of long-term financial shock, it is necessary to liberalise the financial sector adequately (Demetriades and Fattouh, 1999).

2.2.2.3. The openness of domestic market to foreign banks

Liberalisation of financial markets enables banks to serve local clients in the host country, to penetrate foreign financial markets and to provide new financial services. Foreign players compete with local banks and increase their market share through investment banking and leasing. Large market coverage also allows foreign banks to increase their earnings (Walter, 1988: 102–3).

Davis (1983) pointed out that in the first stage of financial liberalisation, foreign banks provide basic financial services such as international trade and foreign exchange. The foreign banks' first objective is to meet clients' financial needs at a low price, but increased competition and demand for financial products (such as syndicate loans) stimulate them to offer a variety of banking solutions.

Other barriers confronting foreign banks include a small number of locations, a limited category of consumers with whom foreign banks can deal, business

constraints, and inadequate linkage to international financial markets. Foreign banks prefer to offer their services to large companies, which are based in industrial zones. Foreign banks also open few branches in the host country in order to reduce their operating expenses (Walter, 1988: 135–6).

Johnson (2000) pointed out that it is essential for banks to have adequate information about factors such as consumer behaviour and market risk in the host country. Foreign banks should also understand the host country's economic and political conditions, the size of its local and foreign financial institutions, its policies on financial deregulation, its local business culture, and its market length.

Usually, the number of local banks declines after financial liberalisation because domestic banks cannot compete with foreign financial institutions (Oxelheim, 1995: 28). Most local banks in developing countries use rudimentary technologies, can provide only basic financial products, are undercapitalised, and often have poorly trained employees. This means that reformers need to strengthen local financial institutions before opening developing markets to foreign participation. Coleman (1996) noted that local banks need market power to protect their market share nationally and internationally. Market power includes high capital, efficient management, staff training and experience, and suitable information technology.

Because financial authorities must ensure that local banks can compete with foreign banks (Bonin and Wachtel, 1999: 95), the government should inject extra liquidity into state-owned banks and eliminate previous credit allocation techniques. This helps local banks effectively examine investors' behaviour (Bonin and Wachtel, 1999: 94).

Usually, local banks are less competitive than foreign banks because of their inadequate services, their costly loans, and their inferior deposit interest rates. Introducing new products in the host country can be profitable for foreign banks, meaning that domestic banks must improve their services to an international level.

Claessens, Demirgüç-Kunt and Huizinga (1998) discovered that national income has no impact on foreign banks' asset share. On the one hand, dissimilarities in assets share are due to other factors, such as 'foreign penetration'. On the other hand, the *overhead/total assets* of foreign banks is high in developing countries due to information drawback, and low in developed countries because foreign banks have substantial wholesale activities (Claessens, Demirgüç-Kunt and Huizinga, 1998: 7).

In developing countries the net interest margin of foreign banks is higher than that of local banks (Claessens, Demirgüç-Kunt and Huizinga, 1998). The multiplicity of financial rules and motives for doing business abroad explain this difference. For instance, foreign banks may prefer to engage in wholesale activities or to fund particular consumers in the host country. Meanwhile, developing countries place some limits on banks' credit—for example, countries with high concentration of state-owned banks have non-commercial conditions for credit distribution. In addition, market inefficiencies and banking scheme deficiencies cause high interest margins in developing countries.

Liberalisation of financial markets enables banks to serve local clients in the host country, to penetrate foreign financial markets and to provide new financial services. Foreign players compete with local banks and increase their market share through investment banking and leasing. Large market coverage also allows foreign banks to increase their earnings (Walter, 1988: 102–3).

Geographic and governmental restrictions discourage providers of financial services from offering competitive products, forcing banks to offer their clients less favourable instruments. Furthermore, banks are obliged to deliver the existing financial products instead of introducing new ones. In any case, it is expected that the geographic expansion of foreign banks will help local banks to improve the quality of their services.

For example, during the early years of financial liberalisation, the Polish government restricted foreign banks' entry to allow local banks to develop their business (Abarbanell and Bonin, 1997) and to avoid customers leaving local banks to take advantage of the foreign banks' better services. However, the newly established banks were unable to service the credit needs of large Polish companies. Generally, the Polish authorities have concentrated on strengthening local banks through recapitalisation, privatisation and consolidation (Abarbanell and Bonin, 1997).

In Hungary, financial authorities opened the market to foreign participation. Simultaneously, the government recapitalised state-owned banks to make them more attractive to "strategic foreign financial investors" (Bonin and Wachtel, 1999). In the Czech Republic, the government opened the market to foreign banks, which provided new products to large businesses. This has contributed to a sharp increase in the market share of foreign banks in that country. Therefore, authorities are asked to strengthen the financial position of state-owned banks before opening the market to foreign banks participation to avoid large decline in their market share.

In operating across borders, banks engage in a variety of activities. Walter (1988) divided bank services in the host country into four categories: conducting traditional international commerce; providing loans and letters of credit to foreign borrowers;

providing loans to governments and corporations; and carrying out an international securities business—this includes trading options and swaps in the host country.²⁸

Walter stresses the importance of maintaining permanent contact with borrowers, of assessing the level of risk in the country, and of evaluating credit sufficiency in each type of credit. Because of the risks involved in international lending, banks should conduct a thorough technical examination of project financing before advancing credit. Walter also noted that banks need good sources of information and a good allocation of financial resources to avoid risky financial ventures in the host country.

Engwal *et al* (2000) pointed out that foreign banks' operation costs tend to be higher during their first few years in a new market because foreign banks take a long time to understand the host country's financial culture. They have argued that the market share of foreign banks increases more in the long term than in the short term. Engwal *et al* also stressed that foreign banks' market share expands more quickly in countries with a trade deficit. On the other hand, Zaheer and Mosakowski (1997) noted that foreign banks' liabilities alter frequently, requiring foreign banks to strengthen their relationships with customers in the new markets. Bergström, Engwall and Wallerstedt (1994) found that foreign banks that have previous clients in the host country are more secure than those that started from ground zero.

Varying interest rates across borders allow foreign banks to finance investments in developing countries without paying great attention to risk levels in their economies. Accordingly, unpredictable financial crises can arise. For example, during the South East Asian financial crises, many borrowers found themselves

²⁸ Option-type contracts enable the investor to buy (call option) or sell (put option) a real financial item at a certain price called strike and on a certain date. In swap-type contracts the two counterparts agree to exchange a real or financial item, determined with reference to the price of say, currencies or interest rates, according to pre-determined rules (Heath, 1998).

unable to repay their outstanding debts and global banks lost huge amount of funds as a result (Brimmer, 1998).

Peek and Rosengren (2000) pointed out that foreign banks tend to add branches in the host country to benefit from economies of scale when lending to domestic investors. The physical presence of foreign banks forces local banks to lend to individuals and small and medium enterprises; meanwhile, foreign banks meet the financial needs of large enterprises, local or foreign.

They also noted that governments use bank funds to finance particular projects according to their yearly economic plan (Peek and Rosengren, 2000). Usually, banks that finance those projects pay low taxes on their annual earnings. Therefore, every change in a government's financial plans will directly affect foreign banks' lending policies in the host country.

Foreign banks offer new management and information technology to local firms, enabling them to improve their productivity (Peek and Rosengen, 2000). Because most global banks are top-class financial institutions in their home country, their reputations and their ability to raise new funds from international financial markets can help prevent domestic financial shock (Focarelli and Pozzolo, 2000). On the other hand, the entry of foreign banks can negatively impact the host country's financial sector in two main ways: first, most state-owned banks are less competitive than foreign banks; second, financial authorities have less control on the market when global banks carry new financial mechanisms into the host country.

Assessing accounting data from banks and macroeconomic data from eighty countries for the period 1988–95, Claessens, Demirgüç-Kunt and Huizinga (1998) analysed the size and influence of foreign banks in each financial market. Comparing

interest margins, taxes paid, overhead expenses, loan loss provisioning and profitability, and foreign banks' market share in local markets, they found that foreign banks in developing countries have higher interest margins, greater overhead expenses and better profitability than local banks. They explain these findings by citing the rising market share of foreign banks and the declining cost of financial transactions.

Several researchers have emphasised that opening markets to the foreign participation increases efficiency, enhances competition and promotes financial resource allocations.²⁹ The entry of foreign banks has forced domestic banks to modernise their operations and to increase their liquidity (Levine, 1996). Using Terrell's study of financial markets, Claessens, Demirgüç-Kunt and Huizinga (1998) found that the countries that admit foreign institutions have lower gross interest margins, lower business costs and lower pre-tax profits.

2.2.2.4. Banking recapitalisation and privatisation

The fourth component of financial liberalisation is banking recapitalisation and privatisation. Usually, transitional countries use government securities, such as long-term bonds, to eliminate non-performing loans. While foreign financial institutions and donor countries funded Poland's securities, the public and the treasury bore the cost in Hungary (Bonin and Wachtel, 1999). Proceeds then went to banks to help them improve their financial position and avoid moral hazards. To further facilitate this process, governments must lower taxes on the earnings of state-owned banks. In addition, when selling shares in state-owned banks to the public, the government

²⁹ See for example, Walter (1988), Gelb and Sagari (1990) and Levine (1996)

must not appropriate the revenue for its own budget. Recapitalisation and provisioning of state-owned banks are required to meet new financial requirements (Bonin and Wachtel, 1999: 94-6).

Pill and Pradhan (1995) noted that financial liberalisation must remove bad debts from bank balance sheets. Banks can make bad lending decisions even after financial liberalisation because they may still be incapable of evaluating and allocating their credit in a proper manner. Pill and Pradhan (1995) emphasised the need to improve management and risk assessment by opening local banks' capital to foreign investors.

McKinnon (1993) stated that recapitalisation allows banks to boost their profit margin by reducing the amount of non-performing loans. Under the recapitalisation programme, state-owned banks replace their non-performing loans with government bonds and consequently reduce their accumulated losses. "Indeed, the bad (uncollectible) loans of the existing state banks may require a major recapitalization of both banks and enterprises before privatization—or even decentralization—can safely take place" (McKinnon, 1993: 7).

Usually, after the completion of banking recapitalisation the government sells the assets of state-owned banks to private investors. Abarbanell and Bonin (1997) pointed out that the objectives of the bank *Śląski* privatisation were to improve its credit allocation, to develop its information systems, to ameliorate its financial services and to increase its brokering activities. The Polish government planned to attract foreign investors, to raise new funds to finance the state budget, to enhance stock market operations and to encourage enterprise reorganisation. The government undertook four measures to privatise the bank *Śląski*: it cleaned bad loans from the

bank's portfolio; it provided training in management skills; it developed the bank's information technology; and it worked with the ING to introduce new financial products. The authorities faced several barriers to their efforts, including the lack of a clear privatisation plan and the fear of foreign banks' influence on local banks. The major obstacles for Polish government in the privatisation of bank *Śląski* were selling bank shares in the market and the determination of tender. Ultimately the bank's shares were sold to the treasury, to domestic and foreign investors, and to bank employees. The bidders were required to provide statements indicating their financial position, investment plan, and period over which they would hold shares. It was also obligatory to designate the number and the price of shares. Bank management improved significantly after privatisation, the bank expanded its network, and bank business practices improved. International *Nederlanden* Group's involvement also enhanced the bank's expertise in lending and borrowing (Abarbanell and Bonin, 1997).

Abarbanell and Bonin (1997) stressed that the Polish government privatised small banks before large ones. The banks selected for privatisation were financially prudent and had sound management. Auditors analysed banks' portfolios and foreign investors' interest in buying their assets to ensure the success of banking privatisation.

Kornai (2000) argued that there are two ways to privatisation, gradual (strategy A) and quick (strategy B). Under strategy A, the state sells profitable enterprises at reasonable price to private or foreign investors, and liquidates loss-making enterprises. Under strategy B, the state sells companies at low prices to facilitate a

rapid transfer to a market economy. Kornai pointed out that in the 1980s most countries preferred strategy A.

Bonin and Wachtel (1999) noted that shock-therapy privatisation quickened the process of selling state-owned banks assets to private and foreign investors in Hungary. Assets of state-owned banks were sold by using special vouchers issued by a government agency. They concluded that private ownership has contributed positively to the development of the Hungarian banking sector as banks have obtained sustainable growth in their assets.

2.2.2.5. Financial liberalisation and banking competition and profitability

The main objective of financial liberalisation is to increase banking competition and profitability. McKinnon (1993) noted that abolishing usury constraints encourages moneylenders to extend their credit and hence promotes competition in the traditional credit market. Loans need to be available for all classes of borrower and the expected rate of return on deposits should be increased to reduce money supply in the market.

Brock and Suarez (2000) found that financial liberalisation has contributed to decline in banks' spread and profitability in India. The indicators used in explaining the scale of intermediation and profitability included the following: operational costs, non-performing loans, priority sector lending, type of deposits and investment in government securities. The empirical results showed that acceleration in competition has lowered the spreads and profitability of the selected banks. The entry of foreign

banks has lowered industry concentration, which led to a decline in banks' intermediation costs and profitability. Another factor that had direct impact on banks' performance according to their study is type of ownership. Their final assessment suggested that improved efficiency and ability to respond to market forces would boost the performance of Indian banks.

Sarr (2000) examined the impact of interest margins on the market-oriented banking sector. He found that in open markets, banks seem to exploit profit maximisation to cover their service fees. Sarr also argued that banks with large deposits could offer attractive lending rates. Economies of scale and non-bank services also drive the marginal cost of deposits by reducing banks' lending and borrowing rates. He concluded that in a liberalised banking sector, deposits do not reflect financial deepening because banks know how interest rate changes affect their deposits. Offering higher interest rates on savings accounts increases banks' operating expenses and thus reduces their profit margin.

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Historically, competition tends to reduce instability in the banking industry and lower market risk helps banks make better lending decisions. Schuler (1992) argued that interest rates on deposits and loans are similar in both market-oriented and centralised banking systems, but that free-market economies oblige banks to promote their services, to offer innovative financial products, and to open new branches. The

result is a decline in financial transaction costs and an increase in the volume of investments (Dowd, 1992: 3–5).

Schuler noted that removing restrictions on banks makes their activities more sophisticated. “Invisible-hand process can result in a sophisticated banking system as the product of step-by-step evolution whose origin stretch all the way back to barter” (Schuler, 1992: 8). However, small banks cannot survive in the new market if their capital is low. They may need to consolidate to become competitive and to benefit from economies of scale.

To avoid falling bank profits, financial authorities should scale up local banks and abandon constraints on new financial products. Financial liberalisation forces banks to pay “market rate” to remain competitive, and this increases their costs. Most small banks withdraw from the market because they are unable to pay the market rate. Cooper (1984) noted that continued competition in the credit market may cut costs for consumers, dramatically lowering banks’ profits.

Researchers anticipate that globalisation of financial services fosters banking sector profitability. Demirgüç-Kunt and Huizinga (1998) used net interest margin, after tax return on assets, and after-tax return on equity to measure the profitability of their selected banks. They observed that in financial markets where banks have high capital adequacy and liquidity ratios, the franchise value³⁰ is low, but lending is high compared with banks’ total assets. Analysing market concentration (assets of three largest banks / total banking assets) and foreign bank entrance (foreign bank assets / total bank assets), they found that local banks seem to have higher market concentration than foreign banks.

³⁰ Banks become fragile during the financial liberalisation when they achieve low franchise value.

Demirgüç-Kunt and Detragiache (1998) noted that financial liberalisation lowers the profit/return on equity ratio of existing banks. In contrast, the return on assets and the net interest margins do not change. Increases in the saving rate are balanced by higher lending rates. Liberalisation also increases banking capitalisation and decreases liquidity (which adversely impacts profitability), but long-term asset allocation remains constant. Foreign banks penetration is greatest in less concentrated financial markets because of low bank franchise values. Table 2.1 shows the impact of financial liberalisation on bank margins, capital, deposit allocation, liquidity and profit, during the transition and in the long-term.

Table 2.1: The level of banks' margin, capital, deposit allocation, liquidity and profit during the transition and in the long-term

	Bank margins	Capital	Deposit allocation	Liquidity	Profit
During the transition	High	High	High	High	High
In the long-term	Stagnant	Stagnant	Stagnant	High	Stagnant

Source: Demirgüç-Kunt, and Detragiache (1998)

Claessens, Demirgüç-Kunt and Huizinga (1998) discovered that foreign banks pay lower taxes than local banks in developed countries, but higher taxes than local banks in developing countries, where they also have lower provisions for losses. Claessens, Demirgüç-Kunt and Huizinga (1998) stated that the host country's taxation policy impacts foreign banks' net profit. Another factor that directly affects foreign banks' net profit is the cost of capital. They concluded that foreign banks earn higher net profit in developing countries than in developed ones.

The relation between overhead/total assets with the net margin/total assets and before-tax profits/total assets demonstrates two facts: first, banks attempt to reduce their overhead expenses; second, they endeavour to maximise their before-tax

profits. Claessens, Demirgüç-Kunt and Huizinga argue that increased inflation and higher real interest rates escalate banks' net margin, before-tax profits and overhead costs. The findings of Claessens, Demirgüç-Kunt and Huizinga (1998) are summarised in Table 2.2.

Table 2.2: The level of foreign banks' overhead costs, interest margins, tax payment and profitability in developing and developed countries

	Overhead costs	Interest margins	Tax payment	Profitability
Foreign banks in developing countries	High	High	High	High
Foreign banks in developed countries	Low	Low	Low	Low

Source: Claessens, Demirgüç-Kunt and Huizinga (1998: 7-10)

Profitability in global financial markets is based upon “*astute management*” on both sides of the balance sheet. Assets and liabilities are affected by liquidity risk, the allocation of financial services, the stability of the financial system, and high leverage ratios in every particular market (Walter, 1988: 35). Therefore, altering market features changes the profitability of market players.

The imperfect competitive banking sector responds to high demand for loans by decreasing credit and by increasing the interest rate spread. Higher interest rates may prevent some borrowers from servicing their debts; meanwhile, depositors may invest in other markets and generate a run on the whole banking system. The result is a decline in banks' deposits and credit (Knight, 1998: 14).

Knight (1998) stressed five factors that promote competition in the banking sector and reduce financial market fragility. First, governments should stop using banks' funds to finance their expenditures. Second, authorities should improve the foreign exchange market to avoid significant foreign exchange rate fluctuations.

Third, banks must inform lenders and borrowers about their financial strength. Finally, capital has to move freely across borders.

The number of foreign banks may influence competition in the financial sector, especially if local banks take steps to protect their market share before admitting technologically advantaged foreign banks. In countries with high barriers towards foreign entry, the “penetration measure” is nil. Meanwhile, foreign banks are well represented in countries with low financial barriers.

Increased competition lowers the cost of financial transactions, which encourages banks to take high risks on their assets and to become more innovative. However, direct governmental interventions in the financial sector prevent banks from exploiting the economies of scale and scope and cause marketplace inefficiency (Cooper, 1984: 197).

The substantial number of foreign banks operating in open financial markets has contributed to a fall in the price of financial services and therefore to lower profits for local banks. Banking competition increases the market share of ‘oligopolistic’ financial institutions. However, authorities can impose restrictions on market management, which can prevent new banks from extending their market share (Laralde and Tarazi, 1998: 140–1).

Claessens, Demirgüç-Kunt and Huizinga (1998) concluded that the entry of foreign banks increases competition in the national financial market and boosts banking profitability. However, this depends on the number and size of foreign banks operating in the host country. In markets with many sizeable foreign banks, banking competition tends to be high, mostly because foreign banks are involved in large-scale banking activities.

2.2.2.6. Financial liberalisation and banking efficiency

The second objective of financial liberalisation is to improve banking efficiency. Shaw (1973) stresses that financial liberalisation adds financial intermediaries between savers and investors, increasing investment efficiency and reducing the cost of borrowing. Increased savings allow banks to attain economy of scale, which in turn allows banks to diversify their portfolios, reduce their costs, and improve their operational efficiency. Shaw (1973) used the following equation to explain the relationship between savings and banking efficiency:

$$M / P = F (Y, \gamma, d-\pi); (\delta M/P) / (\delta d-\pi) > 0. \quad (1)$$

Where: M/P = Money Balance in the central bank

Y = represents the Real Income

γ = reflects the Cost of Holding Money

d = the Nominal Deposit Rate

π = the Real Deposit Rate

Shaw stressed that the nominal deposit rate less the expected rate of inflation induces the real cost of the monetary system. Real deposit rate is the primary indicator of real money. “Income represented by growth is real money accrues either to the monetary system or to money holders depending on the explicit deposit rate that the former pays to the latter and on the rate of inflation” (Shaw, 1973: 23). Deepening allows real money and physical investment to be the determinants of total savings. Growth in real money, which increases as a result of price deflation or deposit rate, induces the real income. Meanwhile, the rise in real deposit rate results in money deepening. This is to be achieved through the increase of money demand to

income ratio. Shaw concluded that “variations in nominal money that do not affect real deposit rate are neutral, to be sure, and the rate of inflation does not matter if nominal deposit rate is adopted to it” (Shaw, 1973: 38).

In case of stagnant growth, the price of inflation rate equals the income growth. Consequently, the nominal deposit rate is determined by subtracting the rate of return on physical investment from the income growth. Shaw (1973) noted that monetary authority has the legitimacy to collect inflation tax even if the money holders are not receiving any return on their savings. Therefore, the money to income ratio declines and the revenues collected as inflation-tax falls below the increase in economic welfare.

Increased savings make banks more likely to fund projects; in turn, these investments increase banks’ earnings and boost their annual growth. The process continues as savings deposits increase.³¹ Kapur (1986) stated that financial liberalisation produces higher interest rates—this will both encourage saving and increase the quality of investments. Thus the banking sector expands, depositors enjoy high interest rates, and borrowers have permanent access to investment financing.

Bonin and Leven (1996) claimed that banking efficiency has five determinants. First, competition between banks results in low interest rates on deposits and loans. Second, banks offer variety of financial instruments and develop new products. Third, the financial market in which banks operate is stable and liquid. Fourth, the payment system is well developed and financial resources are allocated adequately. Fifth, financial transaction costs are low. They also pointed out that an efficient

market-oriented banking sector requires the government to withhold direct control over banks' operations and participate only in developing financial markets. Privatisation thus ends government intervention in the banking sector and allows state-owned banks to select their borrowers on the basis of market criteria.³²

Fink *et al* (1998) argued that developed information systems and market confidence can enhance the efficiency of financial markets. In transitional countries, market uncertainty makes people afraid to use financial institutions, and depositors may prefer to keep their savings under the mattress. "Inter-organisational" problems contribute to this atmosphere of uncertainty. To boost consumer confidence, state-owned banks should terminate their relationship with bad debtors; Fink *et al* (1998) suggested creating an independent agency to control lending and to facilitate stock trading among foreign players.

State-owned banks are weak; hence they are unable to influence the efficiency of private companies and state-owned enterprises.³³ Because asymmetric information and small financial markets have weakened financial institutions' efficiency in transitional countries, international organisations such as the International Monetary Fund and the World Bank should help those countries implement effective financial policies. Policymakers are already required to adopt clear privatisation plans, and Fink *et al* (1998) emphasised that "privatisation of the large former state-owned banks has to take place with strong involvement of renowned foreign banks".

Defective financial products negatively impact efficiency and financial resources allocation in the banking sector (Bléjer, 1999: 388–9). As a result, authorities must

³¹ Some researchers argue that the Shaw and McKinnon model of financial repression is incomplete. For example, Sikorski said "The primary weakness of Shaw's model is the absence of many behavioural mechanisms specifying the working of the banking system" (Sikorski, 1996: 69).

³² We regard a state-owned bank as private when the state's stake is less than 50 per cent of its capital.

encourage foreign banks to bring new and modern financial products into the domestic market. However, technology, economies of scale and reputation will always favour foreign banks when they enter developing countries; these competitive advantages can destabilise local banks and threaten the domestic banking industry.

To develop a strong financial sector, the authorities must first ensure that the banking industry is functioning adequately; once this has been accomplished, they should improve the capital market. These steps will enhance the efficiency of financial resources allocation. Furthermore, the authorities should reform lending mechanisms and control risks; they can do this by managing banks' assets and liabilities and by auditing their loan portfolios (Mullineux, 1998: 23–4).

The amount of competition in the banking sector affects banking efficiency. Imperfect competition in developing and transition economies means that banks play a small role in mediating between savers and borrowers. Comparing a competitive banking sector with a monopolistic one, Knight (1998) found that all banks in a perfectly competitive banking sector have a small proportion of deposits, which can be achieved at a similar rate of return on lenders' funds. High demand for credit and low deposits prevent the monopoly bank from matching the maturity of competitive banks' assets and liabilities. The monopoly bank attempts to maximise its profits by paying low deposit rates and by charging high borrowing rates (Knight, 1998: 9–12).

Claessens, Demirgüç-Kunt, and Huizinga (1998) used net interest income/total assets (*net margin/ta*) to calculate bank efficiency and banks' before-tax profits/total assets (*before tax profits/ta*) to calculate bank profitability. Before tax profits/ta equals net margin/ta plus non-interest income/ta minus overhead/ta minus loan loss

³³ Low liquidity prevents local firms from raising funds that could finance their projects.

provisioning/ta. The relation between overhead and a bank's net interest margin reflect the bank's ability to cover its business costs. The relation between before-tax profits and overhead reflects the bank's capacity to transfer its costs to its clients. Claessens, Demirgüç-Kunt and Huizinga (1998) also used the following equation to measure the banking efficiency:

$$\Delta I_{ijt} = \alpha + \psi F_{sjt} + \psi_i B_{it} + \psi_j X_{jt} + \Sigma_{ijt} \quad (2)$$

Where: I_{ijt} = the dependent variable for domestic bank i and country j at time t

F_{sjt} = the market share of foreign banks in country j at time t

B_{it} = bank variables for bank i at time t

X_{jt} = variables for country j at time t

α = constant

ψ , ψ_i and ψ_j = coefficients

Σ_{ijt} = the error term

The efficiency of financial intermediation is positively correlated with the market share (F_{sjt}) of foreign banks. Foreign banks tend to have high efficiency in developing countries because of their technological advantage over domestic banks. "The efficiency of bank intermediation can be measured by both *ex ante* and *ex post* spreads" (Claessens, Demirgüç-Kunt and Huizinga, 1998: 6). The difference between interest rates charged on loans and those paid on deposits form the *ex post* spread. The *ex ante* spread is determined by the expected risk and return from banks' investments. Country variables include taxation, loan loss provisioning and overheads. Claessens, Demirgüç-Kunt and Huizinga (1998) found that foreign banks pay less tax and have low loan loss provisioning and overheads in developing countries. The volume of loans and deposits depends on *ex ante* and *ex post* spread,

which also alters according to the tax rates, loan loss provisioning and overheads. Claessens, Demirgüç-Kunt and Huizinga (1998) concluded that foreign banks have a significant efficiency advantage in developing countries, and this has been reflected by a relatively high profitability. They also noted that the scale of banking investments is driven by the taxation system rather than by the quality of services provided in domestic and foreign banks.

Claessens, Demirgüç-Kunt and Huizinga (1998) stressed that the entry of foreign banks increases competition in the national financial market and promotes banking efficiency. However, this depends on the number and size of foreign banks operating in the host country. In markets with large numbers of sizeable foreign banks, banking competition tends to be high, mostly because foreign banks are involved in large-scale banking activities.

Engbarth (1997) pointed out that foreign banks are squeezing local banks into new operations and changing their strategies. In Taiwan, for example, the incumbent Chinatrust Commercial Bank is handling the challenge by improving its retail banking, splitting its banking services into retail and corporate divisions, expanding the bank's network locally and abroad, and engaging in securities activities (Engbarth, 1997).

Although banks need to diversify their loans according to the risk, arena and business category, several barriers hamper lending in a small economy. For instance, high specialisation in the banking industry and deposit-taking constraints make it difficult for banks to adequately diversify their portfolios.

Consistent with “*contestable market*”³⁴ principles, local banks will continue to perform in the same manner even after new competitors have entered the market. When existing players apply “*predatory behaviour*,” it is difficult for new players to gain a niche in their markets. Banks can compete over product quality, product price and innovations, and market segmentation usually increases as competition escalates. The new player has to compare the cost of entering the market to the return it can expect from delivering its financial services in that market.

To promote safe financial environments after the transition to a market-oriented banking system, governments must assist banks in monitoring their lending decisions, maintaining adequate international capital ratios, and imposing lending restrictions on highly risky projects (Demetriades and Fattouh, 1999). However, severe regulations can hinder the efficiency of the financial market (Walter, 1988).

2.2.3. Problems associated with the process of financial liberalisation

Dissolving financial barriers escalates instability in the banking sector. Under socialism, financial regulations prevented banks from assessing the risk associated with their portfolios, but financial liberalisation creates moral hazards due to the increase in banking competition and the decline in existing banks’ profitability (Demitgüç-Kunt and Detragiache, 1998).

To minimise the risks associated with global financial markets, new mechanisms for cross-boarder lending have three fundamental elements: they consider project risk

³⁴ A contestable market is one in which financial institutions compete for control of new clients. “Given these conditions and the consequent need for qualitative rather than quantitative expansion, what seems to be required is the promotion of contestability – that is, the threat and the fear of competition” (Bléjer, 1999: 389).

instead of assets and liabilities structure; they arrange large loans with other international banks; and they analyse multinational export credit (Porter, 1993).

Ray and Tomkin (1994) divided the barriers among banks into four categories: political, regulatory, temporal and geographical. Currently, these obstacles are progressively dissolving, resulting in increased competition among domestic financial institutions as well as among foreign and local players. Strong domestic financial institutions are essential if local banks are to compete with foreign banks that have more experience and better technology. In liberalising financial markets, Ray and Tomkin (1994) said that authorities should take into account four fundamental elements: capital adequacy, corporate structure, bank ownership, and risk profile.

To avoid financial instability, banks should diversify their portfolios as much as possible. Walter and Smith (1999) suggested that banks should consider non-financial assets such as risk insurance or gold. They also said that banks need to assess exchange rates and liquidity risks, have high leverage ratios, and manage expenses efficiently to attain high profitability in global financial markets.

Three broad risks confront banks in global financial markets: credit risk, country risk and currency risk (Walter and Smith, 1999).³⁵ Credit risk depends on banks' portfolio diversification and the extent of their exposure to direct foreign investment. To minimise those risks, banks are required to identify their consumers' claims, to clarify all cross-border loans immediately, and to classify the host country according to the degree of exposure (Walter and Smith, 1999).

³⁵ Credit risk occurs when borrowers fail to pay the principal and interest in a timely manner. Country risk emerges when foreign government fail to make required debt payments on a timely basis or to comply with conditions of international agreements. Finally, banks face currency risks when exchange rate fluctuations affect their investments' value.

Changes in business cycles, international interest rates, exchange rates and commodity prices reduce firms' profitability and affect borrowers' ability to repay both interest on their loans and the principal itself. Increased capital inflows combined with poor credit risk assessments can also heighten banks' exposure to risky loans and foreign exchange fluctuations.

Banking across international frontiers involves a variety of risks. Anneart (1999) stated that in a global financial market where all assets are traded by financial institutions, risks that affect different markets segments are correlated. Market segmentation is less evident in open financial markets, where there is high demand for financial services (Lewis, 1993). Lewis also claimed that in highly regulated financial markets, consumption depends on capital market output.

The fragility of the global financial system (because of floating exchange rates and markets risks) affects banks' earnings. Borrowers' inability to repay loans can also destabilise financial markets in general and banks in particular (Porter, 1993). Banks should assess credit risk and arrange loans with international banks properly (Porter, 1993: 59–60).

The literature shows that financial liberalisation plays a major part in globalisation of financial services. It dissolves many regulatory barriers that local and foreign banks faced in the former socialist countries, and it promotes marketplace competition and efficiency. Many scholars³⁶ argue that financial liberalisation has enabled banks to diversify their portfolios and to boost their profit margin. However, banks are still facing various risks in global financial markets. Banks need to be aware of risks associated with lending money to domestic or

³⁶ See for instance: Claessens, Demirgüç-Kunt and Huizinga (1998) and Peek and Rosengren (2000)

foreign investors—such vigilance is necessary to avoid financial crises and economic instability.

2.3. Financial innovations

New financial products have increased banks' liquidity and enhanced their financial assets. Banks penetrate new markets with these products to achieve economies of scale and scope. Advances in information technology have also enabled banks to lower the costs of their financial transactions. Computer systems let banks transfer, record and store financial information inexpensively (Cooper, 1984: 190–3). The overall result is a decline in banks' operating expenses and an increase in their profit margin.

One of the methods used by financial institutions to respond to increased market risk is to introduce new financial instruments. They also use those products to hedge against interest-rate fluctuations and foreign exchange rate risks. Advances in information technology make new products less costly and more liquid. Market transparency and bank auditing give market participants incentives to innovate.

Information technology has changed the management structures of financial institutions and integrated markets. Parker (1998) anticipated that banking costs will continue to fall due to advances in information technology, but warns that new technology does not always protect banks from market shocks. Hence he recommended adequate control, good internal organisation and cautious lending policies (Parker, 1998: 16).

Edey and Hviding (1995) noted that technological advances reduce the costs of trading financial assets across the globe. New information technologies also

encourage financial institutions to expand their operations to financial centres. The aim of such expansion is to diversify into innovative financial products. This process is growing speedily because of the emergence of a centralised market-oriented financial system in former socialist countries (Bonin and Wachtel, 1999).

Banks use computer technology to offer their services globally and to receive deposits from foreign clients. However, the integration is not complete; in fact, most global integration takes place in developed countries and in wholesale activities. Credit market restrictions on foreign banks reduce the scale of financial integration in developing countries.

With computerised financial systems, banks can do business across frontiers with fewer restrictions. Harrington (1992) noted that innovation fosters competition in financial markets and *vice versa*; therefore banks need to be effective and well capitalised to face any unexpected competition. He stated six main causes for financial innovation: high competition in financial markets; advances in information technology; lower cost of financial transactions; structural changes in financial markets; new laws; and financial internationalisation (Harrington, 1992: 53).

The fast growth of international trade and other industries contributes to increased demand for financial services (Blake, 2000). High demand for innovative financial products can also result from petrodollar reserves, macroeconomic imbalances and high rates of saving in countries such as Japan. Blake (2000) pointed out that financial innovation results from increased or decreased supply or demand in

the financial services market.³⁷ Every financial system depends on financial products, selling mechanisms, claims and market structure (Blake, 2000).

Blake (2000) also argued that technology, financial constraints and regulation induce financial innovation. Technology creates new opportunities for banks to develop their borrowing and lending capacities.³⁸ Authorities want to enhance competition and innovation in the banking sector without negative consequences on the financial system. To find acceptance in the market, new assets should have attractive characteristics. Unregulated institutions can change the components of their assets and create new instruments (Blake, 2000: 49).

Many financial centres have implemented new financial products and tactics. Likewise, computer systems allow banks instant access to other financial markets across the globe. These developments let investors and borrowers reduce their market risk; they also raise the liquidity and promote the creditworthiness of financial institutions (Porter, 1993: 342).

Porter (1993) stressed that banks have declined steadily as a source of liquidity. Many investors and borrowers can now meet their financial needs through capital markets.³⁹ As a consequence, the demand for services such as short-term loans has declined, and banks have responded to these demand-side changes by penetrating new markets and by offering new products.

Banks are expanding their focus beyond traditional banking activities. Certain banks have become specialised in some operations such as financing foreign trade. In developed countries, banks have moved into off balance-sheet activities, mergers and

³⁷ Financial innovations also contribute to changes in wealth and customers' tastes. Other reasons for innovation are the business and political cycles.

³⁸ Financial innovations must respond positively to financial regulations.

³⁹ In developing countries such as Algeria, capital markets are underdeveloped.

acquisitions, securities operations and long-term investments. “If the pace of change and innovation continues at its recent rate it seems likely that the impact on banks in the coming years will be both expensive and dramatic” (Porter, 1993: 343).

Financial liberalisation and financial innovation are directly interconnected. Removing strict financial rules assists banks in penetrating new markets and offering their services there; correspondingly, financial innovations force authorities to relax regulations in the financial market. For example, dismantling interest rate control has encouraged innovations such as swaps and options.

Innovation and liberalisation can have negative effects on the banking industry. Both boost the number of players and the amount of financial instruments in the marketplace. Financial institutions are obliged to reduce their prices, meaning that their profit margin declines (Cranston, 1990). “But extensive deregulation has certainly not proven to be a *penacea* for the banking industry and there are claims that the process of deregulation and innovation on the part of banks has had a negative overall impact on banking stability” (Cranston, 1990: 345).

The global financial market is based on economies of scale and scope. Economy of scale means offering a variety of services in a particular market. Economy of scope means diversifying financial products in more than one market segment and linking these segments together. Economies of scale and scope leverage strategies applied by banks in the financial services industry, where operating simultaneously in many financial markets decreases the risk taken on by institutions and boosts the rate of return on each product. In addition, information technology is required to build strong links between the financial segments.

Banks' financial products are designed to meet the financial needs of the specified market (Davis, 1983). In addition, banks' organisation depends on their clients and products. Global banks are often more concerned about consumer values and about product promotion. Profitability comes as a secondary objective when they enter new markets (Davis, 1983: 18–9).

Davis (1983) noted that international commercial banks use consulting and other international activities to penetrate markets that have many banking and non-banking institutions. Their financial expertise and their corporate relationship with clients help them increase their market share. To be more successful, however, they need to promote their internal and external management as well as their global banking relationships. The returns from international banking products depend not on asset and liability prices but on market competition, the ability to cover losses, and the ability to earn extra value.

Davis (1983) also stated that international capital markets play a primary role in creating new financial instruments and in transferring those products to other local markets through international banks. He emphasised that banks in the new environment need to provide high-value products to satisfy their clients' needs.

Interest-rate volatility and the emergence of sophisticated financial instruments drive consumers to new services and to new ways of banking. Technological advances have affected the supply side of financial markets by decreasing the cost of producing and delivering financial instruments (Walter and Smith, 1999). On the demand side, both non-interest and interest banks have increased their liquid products offerings (Davis, 1983).

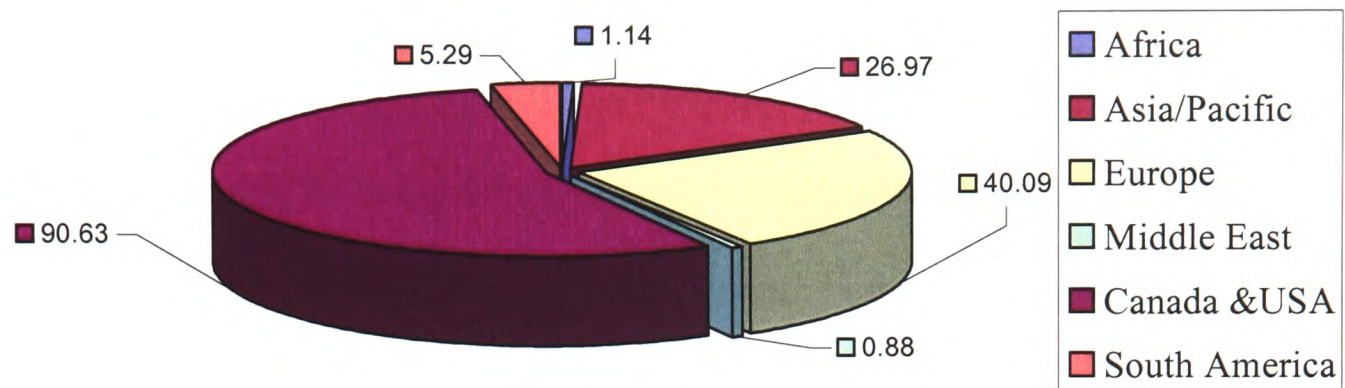
Research shows that financial innovations have played a great part in globalisation of financial services in transitional countries (Davis, 1983). The demand for foreign banks' new financial products in the host country has increased gradually (Blake, 2000). On one hand, this has increased the level of market integration and lowered local banks' market share (Davis, 1983). On the other hand, the emergence of new banks has encouraged state-owned banks to introduce innovative financial products that allow them to be competitive in the local market and to avoid sharp declines in their profit margins.

2.4. Internet banking

The Internet, a global system of computer networks, first appeared in 1969 under the name "Advanced Research Projects Agency Network" in the United States (PBS Online, 2003). At present, about 13 million servers are linked to the Internet across the globe, 99 per cent of which are located in advanced countries (CSE Online, 2003). Many banks use the Internet to offer services for both domestic and foreign consumers. "At an advanced level, Internet banking is called transactional online banking, because it involves provision of facilities such as accessing accounts, funds transfer and buying financial products or services online" (Karjaluoto, Mattila and Pento, 2001: 348).⁴⁰ The Internet also helps banks penetrate other financial markets without requiring their physical presence in those markets. The Internet links all financial market participants across the globe.

⁴⁰ See also Sathye (1999)

Chart 2.1 : The Internet population users worldwide, 1999 (million)



Source: HRW Online, 2003

Chart 2.1 shows that 95 per cent of Internet users are based in Canada, the USA, Europe and Asia/Pacific. In developing countries, Africa and the Middle East still lag behind South America, with fewer than two million Internet users in 1999 (2 per cent of the Internet population). This can be attributed to underdeveloped telecommunication systems and also to lack of investment in new technologies such as the Internet. Therefore, governments in developing countries are required to increase their spending on sophisticated technologies to raise the number of telephone lines and to make the Internet accessible to large numbers of individuals and companies.

Miklaszewska (1998) identified four roles for the Internet in a modern banking industry. First, it facilitates financial transactions between banks and their consumers. Second, it gives financial institutions permanent access to financial information. Third, the Internet connects a bank's head office to its branches. Finally, electronic banking (e-banking) lets customers check their account information, pay bills, transfer funds between accounts and perform other functions. Customers will soon have access to additional services such as online stock and bond trading (Miklaszewska, 1998: 283).

In recent years, technologists have focused on making the Internet more secure for financial transactions. As a result, analysts expect that banks will provide more financial services through the Web. Citibank and Chase Manhattan already offer all their services through their Web sites (Miklaszewska, 1998: 284). However, local banks in developing countries often struggle to provide Internet services, primarily because these countries lack Web design specialists and have only a few available telephone lines.

The Internet increases banks' efficiency and helps them reduce the cost of producing and delivering financial services. The Internet also alters the pricing strategy of the banking product. Banks price their products at the right level for the 'electronic market'. The price of financial services is usually lower through the Internet than in the branch (Jun and Cai, 2001); this has made the Internet an attractive banking environment for clients. As profit margin decreases, new products are delivered through new channels, retail services and securities being the main areas of change. Global banks also use the Internet to expand their activities and to earn new market share (Oxford Analytical Citibank, 1999).

Banks are required to improve the value of their products, which will allow them to generate higher earnings. Consumer loyalty is also essential because "the global nature of the Internet makes it possible for a bank to attract consumers from a wider client base than that afforded by its branch network" (Oxford Analytical Citibank, 1999: 3). The Internet also informs consumers of changes in the prices of financial instruments (Oxford Analytical Citibank, 1999).

The Internet has the potential to reduce banking costs due to the absence of expenses such as salaries, building maintenance, and other equipment. Booz-Allen

and Hamilton (2002) found that 84 per cent of the USA banks spend less than USD25,000 to set up an Internet site. The cost of establishing a traditional branch is USD1.5 million and USD2 million plus other expenses to keep it running. The Internet allows banks to achieve economies of scale and to reach a high banking standard. Global usage of the Internet also helps banks penetrate other financial markets and earn a niche in those markets. This is despite the fact that the fixed costs to set up Internet banking remain high.

The Internet improves two essential factors in global banking businesses: time and location (Oxford Analytical Citibank, 1999). The time needed to access bank services through the Web is extremely short. The Internet is also available everywhere in the world. As a result, Internet technology has globalised the banking industry; many banks use e-banking to expand their market share abroad.

The Internet enhances competition in the banking sector. Many non-banking institutions also offer their services through Internet channels. Banks also face severe competition on the lending side from global markets. Moreover, financial service clients may obtain information about products (e.g., pricing and characteristics) through the Web. This increases transparency and reduces the cost of financial instruments. Therefore, banks have to apply different mechanisms for pricing their products (Oxford Analytical Citibank, 1999).

The Internet gives financial institutions various opportunities to conduct internal and external financial transactions. It enables banks to introduce international payments. It also helps banks cut time, money and risk. Many transactions can be done through the Internet. Availability of data through the Internet helps banks and consumers reduce risk-taking in their financial transactions (Banker, 2000).

Table 2.3: Branch closure in the UK: 1995 – 2000

Name of Bank	Branches			
	1995	2000	No of Closures	Reduction %
Northern Rock	156	76	80	51.3
Halifax	1,203	832	371	30.8
National Westminster	2,215	1,643	572	25.8
Abbey National	1,004	755	249	24.8
Lloyds TSB	2,858	2,200	658	23.0
Alliance & Leicester	397	309	88	22.2
Barclays	2,050	1,727	323	15.8
Bank of Scotland	411	352	59	14.4
Woolwich	462	402	60	13.0
Bradford & Bingley	246	222	24	9.8
Cheltenham & Gloucester	231	210	21	9.1
Royal Bank of Scotland	687	648	39	5.7
HSBC	1,701	1,668	33	1.9
Total: All Banks	13,621	11,044	2,577	19.0

Source: Building Society News, 2001

As shown in Table 2.3, the number of bank branches will decrease as electronic distribution channels become more popular. Internet also enhances the delivery of large range of financial products. These improve banking efficiency by facilitating payment processing. The goal is to attain high value-added products. “The Internet plays a vital role in the key challenges facing Financial Services Institutions today. It provides a tremendous opportunity for Financial Services Institutions to reduce transaction costs, exploit new markets, and roll products much faster than was possible via traditional channels” (Banker, 2000: 4).

The major problem facing Internet banking is the physical delivery of cash. Clients regularly receive financial information through banks’ Web sites. Nevertheless, it is impossible to make a physical delivery of cash through the Internet. Clients also require instant access to products’ prices and financial information. “The very concept of the end-of-day is meaningless in the world of e-commerce, where customers may be anywhere in the world and demand consistent and instant levels of services” (Banker, 2000: 6). Banks should promote innovation

and speed to become more competitive. The Web must also complement branch services, meaning that products offered via the Internet have to describe how they supplement or replace services available inside the branch.

Table 2.4: Advantages and disadvantages of the electronic banking in developed and developing countries

Advantages of the e-banking	Disadvantages of the e-banking
<ul style="list-style-type: none"> • Low costs (particularly fixed costs). • Cross-border expansion. • High franchise value. • Strength link with customers. • Market share growth. • Financial information potential. • Simple to access. • 	<ul style="list-style-type: none"> • New competitors. • Complicate services valuation. • Development costs. • Low security.

Source: Salomon Smith Barney (1999: 5)

Various obstacles confront online banking in transitional economies (Gurău, 2002). First, Internet connections are inflexible and long lasting. Second, there are a limited number of personal computers (see: Appendix IV). Third, individuals do not know about services offered via the Internet. Fourth, there are no clear and complete regulations governing online banking. Finally, local banks have a bad reputation in the market and also adopt poor development strategies.

E-banking assists globalisation of financial services, especially in developed countries where the number of Internet users is high and business culture is well developed. In developing countries, e-banking is still in its infancy and needs major improvements. Nonetheless, researchers predict that e-banking will expand quickly in both developed and developing countries and that this will change the structure of financial markets (Salomon Smith Barney, 1999).

2.5. Non-interest banking model

Although Muslims have practiced Islamic financial rules since the fifth century (Mawdudi, 1950), the first study of Islamic financing did not appear until the mid-twentieth century.⁴¹ Political influence in countries such as Pakistan and the development of Islamic banking ideas among Muslim economists have contributed to a growing literature on Islamic finance. In the past two decades, many Muslim and non-Muslim researchers have conducted investigations into Islamic banking.⁴²

In Mohammed's time, financial transactions were simple. There were no capital flows and no banks; the only markets were those for commodities. Transactions were based on trust between the purchaser and the supplier (Islamic Finance Online, 2000). The money market raises new concerns for Muslims, who have attempted to adapt Islamic financing paradigms to the international securities market.

Table 2.5: The number of non-interest banks that make positive net profit, negative net profit or zero profit (N/A) in eight separate regions

	Positive net profit	Negative net profit	N/A	Total
South Asian countries	46	4	1	51
African countries	23	7	5	35
South East Asian countries	24	7	-	31
Middle Eastern countries	20	1	5	26
Gulf	19	1	1	21
Europe + America	6	-	3	9
Asia (others)	1	-	1	2
Australia	1	-	-	1
Total	140	20	16	176

Source: Banker, 2000d

From this table, we see that 80 per cent of non-interest banks make a positive net profit. This means that most non-interest banks are profit-making institutions; they are able to grow due to the large scale of available business opportunities. Loss-

⁴¹ See for example Siddiqi (1983), Ahmad (1952) and Mawdudi (1950)

⁴² See for instance Al-Omer and Abdel-Hak (1996), Mills and Presley (1999) and Warde (2000)

making banks are mostly based in African and South East Asian countries; in those regions, 87 per cent of banks do not make profits (Banker, 2000c). This is because the financial markets in those regions are underdeveloped and the demand for Islamic financial products is low (Banker, 2000c).

Table 2.6: Paid up capital, total assets, reserves and net profit of Islamic banks in 2001

Paid up capital thousands USD	Total assets thousands USD	Total deposits thousands USD	Reserves thousands USD	Net profit thousands USD
7,333,079	147,685,002	112,589,776	3,075,526	1,238,241

Source: Banker, 2000d

From Table 2.6 we see that the net profit/total assets of non-interest banks are extremely small. This means that their return on assets is low. Reserves (USD3,075,526,000) are about 2.6 per cent of total deposits and paid up capital (USD7,333,079,000) is about 5 per cent of total assets. Therefore, most non-interest banks are required to raise their reserves to promote financial stability and to increase their paid up capital to meet international standards (Banker, 2000c).

It has been argued that the main difference between non-interest banks and interest banks is “the time value of money” (Moore, 1998: 248–50). The function of both banking models is the same, i.e., to act as an intermediary between savers and borrowers. In an interest banking model, the interest rate determines the yield on financial instruments. Whereas, the non-interest banking model uses profit- and loss-sharing criteria to distribute net profits to the bank, to depositors, and to entrepreneurs. Another dissimilarity between the two banking models is that interest banking model maintains a creditor–debtor relationship among banks, depositors and

borrowers, but in non-interest banking model the relationship is principally a partnership.

Universal accounting standards and developed financial market are needed to protect non-interest banks from global financial market risks and to improve the wholesale market, including the money and inter-bank markets (Moore, 1998). Likewise, it is essential to promote communication between non-interest banks. The religious acceptability and high return from assets help non-interest banks generate large deposits (Moore, 1998). For example, in *El-Baraka* Bank of Algeria, total deposits increased from AD2,881,000 in 1996 to AD6,967,000 in 2000 (*El-Baraka* Bank Annual Reports, 1996–2000). The methods applied to invest those assets are still traditional, however, and need improvement.

Gafoor (1995) stressed that non-interest banks' asset evaluation is not an easy process. Usually, authorities are obliged to send groups of experts to assess non-interest banks' financial positions. However, Islamic banking portfolios are based on venture capital, thus it may not be possible effectively to assess their investment risks. Gafoor also noted that taxation on non-interest banks is unlike to those of interest banks. The interest is "passive income"; depositors receive extra funds without taking risks with the bank or with borrowers. Profit is an earned income. Moreover, most non-interest banks are involved in financing commercial activities that are taxed twice; this substantially affects their profitability (Gafoor, 1995).

Non-interest banks open both savings and investment accounts. In an investment account, the bank applies a profit- and loss-sharing mode of financing (Gafoor, 1995). The return is a percentage of the profit, in accordance with an agreement made between the depositors and the bank, and between the bank and the borrowers.

Gafoor also stressed that most non-interest banks guarantee the nominal value of saving account deposits. Depositors can withdraw their money at any time and may hold a chequebook. The advantage of non-interest banks is that bankers and borrowers share responsibility for depositors' funds. Profits have to be distributed between stakeholders according to the first agreement. Gafoor suggests that non-interest banks should provide both short- and long-term loans to exploit the market fully. It is also important to add services charges onto loans. These charges allow banks to cover their administration expenses and to boost their profit.

Nowadays, non-interest banks provide heterogeneous financial services such as equity, project financing, letters of credit, securities safekeeping, funds transfer, investor advice and project management (Warde, 2000). Certain Islamic financial institutions offer derivatives, insurance and fund management. The Research and Training Institute plays an important part in introducing new products.

Non-interest banks can use *urf* (custom), *darura* (overriding necessity) and *musharaka* (the general interest) to create new financial products (Warde, 2000). It is also possible to make conventional instruments, such as zero coupon bonds, conform to Islamic law. Islamic law allows financial products that do not include interest (*riba*), but forbids investment in prohibited products such as wine and pork.

Warde (2000) said that non-interest banks are applying 'mark-up schemes', which are against profit- and loss-sharing principles. High-risk, short-term schemes that require collateral and anticipate profit are unacceptable. Another criticism is that several non-interest banks transactions are similar to those of interest banks. The difference between the two banking models is the length of time for which non-

interest banks held a commodity. Nowadays, many non-interest banks are changing their pricing strategies to comply more exactly with Islamic rules of financing.

Profit- and loss-sharing modes of financing mean that instead of lending to borrowers at fixed interest rates, a bank forms a partnership with the borrower. *Mudaraba* (sleeping partnership) and *musharaka* (long-term equity) are the two forms of this mode of financing. A bank has a proportion of its profit generated by a borrower. Warde said that depositors and bankers in this financing scheme associate their loyalty with the success of the project. Besides, entrepreneurs focus on the project's long-term profit instead of debt servicing; this reduces the rate of default on investments (Warde, 2000, 135–6).

In *mudaraba*, *rabb al-mal* (the money owner) put his funds under the possession of a *mudarib* (managing trustee) according to an agreement. The managing trustee receives part of the profit at the end of the operation, but not in a lump sum or guaranteed return. He is not responsible for the loss of capital. The bank also holds the managing trustee operational risk. There are two different positions on the allocation of profits generated from *mudaraba* transactions. *Hanafis* and *Hanabalīs* claim that capital should be returned to the money owner, after which profit can be shared. *Malikis* and *Shafiīs* argue that a bank must distribute profits when operations have been completed; capital has to be repaid afterwards (Warde, 2000).

Non-interest banks also involve in commodity and foreign exchange markets. These activities are allowed under *sharia* rules, although non-interest banks cannot deal with government or corporate bonds because they include interest rates. Equity investments are acceptable, according to most scholars.⁴³ However, equities are

⁴³ See for instance, Parigi (1989) and Warde (2000)

forbidden when the company's income comes from illicit operations. Islamic finance rules forbid trading the equities and commodities of loss-making enterprises. Scholars predict that these instruments encourage investment promotion (Parigi, 1989: 138). Some exceptions prevail; for instance, profit from forbidden activities (such as wine trading) goes to charities. In all circumstances, financial transactions must meet all Islamic rules for trading financial products.

Non-interest banks face problems of liquidity management and lack of innovation (Banker, 2000b). However, in large Islamic financial centres such as Bahrain, the Islamic banking industry seems to grow at high speed and to produce new products, such as the *Bai-Salam Suquq* and the *Islamic Development Suquq*. The former is designed for short-term investments and the latter for long-term investments. Nevertheless, traditional financial products still dominate the industry. The Bahrain Monetary Agency is playing a major role in establishing the first Islamic International Money Market (Banker, 2000b).

Dissimilarities in non-interest banks' financial statements may be attributed to differences between their accounting practices and the *Sharia* board explanations (Banker, 2000b). For example, investment accounts are registered as off balance-sheet items at certain banks and on balance-sheet items at other banks. Another dilemma that confronts non-interest banks is the absence of transparency.

Derivatives are used mostly for hedging against interest rate and exchange rate volatility and for managing other risks. Almost all types of derivative are forbidden in Islamic law because they involve *gharar* (uncertainty). Scholars representing the *sharia* board suggested that banks should manage derivatives smoothly to make them

fulfil Islamic financial rules. This would entail removing elements that conflict with *sharia* rules (Warde, 2000: 139–40).

Non-interest banks can create new products by changing the structure of conventional banking instruments. For example, the value of bonds includes the principle and the fixed interest rate paid on them. Eliminating interest rate payments make bonds comply with Islamic law. Classic *fiqh*⁴⁴ creates new products by combining two financial instruments (Warde, 2000). Interest banks can be innovative, even in Islamic products: in Pakistan, Grindlays⁴⁵ was the first bank to introduce the *musharaka* agreement.

Warde (2000) noted that conventional banking performance is based on trial and error. This is why interest banks are free to select instruments that match their strategies. By contrast, non-interest banks' products must conform to principles set by *sharia* boards, and this prevents non-interest banks from diversifying their portfolios. To avoid this problem, Warde proposed that non-interest banks improve their lending policy and exploit all market segments that fit with the Islamic mode of financing.

The *Sharia* board is the source and guidance for non-interest banks (Ainley, 1996), but scholars who represent the *sharia* board adopt different methods and principles. For example, some financial deals in Malaysia may not be acceptable in the Middle East and *vice versa*. This is due to different interpretations of Islamic law in various parts of the world. To solve this problem, uniform guidelines for Islamic finance are needed (Duncan, 1996: 12–3).

⁴⁴ *Fiqh* is Islamic law as explained by scholars (Lewis, 2001). There are several schools and some of them are conflicting. Mainly, *fiqh* comprises five basic criteria: (1) analogy deduction; (2) subjective opinion; (3) moral or social preference; (4) inference; (5) public interest and consensus of opinion.

⁴⁵ Grindlays had total assets of USD97,35 billion in 1999 (Pandya, 2000).

Ainley (1996) stated that most non-interest banks are concentrated in regions that accept Islamic modes of financing. According to the Bank Negara (Malaysia) Annual Report (2001), global banking exists in countries with many financial players, a variety of financial instruments, and a large inter-bank market. Meanwhile, non-interest banks mostly operate in small financial markets and trade limited financial products (Ainley, 1996: 13).

Non-interest banks face more global operational difficulties than conventional banks due to variations in financial codes from country to country (Fox, 1996: 24). Fox notes that uniform accounting standards are necessary if non-interest banks are to develop, meaning that non-interest banks need to use international accounting standards in preparing their financial statements.

A large amount of non-interest banks' credit is in the form of short-term loans. Duncan (1996) suggested introducing products that can be used for long- and medium-term financing; he also said that non-interest banks need to reduce substantial short-term lending. Because investment projects can be risky, banks need to analyse their investors' credit-worthiness accurately. The development of project financing is certainly a major step towards modern Islamic finance (Duncan, 1996).

Expected returns and risk-taking can affect Islamic banking performance. The return to depositors and shareholders can vary when financing high-risk, high-return projects. Because of this, most non-interest banks finance short-term investments that allow them to generate low returns and to take low risks (Zineldin, 1990). Zineldin presented three investment philosophies in his examination of Islamic modes of financing:

1. The financial system must be market oriented. Investments should be financed according to demand and supply rules.

2. Demand for long-term investment accounts is low compared with the demand for short-term investment account.

3. The return from investments depends upon “*the marginal efficiency of investment*”. The profit must be equally shared between banks, depositors and investors.

In his study of 16 non-interest banks, Zineldin (1990) found that the return on their investment deposits differed from the return on their equity. Non-interest banks have more autonomy in using their own capital in financing high-risk high-return investments than depositors’ funds. Moreover, the return on long-term investment deposits was always higher than the return on short-term investment deposits. Dividends are allocated in relation to time, deposits and project profitability. Losses are shared between the bank and depositors. Zineldin used four ratios for measuring non-interest banks’ profitability: average net profit, average net profit to total assets, average net profit to total deposits, and average net profit to total equity. The ratio of average net profit to total assets illustrates the risk of the project funded and its business sufficiency. Profitable banks always have a high average net profit/total assets ratio. Because non-interest banks have to perform in a “*group of business enterprises*” that includes shareholders, depositors and entrepreneurs, profit must be maximised to satisfy the group (Zineldin, 1990: 212–9).

Zineldin discovered that small- and medium-sized banks are more profitable than large banks. This means that dealing with large assets is a difficult process for non-interest banks, especially when there is a mismatch between assets and return on

investments. Interest banks, however, seem to have higher returns on their assets than non-interest banks when it comes to short-term lending (Zineldin, 1990: 216).

Non-interest banks generate income from the following services: return from direct investment, services charges, return from equity investment, financing commerce, trading foreign currencies, revenue from subsidiaries, earnings from the banks investments and firms, and *zakat* income (Zineldin, 1990: 213). However, deposits remain the main revenue source for non-interest banks.

Drummond (2000a) points out that accounting standards are unclear in Islamic modes of financing. “None of the contracts that are used by Islamic banks is catered by International Accounting Standards. For example, profit is treated in different manners in the Islamic banks financial statements” (Abdel Karim, 2000: 67). In Bahrain, profit is recorded for the whole period of the project financed. Non-interest banks operating in Malaysia, however, record profits after the payback period. The Accounting and Auditing Organisation for Islamic Financial Institutions has launched 16 accounting standards, including four on auditing and three on *sharia* rules. It recommends that non-interest banks should produce additional information about their activities. Earnings from operations that do not fit *sharia* code must go to charity (Drummond, 2000a).

The Internet has an impact on the growth of Islamic banking. For instance, www.islamicQ.com provides Muslims with full information about Islamic banking practices and products. This site and others provide important information for Muslims who wish to conduct their financial transactions according to Islamic rules (Bokhari, 2000).

Bokhari (2000) stressed that interest banks such as HSBC Investment Bank, Citibank and Deutsche Bank participate in the expansion of Islamic banking. They offer several Islamic financial services in both Western and Muslims countries. These banks' goal is to extend their market share. Therefore, globalisation provides an opportunity for global banks to grow by offering Islamic financial products.

Bokhari (2000) also notes four factors that would facilitate the growth of Islamic banking. First, it is necessary to establish an Islamic central bank to act as a lender of last resort to the Islamic financial institutions. Second, Islamic scholars have to be flexible and must accommodate new products. A third factor is flexibility by Muslim practitioners in their approach of designing Islamic financial products. Finally, banks have to use their capital effectively.

Wealthy Muslims are the main source of capital for most non-interest banks. The exceptions are Iran, Malaysia, Pakistan and Sudan, where governments play a primary role in converting interest banking into interest-free banking. In those countries, banks are forced to make all their services fulfil profit- and loss-sharing paradigms of financing.

Drummond (2000b) stressed that the absence of a money market for short-term assets have prevented the growth of Islamic banking. Money markets play a key role in meeting the short-term financial requirements of the ultimate borrowers. To escape this problem, non-interest banks should finance commerce through *murabaha* transactions. Drummond also argued that bonds can fund long-term projects. Because the non-interest banks' small market share may put pressure on their long-term products, it is necessary to launch money markets for secondary instruments to help non-interest banks manage their balance sheet effectively.

Another criticism of the modern Islamic finance is that borrowers may escape paying their debts, causing inevitable escalations in banks' losses. In Malaysia, the authorities have induced penalties for borrowers who fail to manage their business properly.⁴⁶ Regulatory standards are needed to improve non-interest banks' image across the globe.

Medium- and long-term investment financing accounted for less than ten per cent of Islamic banking activities in 1988. Gafoor (1995) claimed that Islamic financial products are unsuitable for long-term financing because of delay in capital recovery. Long-term projects also bear high market risks; thus non-interest banks need to be experienced in assessing investments.⁴⁷

Gafoor (1995) noted that the government is one of the major borrowers from Islamic banks. Governments use banks' funds to finance their expenditures, consumption or projects. Usually, the return from state projects is low. Therefore, a government may delay repaying its debts, resulting in increased losses for non-interest banks.

Wilson (1990) drew a distinction between banking competition in Islamic countries where there is more than one non-interest bank, such as Egypt, and in countries where there is only one non-interest bank, such as Jordan. In the former, non-interest banks compete with each other, but in the latter non-interest banks compete with conventional banks. He found that interest banks are more competitive in deposit-taking than non-interest banks. He also noted that depositors are uncertain about the future of their funds. He claimed that clients base choices on available

⁴⁶ "The possibility of fraud is there but we have to differentiate between fraud and genuine losses to understand Islamic finance" (El-Khalifa, 2000).

⁴⁷ Non-interest banks recover their capital in instalments.

information about credit conditions. From the consumer's perspective, the process of selecting a good bank is a complex one because bank data can be confusing. Depositors also have difficulties analysing bank data (Wilson, 1990: 19–25).

Wilson argued that non-interest banking competition may relate to the business financed. “The issue of competition in Islamic banking not only encompasses the structure of the banking sector itself, but also the rest of private sector business” (Wilson, 1990: 30). Banks usually have a competitive advantage in activities financed through *murabaha* or *ijara* leasing; in *murabaha* equity, a bank has to categorise companies according to its stake in each of them.

Despite non-interest banks' working capital structure, their market power is still low because most companies in the Islamic world use their retained profit for expansion. In case of joint ventures between a bank and a company, the possibility of losing large assets to liquidation is often high if the joint venture goes bankrupt (Wilson, 1990: 30–1).

Wilson stresses that competition is a key element for improving innovations, reducing prices, and enhancing business control. On the other hand, he advises non-interest banks to minimise their market risk to boost domestic financial market stability and to enhance financial innovation. Newly created financial instruments, however, must satisfy the Islamic *sharia* board (Wilson, 1990: 31–2).

El-Ashker (1987) compared the market strength of three banks: the National Bank of Egypt, the Islamic International Bank for Investment and Development and the Financial Islamic Bank for Investment. He used two criteria for that comparison: capital structure and financial ratios. He found that the non-interest banks have

higher credit components than interest banks (El-Ashker, 1987: 174).⁴⁸ The ability to provide credit differs from one non-interest bank to another depending on the bank's capital cost. Non-interest banks also had low loans-to-total-assets ratios during their early years of their operations in Egypt (El-Ashker, 1987).

Banks' cash resources have been influenced by their own credit strategies. The Financial Islamic Bank for Investment had the highest cash-to-total-assets ratio; the National Bank of Egypt had the lowest. The National Bank of Egypt bore more investment operations than the two Islamic banks. Because of the Financial Islamic Bank for Investment's and the Islamic International Bank for Investment and Development's involvements in trade financing, their long-term investments are minimal. El-Ashker argued that interest banks hold a large proportion of government bonds, which contravenes Islamic financial principles; he also claimed that the profit and loss sharing mode of financing is inadequate for long-term investments with prolonged payback periods (Al-Ashker, 1987).

The aim of applying financial ratios is to evaluate the efficiency and the profitability of the interest bank in comparison to the two non-interest banks. El-Ashker split the financial ratios into seven groups. The first ratio was net profit before tax/total assets, which measures the return on total assets. He discovered that the two non-interest banks have low profitability margins. On the other hand, their capital turnover ratio seems higher than that of the conventional bank. The third ratio is total revenue/total assets. The two non-interest banks seem to have higher revenue-to-total-assets ratios than the interest bank.

⁴⁸ Non-interest banks have the capacity to afford more credit in comparison to their capital resources.

El-Ashker also found that interest banks have higher banking-service-revenues-to-total-revenue ratios than non-interest banks. He noted that this is due to dissimilarities in the structure of each mode of financing. Non-interest banks use more than 95 per cent of their funds to finance commerce and small businesses. Securities trading accounts for a small portion of non-interest banks' activities (El-Ashker, 1987: 181–2).

The third group of financial ratios evaluates the ratio of deposits to total assets. It shows that the interest bank has lower deposits-to-total-assets ratios than the Financial Islamic Bank for Investment and the Islamic International Bank for Investment and Development. The fourth group of ratios indicates the relationship between a bank's financial ability and its lending effectiveness. El-Ashker claimed that non-interest banks give more lending facilities to their borrowers than interest banks, which invest part of their funds in securities. The National Bank of Egypt holds a greater amount of long-term finance, of which government bonds account for the largest part. The ratio of equity participation to total assets is higher in the Islamic International Bank for Investment and Development than in the National Bank of Egypt and the Financial Islamic Bank for Investment.

The fifth group comprises net profits after tax/equity capital and net profit after tax/paid up capital. It measures the shareholders' benefit from banking activities. El-Ashker argued that the absence of interest-rate income in Islamic finance means that shareholders receive more revenues in interest banking model than in non-interest banking model. Non-interest banks' earnings were also affected by *zakat*⁴⁹ (El-Ashker, 1987: 183). The sixth group, which measures banks' liquidity, encompasses

two ratios, cash and net bank due/total deposits and cash net bank due/current deposits. El-Ashker found that the Islamic International Bank for Investment and Development and the National Bank of Egypt are more liquid than the Financial Islamic Bank for Investment when total deposits are taken into consideration. However, the second ratio suggests that non-interest banks are more liquid than interest banks. Group seven evaluates the ratio of bank lending to total funds. It demonstrates that non-interest banks and the interest bank use a greater proportion of their deposits and equity to finance their operations (El-Ashker, 1987).⁵⁰

El-Ashker used those financial ratios to demonstrate that non-interest banks are more competitive and efficient than interest banks in both lending and borrowing. “The religious enthusiasm of all parties concerned seems to represent a major factor behind the success of the banks, a factor which is reflected in what has become known as the resurgence of Islamic economics” (El-Ashker, 1987: 185).

The literature shows that globalisation of financial services has affected Islamic banking performance positively in both home and host countries. Non-interest banks’ market share has grown rapidly in the Islamic world where there is high demand for non-interest financial products. Non-interest banks, such as *El-Baraka* group and *Radjhi*, also trade their products in foreign markets such as the United Kingdom and the United States. Conversely, several interest banks now offer Islamic financial products. Altogether, the non-interest banking model has entered a new era in which non-interest banks compete directly with interest banks.

⁴⁹ *Zakat* is an amount of money paid by wealthy people or other institutions to individuals who are in financial difficulties in the Muslim population (Lewis, 2001).

⁵⁰ El-Ashker (1987) claimed that mark-up should be ignored so as to link lending capacity to financial resources. The amount paid will reduce the amount of cash at the bank.

2.5. Conclusion

During the past decade, many scholars have studied the effects of globalisation on the banking industry.⁵¹ The literature has shown that financial liberalisation, financial innovation and the Internet are the major factors behind this phenomenon. These three elements have changed banks' structures and activities. As a result, banking competition and efficiency have increased for both local and foreign banks.

Scholars agree that replacing a centralised financial system with a market-oriented financial system improves the allocation of financial resources. Foreign bank entries encourage existing local banks to improve their services and to modernise their operations. Nonetheless, the profitability and market share of local banks declined after financial liberalisation; this happened because of competition from foreign banks, which were in a better position in terms of technology and clean balance sheets.

Researchers share the opinion that financial liberalisation can promote banking efficiency in transitional countries (see, for example, Bonin and Leven, 1996; Oxelheim, 1995). Globalisation removes barriers to both local and foreign players and improves economies of scale and scope in the banking sector. Additionally, it reduces the government's role in the banking industry, something that improves banks' fund mobilisation and lending mechanisms.

State-owned banks need to be recapitalised and privatised to improve their services (see for instance, Bonin and Wachtel, 1999). Recapitalisation enables state-owned banks to reduce the amount of non-performing loans in their portfolios (Helleiner, 1999). On the other hand, lending money to loss-making enterprises must

cease immediately (Shaw, 1973). The removal of the existing lending constraints helps state-owned banks to make good lending decisions and to improve their financial performance.

Scholars also concur about the role of financial innovation in integrating financial markets. The lack of innovation by local banks in many developing countries — because of low technology and strict financial regulations — encourages foreign banks to offer new instruments that are more sophisticated and less costly (Davis, 1983). These products create dynamism in the financial market and provide borrowers and lenders with many options when they are placing their funds. The positive response of individuals and corporations to new products helps banks penetrate new financial markets.

Few papers have studied the impact of e-banking on globalisation of financial services. Those papers determine the benefits of selling financial services through the Internet (Miklaszewska, 1998). They demonstrated that the Internet enables individuals and investors to access banks' products from anywhere in the world (Oxford Analytical Citibank, 1999). They also show how the Internet helps banks cut their costs and speed up their financial transactions.

The literature review has also shown that non-interest banks are growing steadily, especially in Muslim countries (Ainley, 1996). As a result, the competition between non-interest and interest banks has gradually increased. Muslim scholars have urged the *sharia* board to adopt a more flexible approach that would allow non-interest banks to launch new products and to become more competitive in domestic and foreign financial markets (Warde, 2000). They have also emphasised the need for

⁵¹ See for example, Armijo (1999), Buelens (1999), Campbell (1996) and Chen (1998)

uniform accounting standards to evaluate non-interest banks' assets and liabilities (Duncan, 1996).

Many scholars⁵² noted that globalisation of financial services has contributed to an increase in banking profitability and competition. However, the experience of countries such as Malaysia shows that local banks' profit margins decline after financial liberalisation (Brimmer, 1998). To avoid a large drop in their earnings, local banks must improve their technology, staff training, capital and portfolio diversification to compete with those of foreign banks.

In a global economy, banks must boost their asset productivity to achieve economies of scale and scope. They need to extend credit to only high-return and low-risk businesses. They should develop securities activities, reduce low-performing assets, offer quality services, and cut costs. In addition, they should adopt "risk-adjustment returns" by using high-earning assets to foster capital distribution and increase "risk-adjusted returns" (Oxford Analytical Citibank, 2000: 3). They also need to improve "internal risk management" to ensure appropriate use of capital and thereby improve capital efficiency. The high net interest margin is important in modern retail financial services. Reducing non-performing assets and shifting to non-interest income are also necessary measures. Profitable banks tend to produce high revenues from their capital and assets. Consequently, they need to boost revenue growth, to deduct low-yield assets and to reallocate the composition of their assets (Oxford Analytical Citibank, 2000).

The next chapter analyses the developments in the Algerian banking industry since independence. This comprises four successive periods: (1) before independence

⁵² See for example, Levine (1996); Peek and Rosengren (2000)

(1830–1962); (2) immediately after gaining independence (1962–68); (3) during the socialist economic regime; and (4) the transition to a market-oriented banking system. To fulfil the research aims, we focused our examination on the transitional period, i.e. 1990 onwards. This enabled us to analyse the changes that occurred in banking industry and stock market during and after financial liberalisation.

Chapter 3:

THE ALGERIAN BANKING INDUSTRY AND STOCK MARKET

3.1. Introduction

This chapter analyses the institutional framework of the Algerian banking industry, showing its characteristics before and after independence. It also examines how financial liberalisation affected each banking group operating in Algeria.⁵³ The removal of restrictions such as interest rate ceilings and direct government interventions in state-owned banks' operations are expected directly to affect banking competition, profitability and efficiency (Benhalima, 1998).

Algeria is a former socialist country in which more than 90 per cent of the banking sector is owned by the state. After the country gained its independence in 1962, financial authorities implemented a centralised financial system, nationalising all foreign banks to create a monopolistic banking sector where all banks were owned by the state. State-owned banks' funds were used to finance state-owned enterprises and government expenditures, and the Ministry of Finance played a major role in mobilising financial resources. This situation remained unchanged until 1990, when the government first initiated its programme of financial liberalisation.

The Algerian banking sector has had four development periods (Benhalima, 1998). The first period was before independence, i.e., before 1962. In this period, the

⁵³ The increased number of private and foreign banks operating in Algeria can be attributed to financial liberalisation.

Algerian financial market was under the control of colonial banks, which fell into four categories: issuing, peoples (*populaire*), deposit and merchant banks. The second phase lasted from 1962–68. In this period, foreign banks dominated the national financial market. These banks were taken over by the newly established state-owned banks: *Banque Nationale d'Algérie* (BNA), *Banque Extérieure d'Algérie* (BEA) and *Crédit Populaire d'Algérie* (CPA). The authorities also established a development bank, *Banque d'Algérie de Développement* (BAD) to finance long-term investments. In the third period, 1968–90, all foreign banks were nationalised and replaced by state-owned banks. In the 1980s the government set up two new state banks, *Banque de Développement Local* (BDL) and *Banque de l'Agriculture et de Développement Rural* (BADR). The final phase, from 1990 onwards, took place after the Algerian authorities had initiated financial liberalisation. As a consequence of this move, several foreign and private banks moved into the Algerian financial market. Authorities also established the Algiers Stock Exchange and privatised state-owned enterprises, which transferred to joint-stock companies – “*des société par actions*”. Currently, only four companies are trading their shares on the Algiers Stock Exchange (Ministry of Finance, 2002).

There are three main categories of banks: domestic, foreign and Islamic (non-interest). These differ in their structure, activities and market share. State-owned banks still have a 90 per cent market share, and are followed by Algerian private banks and foreign banks. However, foreign banks' market share has grown steadily over the past five years and the sole non-interest bank, *El-Baraka* Bank, has likewise expanded its business by opening new branches and attracting new customers.

The Algerian financial market is small in terms of number of players and volume of financial transactions.⁵⁴ The government-controlled state-owned banks through the Ministry of Finance and the *Banque Centrale d'Algérie*. In 1990, 80 per cent of state-owned banks' loans went to state-owned enterprises (Khalaf, 2000). Because the country had no stock exchange, the government had used the development bank to finance long-term investments. There were two forms of investments: centralised and decentralised.

In 1990, the new Law on Money and Credit led to various changes in the structure of the Algerian banking sector. The law allowed for the creation of private banks and for the establishment of foreign banks' branches in Algeria (Benhalima, 1998). The Bank of Algeria granted seven licences to private banks during the period 1990–2000 (Bank of Algeria, 2000). It also granted many licences to foreign banks such as the Natexis El-Amana Bank and the Arab Bank Corporation. Nevertheless, only a few foreign banks opened branches in Algeria during that time because of political instability. In the past two years, Algeria has become more politically stable and this has encouraged other foreign banks to set up business in the country (Ministry of Finance, 2002). Analysts predict that the increase in the number of private banks and the appearance of new financial products will encourage local banks to modernise their services and to learn from the experience of well-developed banks such as CitiBank and *Société Général d'Algérie* (SGA). Likewise, the withdrawal of the government from the banking sector will enable state-owned banks to reduce their bad debts and to improve their lending mechanisms.

⁵⁴ There are 19 banks operating in Algeria: 6 state-owned banks, 7 Algerian private banks, and 6 foreign banks (Bank of Algeria, 2003).

There is currently only one non-interest bank in Algeria, *El-Baraka* Bank. It provides limited Islamic financial products such as *musharaka*, *murabaha* and *mudaraba*, but has a monopoly on these financial instruments because no other financial institution offers similar products. *El-Baraka* Bank has only eight branches across the country, two of which are in the capital (*El-Baraka* Bank Annual Report, 2001).⁵⁵

Foreign banks are the main providers of e-banking services in Algeria. Although large local banks have their own Web sites, they do not use the Internet to sell their products. Only 100,000 people in Algeria (0.3 per cent of the population) are Internet users and only 1.5 per cent of Algerian enterprises have their own Web sites (El-Watan, 2000).⁵⁶ Consequently, the Internet has a minimal impact on the Algerian financial market.

3.2. The Algerian banking system

3.2.1. The Algerian banking system before independence

Modern banking began in Algeria in the mid-nineteenth century (Ernest-Picard, 1930). The French authorities established many commercial and merchant banks to facilitate the financing of commerce (Rossignoli, 1973).⁵⁷ Those banks operated only in major cities; they did not serve rural areas. Some projects acquired credit through issuing, deposit or merchant banks; people's banks funded small firms; and the *Caisse de Crédit Agricole Mutuel* served the financial needs of the agricultural sector.

⁵⁵ In 1998, *El-Baraka* Bank employed 234 staff.

⁵⁶ The Algerian government has opened the Internet services market to foreign competition. These new firms are trying to increase the number of users, but the process is still slow.

From 1851 to 1880, the French authorities attempted to promote savings and to combat usury in the new colony (Ernest-Picard, 1930). The colony's strategic geographical location and its natural resources gave French authorities an incentive to establish Algeria's first bank, *Banque d'Algérie*. The roles of the *Banque d'Algérie* were to improve credit mobilisation, to encourage capital inflows into the colony, to enhance trade, and to extend credit to industry and agriculture in order to develop the economy. In the 1850s, the French government had also planned to establish a stock exchange in Algeria (Rossignoli, 1973).

Before 1880, the *Banque d'Algérie* portfolio included only secured loans (Rossignoli, 1973), but in the 1880s and 1890s the bank extended many loans to the agricultural and housing sectors to facilitate the increasing numbers of Europeans who entered Algeria during that period.⁵⁸ The result was a sharp decline in the bank's assets. After the World War II, the French authorities decided to nationalise the *Banque d'Algérie* to boost its financial position and to improve its management. The bank was also given more authority in supplying credit to the economy.⁵⁹

The first French merchant bank to establish its network in Algeria was the *Crédit Algérien*. In its first phase, it funded property acquisitions, and in its second phase it specialised in financing infrastructure. The second bank that offered services to investors was the *Banque Industrielle pour l'Algérie et de la Méditerranée*. It provided financial advice to investors in agriculture, commerce and industry; assisted other

⁵⁷ The Algerian banking system was an integrated part of the French banking system until independence (Rossignoli, 1973).

⁵⁸ Most of these newcomers were involved in farming (Rossignoli, 1973).

⁵⁹ The *Banque d'Algérie* never acted as a central bank under French colonial rule because of financial rules adopted by the French government. For instance, French commercial banks were refinancing themselves through their parent banks in France. French banks were also not obliged to obtain financial ratios, as was the case in France (Rossignoli, 1973).

Algerian financial institutions with credit evaluation; and issued shares and bonds for companies and the government (Rossignoli, 1973).

After the World War II, French authorities in Algeria adopted policies to promote credit mobilisation and to strengthen France's financial link with the colony (Rossignoli, 1973). The plan also reinforced French control over credit allocation and deposit collection. Two committees were established in 1948 and several financial rules were initiated in 1947.⁶⁰ The role of the committees was to verify all banking decisions and to analyse banks' practical problems.

The French banks that entered Algeria after the World War II took over almost all *Banque d'Algérie* activities, especially those related to the agricultural sector and to commerce. France's large public and semi-public credit institutions were also involved in various lending activities in the 1950s, although those institutions were forbidden to open branches in the colony.

The *Caisse de Crédit Agricole Mutuel* and the *Société Agricoles de Prévoyance* managed credit to the agriculture sector. The *Caisse de Crédit Agricole Mutuel* extended short-term loans and the *Société Agricoles de Prévoyance* granted short-, medium- and long-term loans as well as receiving deposits from farmers. Benissad (1980) pointed out that short-term credit was commonly used in financing the agriculture sector. In fact, 43.7 per cent of the credit went to the agricultural sector, and 86 per cent of loans were short-term. Benissad (1980) noted that the colonial organisation of credit to the agricultural sector was based on notions of social and economic dualism.

⁶⁰ The two committees were the *Comité d'Organisation Professionnelle* (professional organisation committee) and the *Comité de Crédit* (credit committee).

During colonisation, the Algerian market was entirely linked to the French market. The *Banque d'Algérie* had almost no influence on the market; the Treasury, acting through the issuing banks, met the colony's financial needs. The *Conseil National du Crédit* (National Credit Council) served as the Algerian credit market's supervisory institution. To maintain economic stability, the council controlled liquidity ratios, personnel, inter-bank activities, and competition. It also granted licences for banks to operate in Algeria and for mergers (Rossignoli, 1973).

Outside the *franczone*, foreign exchange transactions controlled and capital outflow restricted (Rossignoli, 1973). Countries within the *franczone* were obliged to adopt fixed foreign exchange rates. Although capital flowed freely inside the *franczone*, capital movements took place by means of an advance account. The *Banque d'Algérie* had to open two accounts at the *Banque de France*. The first account showed daily financial transactions between Algeria and France. The second account was used when the first account had a deficit balance.

Before 1962, banks operating in Algeria fell into four categories: commercial banks, merchant banks, credit institutions and development banks (Rossignoli, 1973). French commercial banks had a network of 409 branches: 149 in Algiers, 154 in Oran, 83 in Constantine, and 23 close to oil regions in the Sahara. European investors entirely controlled the activities of those banks, and credit was extended in the form of short- or medium-term loans. There were three merchant banks: *Crédit Algérien* (established in 1881), *Banque Industrielle pour l'Algérie et de la Méditerranée* and *the Banque de Paris et des Pays-Bas*. The first was engaged in funding real estate property and infrastructure. *Banque Industrielle pour l'Algérie et de la Méditerranée* operated as an advisory body for commercial and private companies. The third bank

was particularly involved in financing commercial and industrial businesses. Credit institutions did not have branches in Algeria. They mostly extended medium- and long-term loans to industry companies, funded local authorities, and funded the rediscount bills of commercial banks. The only development bank was the *Caisse d'Equipment pour le Développement de l'Algérie*, which mainly financed large public and private companies (Rossignoli, 1973).

3.2.2. The Algerian banking system immediately after gaining independence (1962–68)

Many European investors left Algeria immediately after independence was declared on July 5, 1962. This had negative implications on the national economy as whole and on the banking sector in particular. Credit to the public and private sector declined dramatically because of the fall in the amount of deposits held at French-owned commercial banks and credit institutions (see Table 3.1). To improve the mobilisation of financial resources and to obtain control over the national banking sector, the Algerian financial authorities established several state-owned financial institutions and nationalised almost all foreign financial institutions. Both measures led to the creation of a state-owned banking sector and to the disappearance of foreign players.

From 1962–65, the financial authorities established three credit institutions. The people's banks also continued their market activities with financial support from the Algerian government, but they were obliged to lend to priority sectors designated by the state. The small savings banks and the *Caisse Nationale d'Epargne* closed down after a central savings bank, the *Caisse Nationale d'Epargne et de Prévoyance*

(CNEP), was set up in 1964. CNEP was established to fund housing, and to provide “social credit” and credit for domestic authorities (Benissad, 1980).

Table 3.1: The French commercial banking network in Algeria in 1962

Bank	Number of branches
<i>Crédit Foncier d'Algérie et de Tunisie</i> ⁶¹	133
<i>Compagnie Algérienne de Crédit et de Banque</i> ⁶²	131
<i>Crédit Lyonnais</i>	61
<i>Banque Nationale pour le Commerce et l'Industrie d'Afrique</i>	45
<i>Société Générale</i>	18
<i>Société Marseillaise de Crédit</i>	8
<i>Crédit Industriel et Commercial</i>	8
<i>Comptoir National d'Escompte de Paris</i>	4
<i>Crédit du Nord</i>	2
<i>Barclays Bank</i>	2
<i>Worms et Cie</i>	2
Total	414

Source: Rossignoli (1973)

Both people's banks and foreign banks suffered large financial losses in the years after independence.⁶³ Their deposits lowered significantly: after the departure of European businessmen and staff, households' deposits decreased from 20 to 5 billion old francs. As a consequence, several banks closed down and others required state assistance to continue their operations. The number of foreign banks declined from 18 in 1962 to 7 in 1968 (Rossignoli, 1973).

Before the nationalisation of the banking sector, the *Banque Centrale d'Algérie* (BCA) did not control credit flows and market liquidity. Foreign banks had a monopoly on both functions. However, the government policy of reducing foreign banks' market share increased the BCA's role as a “bankers' banker,” and gave the BCA more control over internal and external credit flows. BCA granted many medium- and long-term loans to the agricultural sector. It also acted as an

⁶¹ The *Crédit Foncier d'Algérie et de Tunisie* granted medium- and long-term credit to different sectors of the economy.

⁶² The *Compagnie Algérienne de Crédit et de Banque* financed only trade and profitable businesses.

intermediary between the domestic *comptoirs d'escompte* (discount house) and farmers. This contributed to better allocation of credit to the agricultural sector.

The credit that went to the agricultural sector constituted more than 60 per cent of total loans (Rossignoli, 1973). This was because most investments were within the farming industry. Other industrial sectors were underdeveloped and included only a few factories. Industry and trade respectively received less than 20 and 15 per cent of the credit. Of the available industrial credit, more than 50 per cent went to the energy and metallurgy industries (Rossignoli, 1973). The departure of European staff led to the closure of many factories and to a decline in trade volume, and it took a long time for the new state to build its own industry (Benissad, 1980). The production of the remaining factories declined substantially because of progressive deterioration in management and decrease in the source of financing.

The government founded the *Caisses Algérienne de Développement* in 1963 for financing public investment and infrastructure. After 1966, the *Caisses Algérienne de Développement* specialised in funding direct public investments. The bank used national and foreign financial resources to meet the financial needs of its borrowers. In the period between 1962 and 1968, investments in the public and socialist sector were also financed through the state budget and commercial bank loans (Benissad, 1980).

Government banking policy from 1962 to 1968 contributed to high banking specialisation. The minister of finance, Kaid Ahmed, pointed out that state-owned banks' role was to collect financial resources and to use those resources to fund the

⁶³ The managers of people's and foreign banks were Europeans and their operations were with French companies.

economic planning operations designated to each bank (*Ministère de l'Information*, 1967: 14–5).

3.2.3. The Algerian banking system during the socialist economic regime (1968–90)

After 1968, all of the banks were merged into three large banks that operated under the control of the central bank. However, two foreign banks continued their activities in Algeria: the *Banque Populaire Arab* and *Compagnie Française de Crédit et de Banque*. The remaining foreign banks gradually decreased their activities because of nationalisation. Financial regulations forced those banks to close their branches, which were then taken over by the new national banks.

Foreign banks also extended credit to farmers, but after 1968 the *Banque Nationale d'Algérie* (BNA) became the only bank to specialise in financing the agricultural sector. Farmers were obliged to open their bank accounts with BNA. The BCA moved to other duties, which included direct lending to the government and making payments conjointly with public funds.⁶⁴ According to Article 62 of Algeria's Financial Law, the BCA is a financial institution owned by the state. It is responsible for the supervision of the banking system and the management of foreign exchange reserves.⁶⁵

During the socialist economic regime, the government's objectives were to boost investments, to control capital movements, and to ensure the success of political adjustments (Benissad, 1980). Socialist policies also included controlling foreign

⁶⁴ The aim of this new banking policy was to meet the financial needs of growing public sector.

⁶⁵ See Benissad (1980) and Rossignoli (1973)

exchange, centralising funds towards national enterprises, controlling consumer credit and supporting central bank interventions on agricultural credit.

Individuals and almost all state-owned enterprises were obliged to open their accounts with BNA, which was also the main source of funds for most industries (the hydrocarbon sector was an exception). About 75 per cent of BNA's loans were short-term credit; *Banque Extérieure d'Algérie* (BEA) made medium- and long-term loans to companies operating in the energy and metallurgy industries. That BNA had the lion's share of both short- and long-term loans, with more than 80 per cent of the market, and the largest network in the country, with 73 branches in 1969, explains why BNA had the largest market share, followed by BEA and *Crédit Populaire d'Algérie* (CPA) (Rossignoli, 1973).

The main roles of state-owned banks were collecting deposits at low interest rates and financing government expenditures and state-owned enterprises' projects. This meant that interest rates on deposits and loans were negative in real terms. Banks were also forced to lend to particular sectors of the national economy such as agriculture and real estate. The BCA provided the commercial banks with liquidity by rediscounting their bills at fixed rates.

Foreign exchange activities were strictly regulated by the central bank, which was the only financial institution permitted to hold foreign currencies. The absence of a real foreign exchange market prevented foreign investors from bringing their capital into Algeria. Likewise, local investors were unable to operate in foreign markets because of the tight control on capital transfers.

Self-managed enterprises obtained credit through the remaining foreign banks, which only extended credit to solvent enterprises. Insolvent enterprises continued to

operate only because they had state help (Benissad, 1980). By the late 1960s, these dramatic changes in the financing of self-managed enterprises had created confusion around distributing credit to those enterprises.

Table 3.2: State-owned banks' operations during the socialist economic regime

Bank	Activities
<i>Banque Extérieure d'Algérie</i> (BEA)	<ul style="list-style-type: none"> • Finances national companies in industry, especially hydrocarbon. • Enhances transactions with foreign countries. • Finances foreign trade.
<i>Banque Nationale d'Algérie</i> (BNA)	<ul style="list-style-type: none"> • Finances government projects. • Finances public enterprises. • Finances the agricultural sector.
<i>Crédit Populaire d'Algérie</i> (CPA)	<ul style="list-style-type: none"> • Finances small to medium public enterprises, hotels, fisheries and craftsmen.
<i>Caisse de Crédit Municipal d'Algérie</i>	<ul style="list-style-type: none"> • Provides credit to individuals "social loans". Functions as a traditional pawnshop.
<i>Caisse Algérienne de Développement</i>	<ul style="list-style-type: none"> • Mobilises loans from national and international banks. • Facilitates credit to small and medium enterprises. • Manages bonds and foreign investments and assets.

Source: Rossignoli (1973)

The scope of public investments started to grow quickly when the government initiated its first quadrennial plan (1970–73). Under this programme, control on capital flows was reinforced considerably. To cope with new economic conditions, the financial authorities adopted three ways of financing their economic planning: medium-term loans from commercial banks, long-term loans granted by the BCA and Ministry of Finance, and borrowing from international financial markets. In 1975, self-financing became permissible and 1978 saw the creation of another means of financing, the development grant. Despite these efforts, capital was only available for priority projects, which were almost non-profit making.

State-owned enterprises were more concerned with production than profitability (Benissad, 1980). As a consequence, they had negative growth in real terms. Despite this, state-owned banks continued to fund their projects under the government

programme of economic development and employment. Over time, the loans that went to those enterprises became non-performing and started to appear in state-owned banks' balance sheets.

Households in the Algerian financial system were placing their deposits in the five commercial banks or with the state-owned savings bank, *Crédit Nationale d'Épargne et de Prévoyance* (Benhalima, 1998). In the main, currency was the only financial instrument used by households to conduct financial transactions. However, households were not allowed to hold treasury bills.⁶⁶ To maintain low market risk, Algerian financial law also required households' funds to be channelled into unproductive investments (Beltas and Jones, 1993).

Almost all investments were by the state, and the private sector was small. Investment decisions were based on the budgetary policy of the government rather than on the productivity of the project (Benhalima, 1997). It was also compulsory for banks to finance projects selected by the government; concerns about their profitability were not admissible (Benhalima, 1997).

Authorities adopted two methods of mobilising local financial resources. First, the government used state-owned banks to collect savings. Second, the treasury issued investment bonds in two categories: 5-year maturity at 5 per cent and 10-year maturity at 6 per cent (Rossignoli, 1973). Pension funds and insurance companies were required to hold those bonds. State-owned enterprises were forced to keep their deposits and accumulation depreciation in a treasury account opened specifically for companies' deposits.

⁶⁶ Households were powerless to purchase several financial assets and the demand for their services was limited.

Four separate accounts were opened to receive deposits: *comptes de chèque* (cheque account), *comptes courant* (current account), *bons de caisse* (certificate of deposits) and *comptes à échéance fixe* (fixed-term account). The *comptes de chèque* was opened for individuals and the *comptes courants* for people engaged in commerce, farming or industry. Both of these were current accounts. The two other accounts were *certificat à term fixe* (fixed-term certificates) and *dépôt à term fixe* (fixed-term deposits).

State-owned banks rarely traded government securities, which were mainly in the form of public treasury bonds. State-owned banks mostly granted credit in the form of overdrafts on current accounts. Guaranteed loans were used only in foreign transactions. The Finance Act of 1971 also prevented state-owned banks from extending consumer credit.⁶⁷

In the 1970s, the relationship between state-owned enterprises and state-owned banks was strengthened to monitor the distribution of credit to the national economy. State-owned enterprises were obliged to submit their business plans to the state-owned banks. Credit to state-owned enterprises was granted based on the government's annual financial plan, and the Ministry of Finance had authority to modify the amount of credit extended to state-owned enterprises.

After 1971, various mechanisms limited competition in the banking sector (Benissad, 1980). First, in the absence of private banks, state-owned banks had a monopoly on funding industries and on collecting savings. Every enterprise was required to deal with one commercial bank. Second, credit arrangements between

⁶⁷ Companies had no right to lend to each other. The exception was trade credit.

state-owned enterprises were forbidden (Benissad, 1980).⁶⁸ Both regulations enabled state-owned banks to observe state-owned enterprises' financial adaptability and to be the only source of their funding. Second, the Algerian financial market was closed to foreign competitors and current and capital account transactions were strictly controlled.

State-owned enterprises were operating according to the government's plans for employment and consumer prices, and were not concerned about productivity and profitability. This resulted in a decline in state-owned enterprises' capital output ratios. The increase in the state budget deficit due to declining oil revenues led to a fall in the amount of subsidies the government extended to the public sector. State-owned enterprises became unable to service their debts and non-performing loans began to augment. These non-performing loans caused an imbalance in the state-owned banks' balance sheets. The sudden decline in oil prices in 1986 made matters worse, and non-performing loans accounted for a high proportion of commercial banks' assets. To reduce the pressure on state-owned banks, the government initiated financial liberalisation in the 1990s (Benhalima, 1998).

3.2.4. The transition to a market-oriented banking system (1990 onwards)

The financial liberalisation programmes introduced in the 1990s had the following goals: (1) to decrease the government's role in the financial sector; (2) to organise local savings; (3) to introduce market-oriented banking mechanisms; (4) to improve banks' solvency; and (5) to enhance competition in the banking sector (Jbili *et al*,

⁶⁸ The consequence was the absence of inter-enterprises debt (Benissad, 1980).

1997). The Law on Money and Credit of 1990 was the first step to be taken by the Algerian government to remove many barriers towards domestic and foreign banks. It reduced the role of the state in the banking sector and also gave the central bank full authority to manage the financial sector. The law enabled both private banks and foreign banks to operate in parallel with state-owned banks. It also allowed state-owned banks to select their borrowers and to enter other businesses.

The aim of the financial restructuring initiated by the government in the 1990s was to set up a sound institutional framework. The Ministry of Finance withdrew gradually from funding the national economy, although exceptions were made for “strategic” sectors such as hydrocarbons and infrastructure (Benhalima, 1998). The authorities also allowed banks to finance a variety of industries and to select their borrowers. Starting in 1993, the commercial banks’ refinancing came directly from the money market.

The government implemented several programmes to restructure the financial sector. First, direct lending to state-owned enterprises and the treasury was gradually removed to enable banks to improve the quality of their credit. Second, new procedures for financing the government budget reduced the amount of funds used by banks to finance government expenditures.⁶⁹ Third, the Treasury ceased its involvement in financing state-owned enterprises, and in 1994 state-owned banks were given more autonomy in managing their credit to the economy. Fourth, authorities abandoned the compulsory holding of treasury bills by state-owned banks. However, state-owned banks still have a significant proportion of treasury papers on

⁶⁹ The government budget deficit is now financed on a market basis and direct credit has been reduced dramatically.

their balance sheet, and *Crédit Nationale d'Épargne et de Prévoyance* has continued to finance public housing.⁷⁰

To promote competition among local banks, authorities opened the national financial market to private participation. In 1990, the government also abandoned rules that obliged state-owned banks to finance “priority sectors”. These measures have contributed to a steady increase in competition between state-owned and non-state-owned banks. Nevertheless, the high specialisation of state-owned banks and their small number has impeded competition in the market.

Third, Algerian authorities adopted gradual interest rate liberalisation. The process started in 1990, when administrative interest rates on credit were eliminated for both private and public sectors (Nashashibi *et al*, 1998). Interest rates on deposits were totally liberalised by the end of 1990. In 1995, the authorities ended the banking spread method of lending and allowed banks to offer competitive lending rates.

Ceiling interest rates on credit were the norm during the 1990s. The consequence was a negative interest rate in real terms. Besides, the dramatic increase in inflation was not reflected by a change in the interest rate. In 1994, authorities removed the ceiling rate on credit and fixed the interest rate spread at 5 per cent to avoid collusion between commercial banks (Nashashibi *et al*, 1998). The decline in the inflation rate since 1996 has also led to a positive interest rate.

Fourth, capital account transactions have been liberalised to improve competition in the financial market, to mobilise foreign exchange resources, and to facilitate the movement of foreign direct investments into the country (Nashashibi *et al*, 1998). In

⁷⁰ In 1995, the government used new auction methods to trade treasury bonds in the money market. All financial institutions are allowed to purchase those bonds.

April 1994, the government abandoned barriers preventing the use of foreign exchange. However, restrictions on residents' capital were continued to avoid capital outflows from Algeria.

Fifth, the government replaced non-performing loans with bonds (Nashashibi *et al*, 1998). The first bonds were issued in 1992–93 and they accounted for about 23 per cent of GDP. The treasury used external debt rearrangement to pay back most of those bonds. In 1994, an audit of state-owned banks' balance sheets showed that all banks except BNA needed injections of capital. In 1995, CPA and BEA received AD10 billion under a programme of recapitalisation. In 1997, the financial authorities issued the second loan-bond swap for the benefit of BADR, BNA and CNEP.⁷¹ Those bonds accounted for 8.5 per cent of GDP and they were not serviced in cash (Iradian, Bazzoni and Stefania, 2000). In total, between 1991 and 1997 the government injected AD168 billion into state-owned banks to cover the losses that resulted from foreign exchange and from previous loans to state-owned enterprises (Iradian, Bazzoni and Stefania, 2000).

Sixth, commercial banks arranged new credit terms for the benefit of profit-making state-owned enterprises. Meanwhile, many short-term overdrafts were replaced by medium-term loans. Enterprises applying for those loans were required to have equity participation from banks, performance contracts, and proof of commercial viability.⁷² Extending the maturity date of loans helped state-owned enterprises to stay alive and thus avoided job losses (Nashashibi *et al*, 1998).

⁷¹ The interest rate on those non-negotiable bonds was fixed at 10 per cent. BADR accumulated large amounts of non-performing loans to the pharmaceutical and food agencies.

⁷² These are used to monitor the financial strength of state-owned enterprises.

Because of the small size of the private sector and delays in privatisation, state-owned banks continue to fund public projects. Despite many accumulated bad loans, the government still believes that privatising those banks will cause financial market destabilisation and large job losses. The result is that the accumulated bad loans reached USD17 billion in 2000 (Bank of Algeria, 2000).

Table 3.3: Credit to the private sector / GDP

	1993 (%)	1998 (%)
Algeria	7	14.6 ¹
Jordan	61	73
Morocco	25	25 ¹
Tunisia	54	51
Turkey	16	25 ¹

Source: IMF statistics, July 1999

¹ Data for 1997.

The Algerian private sector received a small amount of credit, only 7 per cent of GDP in 1993 compared with 93 per cent extended to public sector (see Table 3.3). In 1997, credit to the private sector was only 14.6 per cent; 85.4 per cent went to the public sector (IMF, 1999). However, in 1999, credit to the private sector increased slightly, to about 17.8 per cent. Credit to the public sector was around 82.2 per cent of the total credit injected into the economy (IMF, 1999).

Seventh, the government established the first inter-bank foreign exchange market in 1996. Since then, foreign exchange rates have been determined by market mechanisms. Revenues from foreign exchange activities go to local banks instead of to the central bank. Local banks are given the autonomy to trade both local and foreign currencies, but the amount traded is small and banks are obliged to fulfil foreign exchange regulations.

Eighth, the secondary market for treasury bills opened in March 1998. It included two categories of securities, short-term treasury bills with maturity between 13 and

52 weeks, and medium-term treasury notes with 2-year maturity. Those securities were traded twice a week. Only primary dealers, *Spécialistes en Valeurs du Trésor*, have the right to trade securities. The small numbers of traded securities and market dealers have weakened the market substantially.

The new law phased out direct financing of the government budget deficit. Instead, the government established an auction market to sell treasury bonds to financial institutions. Another source of government budget financing was the central bank. However, insurance companies and pension funds are still obliged to hold certain government papers. It is extremely important to develop new long-term financial products within the auction market. This helps the government fund its expenses without resorting to central bank funds.

Ninth, after 1994 the authorities initiated further financial restructuring to improve commercial banks' accounting standards. All banks are required to meet the capital/risk-weighted asset ratio including non-interest banks. In 1995, the government introduced new financial rules for provisioning, risk concentration and loan classification (Nashashibi *et al*, 1998). The new regulations oblige banks to record overdue interest payment as income and to make provisions for off-balance sheet items.

Another stage in financial liberalisation is the entry of foreign banks into the national market. Almost all branches opened by foreign banks are located in five cities: Algiers, Oran, Constantine, Annaba and Hassi Messoud.⁷³ They follow their customers, who operate in those areas. Those cities also have more developed

⁷³ Algiers is the capital of the country. Oran, Constantine and Annaba are the three other major cities. Hassi Messoud is the main oil region of Algeria.

telecommunication systems compared with other regions. Foreign banks also attempt to strength links with multinational companies in those regions.

The entry of foreign banks into Algeria has contributed to the launch of new financial products. For example, in August 1999, Citibank announced a new instrument called '*banque à distance*' (Agence Algérienne d'Information Online, 1999). This instrument allows clients to access their accounts from a distance. It was the first financial product that allowed Algeria's financial service customers to access their accounts instantly and directly, to conduct all their banking operations (including foreign transactions) from a distance, and to access their credit accounts from a computer station. *Banque à distance* also helps Citibank's clients increase their efficiency and quicken their financial transactions.

Techniques adopted by foreign banks are different from those of local banks. For instance, Citibank's strategic orientation in North Africa provides its clients with innovative financial products and enables wealthy customers and large companies to access modern financial services (Citibank, 2000). Banks from the Gulf, such as the Aran Banking Corporation and the Arabic Bank, have been engaged mostly in financing trade and small businesses (Arab Banking Corporation Annual Report, 1999). It has been found that almost all foreign banks' activities are with large national and foreign companies (interview notes, 2001). For example, Citibank deals only with the energy companies *Sonatrach* and *Sonelgas*, and with the pharmaceutical sector (financial executive, Citibank, 2001).

Algerian private shareholders have stake in the capital of foreign banks such as SGA and Arab Banking Corporation (ABC), 28 and 20 per cent, respectively (Ghilés, 1999a). The only foreign bank whose entire capital belongs to its parent company is

Citibank. It has been also discovered that foreign banks have small capital compared with state-owned banks (see Table 3.4). This has a negative effect on foreign banks' lending potential (interview notes, 2001).

Table 3.4: Foreign banks' source of capital in Algeria

	Parent Company	Private Shareholders	Other Shareholders	Total
Citibank. (USA)	AD1.2 billions (100%)	-	-	AD1.2 billions
<i>Natexis.</i> (France)	AD400 millions (80%)	-	AD100 millions (11%)	AD500 millions
SGA. (France)	AD305 millions (61%)	AD140 millions (28%)	AD55 millions (11%)	AD500 millions
ABC. (Kingdom of Bahrain)	AD828.1 millions (80%)	AD236.6 millions (20%)	AD118.3 millions (10%)	AD1.183 billions

Source: Ghilés (1999a)

Almost all foreign banks operating in Algeria are highly profitable (Agence Algérienne d'Information Online, 2001). For example, the *Natexis Amana* (France) earned USD1.06 million in 2000, while the capital of the bank was only USD8 million. The Arab Banking Corporation (Kingdom of Bahrain) had capital of USD20 million and generated USD5.31 million in profit during the same year. The only foreign bank that made a loss during the accounting year 2000 was SGA (France) (Agence Algérienne d'Information Online, 2001).

3.3. The Algiers Stock Exchange

The Algiers Stock Exchange began operating in July 1999 (IMF, 2000). The role of Algiers Stock Exchange is to facilitate the privatisation of state-owned enterprises and to improve the mobilisation of financial resources. Currently, the four listed companies' shares float at about 20 per cent of their capital. Brokers (*Intermediaries*

en Opérations de Bourse) operate as guarantors of each transaction because of absence of legal contract enforcement and poor standardisation. The stock market valuation company (*Société de Gestion de la Bourse des Valeurs*) controls the trading of shares and the securities and exchange commissions (*Commission d'Organisation et de Surveillance des Opérations de Bourse*) have a duty to enhance transparency in the market and to protect market dealers.

The Algiers Stock Exchange was established in three stages. In the first stage, which took place between 1988 and 1992, the authorities set up the society for stocks and shares (*Société des Valeurs Mobiliers*). The capital of the *Société des Valeurs Mobiliers* in January 1988 was USD54,100. The role of the *Société des Valeurs Mobiliers* was to organise trading of stocks and shares. In the second stage, which lasted from 1992 to 1998, the *Société des Valeurs Mobiliers* faced several problems, such as insufficient capital and a change of its designation to a stock market valuation company (*Bourse des Valeurs Mobiliers*). In February 1992, the *Bourse des Valeurs Mobiliers* capital was raised to USD427,523. The delay in increasing the BVM capital had obstructed its operations.

The *Société de Gestion de la Bourse des Valeurs* controls the stock exchange operations (*Commission d'Organisation et de Surveillance des Opérations de Bourse*, 1998). It manages the negotiation system of shares, mobilises financial transactions within the stock exchange, organises operations concerning compensation for share trading, and promotes market transparency. The mode of functioning of the *Société de Gestion de la Bourse des Valeurs* is entirely automatic. It assists intermediaries to reduce risk, conduct large transactions, reduce costs and quicken transactions (*Commission d'Organisation et de Surveillance des Opérations de Bourse*, 1998).

The *Société de Gestion de la Bourse des Valeurs*, the company managing the Algiers Stock Exchange, claims that the market is performing successfully. Certainly, stockholders have received high dividends on their shares. After a good business year (1999), the *Eriad Sétif* paid a dividend of AD100 per share to its shareholders. The pharmaceutical group *Saïdal* also paid high dividends to its shareholders. The high performance of listed companies will encourage other companies to trade their shares in the Algiers Stock Exchange (Ihsan, 2000). Under the new government programme of privatisation, state-owned enterprises have the right to go public (article 15 and 25 of order number 15–22, 26 August 1995).

The delay in the privatisation of state-owned enterprises has hampered the Algiers Stock Exchange (Ihsan, 2000). The *Société de Gestion de la Bourse des Valeurs* selected a few companies to trade their shares in the market, but none of them has been subscribed yet except the hotel *El-Aurassi*. These delays notwithstanding, it is expected that 20 companies will enter the market in the near future. Those companies' applications have not been officially accepted because of managerial and technical problems.

3.4. Conclusion

The analysis in this chapter has shown that financial liberalisation is the fundamental driving force of the financial market integration in Algeria. Financial liberalisation removes many regulatory barriers towards domestic and foreign banks. New financial rules enable state-owned banks to select their borrowers and to extend their operations to new markets. The establishment of the Algiers Stock Exchange is

another result of financial liberalisation. The government also created an inter-bank market and a market for trading treasury bills. However, further procedures such as privatisation of state-owned banks are strongly required before the centrally planned economy can be completely transformed into a market-oriented one.

With a 90 per cent market share, state-owned banks control almost all lending and borrowing activities (Iradian, Bazzoni and Joly, 2000). All state-owned enterprises still have their accounts with state-owned banks, which remain their main source of funding. The small presence of foreign banks and Algerian private banks has negatively affected banking competition as well as investments in both public and private sectors.

Banking recapitalisation has helped state-owned enterprises to clean non-performing loans from their balance sheet and to improve their financial strength. For example, the capital of BNA rose from AD4,200 million in 1994 to AD8,000 million in 1998, a 95 per cent increase (BNA Annual Reports). Nonetheless, the quality of state-owned banks' portfolios has suffered from poor lending policies and underdeveloped payment systems.

As previously noted, several foreign banks opened branches or representative offices in Algeria in the past decade (Nashashibi *et al*, 1998). However, their main activities remain concentrated in the large cities and near the oil fields in the south, the primary locations of large foreign and domestic companies. The small presence of foreign banks in the national financial market is due to the high risk they perceive in the country and to regulatory constraints imposed by the central bank. Operational obstacles also confront foreign banks, including limited financial instruments, small capital and the undersized banking network (interview notes, 2001).

Banking privatisation is on the Algerian government's agenda, but political and social constraints have prevented the sale of state-owned banks' assets to private and foreign investors (Banker, 2000a). Labour organisations also oppose the privatisation of the public sector, including banks, because they claim that the process will cause large job losses. Privatisation is considered a key factor in any programme of financial liberalisation, as it enables state-owned banks to improve their internal and external management and to benefit from the process of globalisation of financial services (see Michael, 1997).

Chapter 4:

INTEREST VERSUS NON-INTEREST BANKING MODEL

4.1. Introduction

This chapter analyses the lending and borrowing mechanisms of interest banks and non-interest banks. It also determines the operational constraints facing the interest banking model and the non-interest banking model in the collection of public savings and the financing of investments. Profit and loss sharing is the most basic determinant of non-interest banks' funding allocations (Siddiqi, 1983), whereas interest banks apply market criteria in mobilising their financial resources (Aggrawal and Tariq, 2000). Because interest banks and non-interest banks compete in the global financial market, it is important to understand the strengths and weaknesses of each banking model and to study the impact of globalisation of financial services on their efficiency and profitability.

Rules that manage Islamic financial transactions are based upon four main sources: *Quran*, *Hadith*, *Ijmaa* and *Qiyas*.⁷⁴ Although these texts are more concerned with psychological, sociological and anthropological issues, they also determine trading rules in financial markets. To improve Islamic finance and promote economic

⁷⁴ *Quran* is Allah's (God's) words sent to Prophet Mohammed. *Hadith* is the verbal transmission of the *Sunna* of Prophet Mohammed words. *Ijmaa* is the consensus of the community. And *Qiyas* is based on analogical reason. These four sources are used to determine what is *halal* (permitted) or *haram* (forbidden) according to Islamic law (Schacht, 1964). For example, the trading of wine and pork are banned by *Quran*.

growth, non-interest banks need new financial mechanisms that do not violate Islamic rules against usury.

Interest rates encourage savings and investment, which boosts the economy and increases societal wealth (McKinnon, 1973; Shaw, 1973). But in the Islamic world, religion greatly influences people's daily financial transactions. According to the *Quran* it is forbidden for Muslims to ask their borrowers to make a payment exceeding the principal. For this reason, Islamic scholars have deemed interest rates unacceptable. Muslims should receive back only the principal plus the proportion of the profit generated from banking activities.

The profit and loss sharing mode of financing dramatically affects the techniques used by non-interest banks in managing their assets and liabilities. On the other hand, the role of money is different in interest banking model and non-interest banking model. In non-interest banking model, money is invested to satisfy economic and social needs and to increase societal wealth (Warde, 2000). In the West, money is invested to create value and to increase shareholders' profits.

Historically, non-interest banks appeared in the 1970s after some Muslim governments, such as those of Iran and Pakistan, finally approved them (Gafoor, 1995).⁷⁵ The non-interest banking model is based on the profit and loss sharing mode of financing. In technical terms, non-interest banks play almost the same role as interest banks: they are intermediaries between lenders and borrowers. However, many practical differences exist between the two banking models.⁷⁶ Despite Islamic

⁷⁵ Three decades later, in 2000, it was estimated that non-interest banks managed between USD100 and USD150 billion, that their assets exceeded USD4,137 billion, and that their annual growth is almost 15 per cent (Banker, 2000c).

⁷⁶ For example, under non-interest banks, the relationship among savers, investors, and the bank is a partnership. In investment accounts, the principle is not guaranteed as well.

law, interest banks are widely accepted in Muslim countries. In Algeria, almost all banks apply the interest banking model principles of taking deposits and extending credit. Individuals and investors also prefer to deal with interest banks because deposits seem to be safer than with non-interest banks.

The globalisation of financial services opened the way for both non-interest banks and interest banks to compete head to head. It is anticipated that the competition between the two groups of banks will steadily increase and that this will affect their profitability. However, this will only occur if banks are highly efficient, and efficiency depends on banks' abilities to satisfy their clients at low cost.

4.2. Analysing financial instruments

To maintain high efficiency, non-interest banks offer a variety of financial instruments to both depositors and investors. *Mudaraba* (capital trust financing),⁷⁷ *murabaha* (cost-plus profit contract), *musharaka* (partnership), *ijara wa-iqtina* (hire purchase contract) and *ijara* (leasing) are the main financial products offered by non-interest banks (Duncan, 1996).

In *murabaha* the money owner (*rabb al-mal*) put his funds under the care of a managing trustee (*mudarib*) according to an agreement. Depositors receive part of the profit on an operational basis and not as a lump sum or a guaranteed return. The *mudarib* is not responsible for the loss of capital. As a result, non-interest bank bears high operational risk. There are two viewpoints about the allocation of profits generated from *mudaraba* transactions. *Hanafis* and *Hanabalīs* claim that capital

should be returned first to the *rabb al-mal* and then profit can be shared; *Malikis* and *Shafiis* argue that a bank should distribute profits after the completion of entire operations and that capital should be repaid afterwards (Warde, 2000).⁷⁸

Murabaha is used to finance short-term investments and commerce. The bank provides funds and the entrepreneur manages the business. At the end of the project, the entrepreneur should return the capital plus a proportion of the retained profit. If the project performed poorly, the bank loses not only the possibility of making profit but also loses part of the capital invested. Because the bank bears the losses, it must have the right to transfer ownership of goods at any time after the contract in case it needs to purchase properties or any other commodities for the benefit of its clients by means of a *murabaha* contract. It is also necessary that banks insist on collateral for large loans to reduce credit risk.

Musharaka applies to financing working capital and to equity financing. A bank may provide capital, audit and management assistance for the investment venture. The profit earned at the end of each accounting period is shared as stated in the agreement between the bank and its partners.⁷⁹ *Musharaka* can be subdivided into *mufawada* (limited liability partnership) and *sharikat-e-nan* (limited investment partnership).⁸⁰ In *mufawada* all partners contribute to the joint venture capital and have equal responsibilities for profits and losses incurred at the end of each financial

⁷⁷ *Mudaraba* contracts can be negotiable or non-negotiable. The bank may involve itself directly in the project's management or may just provide sufficient funds to the entrepreneur. Usually, the bank provides technical advice to the entrepreneur and examines the venture accounts.

⁷⁸ *Hanafis*, *Hanabalīs*, *Malikis* and *Shafiis* are four Islamic schools of thought (Vogel and Hayes, 1998).

⁷⁹ It is similar to an equity market in the Western context. Shares are sold to the government, to the public or to banks, and company's assets must guarantee all shares.

⁸⁰ The practical implication of this subdivision of *musharaka* is to enable investors to involve fully or partly in the management of the business venture.

year. In *sharikat-e-nan* all partners provide funds and management, but partners do not guarantee each other. However, the bank and investors bear losses together and this can cause high systematic risk (Warde, 2000).

It is possible to combine *musharaka* and *mudaraba* contracts by investing initial capital on a *musharaka* basis and working capital on a *mudaraba* basis. The *mudaraba* and *musharaka* are unacceptable if the *mudarib* engage in prohibited activities such as gambling or wine-making. It is worth noting that the entrepreneur can repay the loan progressively in case of *musharaka mutanikasa* (diminishing partnership). The objective of introducing this kind of repayment is to raise the entrepreneur's capital share of the project.

The payment in an *ijara* contract (leasing) is made in advance. The leaseholder remains the owner of the leased assets except in "*ijara wa iktian*" (hire purchase contract) where assets are transmitted to the lessee. The asset price cannot be predicted because, from an Islamic standpoint, only God knows what will happen in the future. *Ijara* is used to finance medium-term projects.⁸¹ However, several difficulties arise with leasing. These are related to the nature of the contract, to procedures for measuring the return on assets, and to the method of calculating depreciation on fixed assets.

Another financial product used by non-interest banks is *bay salam* (forward sales), in which banks' clients pay in advance the price of commodities they will receive afterwards (Duncan, 1996). This instrument is used extensively in the agricultural sector. In *istisana* (manufacturing contract), the payment must be made in advance and commodity is delivered afterwards. The seller also has the right to negotiate the

price of a commodity before its delivery (Mills and Presley, 1999). This is important to avoid confusion between the seller and the purchaser about the price of a commodity. The remuneration for the bank can be in the form of conduction fees or profit. *Istisna* applies to semi- and fully manufactured products; goods in their raw state are not eligible for *istisna* contracts.

Istisna is used mainly for financing long-term investments. The non-interest bank may own the business and charge the lessee fees based on the business's profit rate; or the non-interest bank may sell the business to the lessee, adding additional costs to the selling price. In Western countries, long-term projects are funded by various financial means, such as the issuance of long-term securities.

Non-interest banks also deal with commodities and foreign exchange trading. These activities are allowed under the *sharia* code of financing. But non-interest banks are not allowed to deal with bonds, whether issued by government or corporations, because they involve interest rates that are forbidden under Islamic financial rules. Fixed-income securities such as fixed-coupon bonds are also unacceptable under Islamic law. Investors may venture on activities financed by a non-interest bank, but Islamic law prohibits investors to engage in activities that cause economic or moral damage to society.⁸² An equity investment can also be used to fund a joint venture, but certain equities are not tolerable when the company's income comes from illegal operations such as gambling and wine trading (Mills and Presley, 1999).⁸³

⁸¹ Leasing is adopted in all operations with non-interest banks.

⁸² Examples of activities that cause social damage are production or trading of tobacco, arms and drugs.

⁸³ Equities and commodities can be adopted only if the investor's intention is to increase the economic value or wealth of society.

Non-interest banks offer other types of financing such as letters of credit, corporate finance and investment banking services. Financial innovations lead to the appearance of *takaful* (co-operative insurance) in which the bank receives funds from its participants in instalments and uses those funds to finance its investments. Another innovation is the Islamic Equity Repo that was introduced in 1999 (Brooks, 1999).

The list of interest banks offering Islamic financial products is growing steadily (Banker, 2000b). Examples include Citibank Islamic Investment Bank, ABN AMRO Global Islamic Financial Services and ANZ Islamic Investment Fund. Those banks have succeeded in converting many conventional products into Islamic financial instruments. Their long-term experience in managing banking assets and liabilities can be used as a means to improve Islamic finance. For commercial reasons, the new products have attracted many non-Muslim investors.⁸⁴ They also allow interest banks to diversify their portfolios and to increase their market share in South East Asia and the Middle East.

It is illegal for non-interest banks to trade shares of companies involved in prohibited operations such as the production of tobacco. The same prohibition applies to entertainment companies, companies that receive more than 5 per cent interest income, companies that have dividends to total assets equal or above 45 per cent, and companies that have total debt to total assets equal or above 33 per cent (Zaher and Hassan, 2001). Islamic investors are not allowed to buy insurance products because they include *gharar* (speculation). The only acceptable insurance instrument is mutual insurance, and the only available product in this domain is *takaful* (co-operative insurance).

Financial products are prohibited when they involve usury (Siddiqi, 1983). From an Islamic standpoint, usury occurs when a buyer of a commodity pays an additional amount of money above and beyond the current price (this is “*riba al-fadl*”, an increase based on difference in quality) or when he receives reward from a loan in advance, making any positive return (this is “*riba-nasi’ah*”, an increase related to deferment). The borrower has to pay only the current commodity price. However, the seller can justify receiving more money if the trading of commodity achieves economic growth in the society. In a market economy, the interest is defined as the fee paid by a borrower to a lender for the use of borrowed money. For some modern Islamic scholars, the interest can be accepted if the money received by the bank has been invested and has produced a positive return (Zaher and Hassan, 2001). For negative returns, the investors and the bank have to share the loss.

The absence of a real Islamic inter-bank market makes non-interest banks face high liquidity. Non-interest banks are also not allowed to raise funds from conventional financial markets because of “the vagaries of interpretation by Islamic scholars” about the suitability of conventional financial products (Banker, 1998: 57). Non-interest saving products are only acceptable in markets where there is a strong support from Islamic scholars. Researchers representing the *sharia* board need to agree on the criteria followed by banks in selecting their financial products.

The secondary market for Islamic financial products is tiny and illiquid. Investors and banks cannot exploit the market potential because of the limited number long-term instruments that are available. As a consequence, it is critical to create new long-term products and to develop the current money market to improve the non-interest

⁸⁴ See Brooks (1999), pp. 37–40.

banks' liquidity.⁸⁵ Providing large-scale, off-balance-sheet financial instruments would also enable non-interest banks to diversify their portfolios and to boost their liquidity.

There is a need for a uniform *sharia* board that discusses the worldwide acceptability of new financial instruments. The role of the board should be to select and identify new financial products that comply with Islamic financial law. This board could also explain these new products from both religious and economic standpoints.

The price of stocks is usually based on uncertainty, and this causes speculation (Warde, 2000). Thus, most securities trading are forbidden by the Islamic code of financing. Rational investors also have better information about stocks than speculators.⁸⁶ Speculation includes arbitrage, which is unacceptable in Islamic law because the arbitrageur benefits from the differentiation in the stock price but makes zero investments. Investing in highly risky stocks is not allowed under Islamic financial rules, as it is similar to gambling (Black, 1986). It is also forbidden under Islamic financial rules to oblige the counterpart in any business transaction to accept the terms of a contract. If the terms and conditions are known in advance, the contract is acceptable from an Islamic point of view.

Islamic investors face several problems in the stock market. First, there are no clear guidelines about the use of securities. Second, investors are not all equally informed, which makes markets less efficient. Bond trading is not allowed because the issuer is obliged to pay the bondholder a fixed interest rate. Replacing current

⁸⁵ See Warde (2000) on how to improve investments under Islamic banking practices.

⁸⁶ See Black (1986)

bonds with “transaction based contracts” can create Islamic debt securities. For example, under a *murabaha* contract the bond issuer can buy the asset at a fixed price, then resell it at the original price plus profit and use the payment to pay the subscriber back. The issuer can pay the bondholder a proportion of the return generated from the company’s activities and repay the nominal value of the bond at its date of maturity. The same can apply to preferred stock. Instead of paying a fixed income, the company pays the stockholder a return based on the company’s profit.

Most scholars attempt to define Islamic financial principles and then create new financial products based on those principles. *Murabaha*, *musharaka* and *mudaraba* are examples of innovative behaviour in Islamic banks. Those products are used in financing small- and medium-sized projects. However, because of rapid developments in the banking industry, we suggest a new approach in which non-interest banks create innovative financial instruments by remodelling conventional banking products. This could be done by replacing the interest rate with fees equal to banking costs plus earnings on each transaction.

4.3. Mode of receiving funds and financing

The source and allocation of non-interest banks’ capital funds are different from those of interest banks. First, non-interest banks can use current account funds to offer short-term credit to people in financial difficulties, but lenders should not be charged any fees.⁸⁷ It is forbidden to use current account deposits for financing or investing in

⁸⁷ In both interest and non-interest banks the nominal value of deposits is guaranteed and reserve requirements on them are 100 per cent. Nevertheless, the policy of banks in certain countries like Sweden and the United Kingdom is to pay a low interest rate on deposits held in a current account (Kazimi, 1986).

securities. Second, depositors in interest banks receive interest on their savings accounts, whereas in non-interest banks, depositors receive part of the profit generated by the bank each financial year.⁸⁸ Finally, in investment accounts non-interest banks do not guarantee the nominal value of deposits. Instead, losses and profits are shared according to each depositor's proportion of the total amount invested in the business venture.

Islam is highly concerned about social welfare and equality (Zaher and Hassan, 2001). This has direct effects on the allocation of financial assets and investments within society. The objective of establishing a new business is to create value by optimally allocating financial, natural and human resources. From the Islamic point of view, the state is required to exercise minimal control over the business entity's management to help banks avoid bad debts and to achieve economies of scale.

Western banks have financial obligations towards their depositors, who have transferred the risk of holding their cash to the bank.⁸⁹ By contrast, non-interest banks collect public savings because of depositors' moral consciences (Kazimi, 1986). The *Quran* obliges Muslims to donate or invest their savings in projects that benefit society: "O you who believe, be afraid of Allah and give up what remains (due to you) from *riba* (usury) from now onward, if you are really believers" (Quran, verse 278).

⁸⁸ Non-interest banks do not pay premiums in loss-making cases, and usually returns are higher for long-term deposits than for short-term ones. Savings account funds are also invested in short-term projects. However, the nominal value of deposits is not guaranteed in the non-interest banking model.

⁸⁹ In the non-interest banking model investment accounts, holders receive interest rates and the nominal value of their funds is guaranteed.

In Pakistan⁹⁰ the Islamic mode of financing takes three forms: lending, trade financing and investment financing.⁹¹ Bank lending takes two forms: with service charges and without service charges.⁹² Examples of lending without a service charge are student loans and credit to poor individuals. In trade financing the bank uses leasing or hire purchase contracts. Under hire purchase, the bank receives goods from its customers and those customers agree to repurchase the commodity over time. The transfer of commodity ownership can happen immediately or after a period of time.⁹³ In investment financing, banks offer three different products: *mudaraba*, participating term certificates and *musharaka*. The participation term certificate is used for medium- and long-term financing. By the end of each financial year, the bank takes a proportion of the retained profit or loss obtained from funding the project.⁹⁴

Non-interest banks are advised not to use large-scale profit and loss sharing for generating high earnings. Non-interest banks face high credit risks if more than 90 per cent of their operations are based on profit and loss sharing criteria. Risk-oriented individuals and investors have also attempted to take advantage of the Islamic code of financing to access bank funds (Gafoor, 1995).

In Malaysia, Islamic financial institutions were created, but previous players have continued to offer conventional products (Zaher and Hassen, 2001). Instruments offered by Islamic players have attracted many depositors and investors. Similarly, in

⁹⁰ The Pakistani government converted the interest banking model into a non-interest banking model in 1985 (Gafoor, 1995).

⁹¹ It was the case in the 1980s. Nowadays, banks in Pakistan provide several other Islamic financial instruments.

⁹² The service charge equals overheads divided by total assets. Overheads are deducted from gross revenue and the net profit is shared on the basis of the bank's capital and deposits (Kazimi, 1986).

⁹³ Overdrafts are available under a mark-up basis and payments take place instantly or can be postponed.

⁹⁴ For more details see Ingram (1985)

Bahrain the banking sector is growing rapidly due to a sound regulatory system and high financial disclosure.

In *musharaka*, lenders and borrowers share responsibility for the success or failure of projects. Therefore, investors attempt to achieve maximum return, which reflects the increase in the value of the money invested. Non-interest banks' lending policy is to finance low-risk investments. Lenders lose their funds if projects failed to generate positive return. The failed investments appear to be more costly for interest banks than for non-interest banks, which share the loss with depositors. Non-interest banks bear high credit risk because of their funding paradigm, which is based on profit and loss sharing.

Islamic banking is designed to boost public savings and to increase the volume of investments in the national economy (Dudley, 1998). *Sharia* prohibits accumulating cash under mattresses and urges individuals to use non-interest banks to invest their savings appropriately. Non-interest banks are urged to protect depositors and lenders by reducing the risk of speculation in the market. Dudley (1998) noted that the reliability of the business venture is a means to help non-interest banks to maintain surveillance over investments and to reduce the level of unsecured debts.

Islamic financial institutions are advised to invest in markets with low credit risk and to be attentive in selecting domestic borrowers. For instance, under a *murabaha* contract, non-interest banks are asked to have collateral with the entrepreneur to avoid moral hazards in the financial sector. The entrepreneur must supply the bank with regular information about the development of the project. It is also imperative to fix an expected profit rate in advance.

Baydoun and Willet (2000) noted that reports should include a value-added statement, a current value balance sheet, and a historic cost balance sheet. Islamic financial institutions are also required to explain how funds are generated and used during the financial year. Recent information about new financial transactions is important, particularly under a *mudaraba* contract.

Customers should be informed frequently about the development of the projects financed in order to boost public confidence. Under a *musharaka* contract, customers should also have the right to decide with the bank whether or not to fund a particular project. Usually, depositors refuse to finance risky projects, and this prevents banks from achieving economies of scale.

Full information disclosure is required to measure investment risk and to ensure that non-interest banks are financially sound. Other objectives include maintaining confidence in the financial market and ensuring that resources are distributed to the most productive investments. On the other hand, it is vital to improve the Islamic accounting standards, to enhance transparency, to ameliorate auditing and to reinforce market integration (Baydoun and Willet, 2000).

Alterations in the format of non-interest banks' financial statements are due to the following reasons: there is no single *sharia* board that determines Islamic financial reporting standards; non-interest banks themselves apply different accounting practices, and Islamic supervisory guidelines are not clear and do not cover all the accounting issues. To solve these problems, harmonisation of financial rules concerning fund mobilisation, profit allocation, cost classification, etc. is recommended. At the Islamic Banking Conference held in Bahrain in February 2000, it was emphasised that the role of the Financial Services Board is to set standards for

an Islamic financial system and to ensure that non-interest banks are incorporating international standards of banking supervision (Banker, 2000e).

It has been found that most non-interest banks make imprudent long-term investments. Most of their loans are for short- or medium-term. It is extremely important to introduce long-term financial instruments to help non-interest banks to grow in the long run and to help them attract new customers.⁹⁵ Converting existing conventional products can create sustainable long-term Islamic financial products.

In a global financial market, both Islamic and Western banks need to reduce their risk exposures in each sector they finance. Non-interest banks appear to have more risky assets than interest banks that are trading with debts because of the nature of the contract between non-interest banks and their clients. Non-interest banks' borrowers can escape paying their debts when the business venture yields a negative return. Consequently, non-interest banks are required to use equity financing to limit risk-taking in their investments (Aggarwal and Tariq, 2000). Usually, returns generated from equity investments are higher than those from fixed-return instruments.

Good risk management tools help non-interest and interest banks hedge against speculation and high volatility in national and international financial markets. Interest banks usually use interest rates as a way of managing their portfolio and liquidity. The same instrument is used for hedging against pricing risk. The inter-bank market also enables interest banks to raise funds in the short-term. This is why interest banks maintain higher levels of liquidity than non-interest banks.

The fund classifications used by non-interest banks are exceedingly complicated (Aggrawal and Tariq, 2000). There is no obvious distinction between deposits and

investment funds, whereas in conventional banking it is obvious that if the principal is uncertain, funds are not considered deposits (Mills and Presley, 1999). In theory, deposits held in an investment account are used to meet the financial needs of non-interest banks' ultimate borrowers and as a result, they are not guaranteed. But, the practice shows that most non-interest banks guarantee deposits in savings and investment accounts (*El-Baraka Bank Management Report*, 1998).

Securitisation is used mainly in leases, vehicle loans, mortgages, insurance and junk bonds. Deposits are securitised by linking the expected return to an index that reflects the market value of the asset. Securitisation of loans and deposits helps banks raise funds and reduce risk bearing assets and liabilities. However, securitisation is still underdeveloped in the Islamic world; thus non-interest banks need to obtain technical assistance from foreign experts to create new investment products.

Co-operation between non-interest and interest banks can improve the performance of Islamic banking. Large interest banks have the financial resources and the technological tools to launch new Islamic financial products. Other advantages of banking co-operation include reduction in liquidity risk, promotion of current services, and improvements in information disclosure. Interest banks are also able to raise funds to finance large projects under Islamic banking principles. To avoid the problem of usury, the interest would not be paid on borrowed funds. Interest banks are also in a position to improve the image of Islamic banking in non-Muslim countries, which is essential at this stage of development. Citibank and HSBC are examples of successful interest banks that contributed substantially to Islamic finance.

⁹⁵ See Siddiqi (1983), Aggrawal and Tariq (2000)

4.4. Measuring banking profitability

Non-interest and interest banks' profitability is highly sensitive to the techniques used in Islamic and conventional banking models to manage financial assets and liabilities. In liberalised financial markets, banks are free to choose the pathway that allows them to diversify their earnings. On the other hand, non-interest banks use three methods to allocate profits. First, they share the annual net profit with entrepreneurs on a predetermined basis. Second, in *musharaka* the profits or losses are allocated according to the contribution of the entrepreneur and the bank in the business enterprise. Third, in both *murabaha* and *mudaraba* the profit is distributed according to the incomes generated from the business venture. This is because under *murabaha* and *mudaraba* contracts the bank provides capital and the entrepreneur provides management only.

In Islamic banking, depositors receive dividends when the bank generates positive return on its investments and lose part of their funds when the venture yields negative returns. Consequently, non-interest banks endeavour to allocate their funds to profitable investments—this generates high returns and thus satisfies depositors. Earnings from non-interest banks' projects are shared among depositors, the bank, and entrepreneurs, as stated in the agreement.

Banks with a high volume of interest-bearing financial instruments suffer substantially during hyperinflation. The high inflation rate causes a sharp decline in banks' assets as well as increases in their losses. Non-interest banks suffer more than interest banks in the hyperinflationary environment. This is because interest banks

respond to increased inflation rates by increasing their interest rates. Non-interest banks are advised to ask borrowers to pay extra fees equivalent to the decline in the value of their assets because of the increase in inflation rate.

Usually, non-interest banks' premises are not depreciated, but other fixed assets are depreciated in equal instalments over their expected lifetime (Haqiqi and Pomeranz, 2000). Depreciation must be reported as a liability and securities should be recorded at their market price to avoid overestimating banks' profits in the long term.

Another accounting aspect that affects non-interest banks' profitability is provision. Non-interest banks' bad debts usually exceed their provision for doubtful debts. They also have various difficulties in adequately identifying the risks associated with their investments. Non-interest banks are required to make provisions for contingent liabilities and commitments in both the short- and long-term. They should also assess provisions for small volume outstanding debts by taking into account the structure and risk of their loan portfolios.

Non-interest banks monitor their performance continuously by implementing suitable financial evaluation standards. Consistency in assessing loan portfolios helps non-interest banks to reduce their risky assets. On the other hand, non-interest banks need to adopt strict lending policies to improve the quality of their portfolios. For example, under leasing contracts non-interest banks are required to transfer asset ownership to the lessee before making the full payment to the bank. This is because under the non-interest banking model, the lessee is not obliged to make extra payments if the asset is lost.⁹⁶ The lessor may claim compensation for any damage

⁹⁶ Usually, the return from leasing appears to be higher than in *murabaha* contracts.

caused to the leased assets if there is negligence on the part of lessee (Mills and Presley, 1999).

The acceleration of financial market integration makes the price of non-interest and interest banks' tradable securities and other financial products very volatile. The result is a dramatic decline in banking earnings. For example, the main reasons for the increase in banking losses during the Asian financial crises included weak corporate governance, poor lending policies, and a large volume of short-term capital inflows (Demetriades and Fattouh, 1999). Many companies do not explicitly record all their liabilities, which leads them to misjudge their ability to service their debts on time.

The largest proportion of non-interest banks' incomes comes from *musharaka* and *mudaraba* contracts. Trading foreign and domestic companies' stocks accounts for only a small proportion of non-interest banks' incomes. In interest banks' income structure, the interest rate margin represents a large portion of their revenues, although incomes from non-traditional activities such as insurance are growing steadily, notably in developed countries.⁹⁷

Non-interest banks follow different methods in allocating their net profit. Some non-interest banks distribute their profit after deducting direct overheads from investment income (according to *Malikis* and *Shafiis*). Other banks subtract all expenses (including depreciation and wages) from investment income and distribute their net profit afterwards (according to *Hanafis* and *Hanabalis*). The share of savers in banks' net profit decreases when expenses are deducted from investment income.

⁹⁷ This was the case in the UK in the 1970s. Most commercial banks were generating their incomes from interest rate spread. This, however, has changed because of increased securitisation.

Depositors' share of non-interest banks' net profit is based on the amount of cash received from entrepreneurs (Hamat, 1994). Usually, non-interest banks raise cash to compensate depositors in case of increased bank charges. Under a *murabaha* contract, the purchaser has also the right to refuse a commodity on account of its poor conditions and thus the bank bears the loss of unsold commodities (Banaga, Ray and Tomkins, 1993).

It has been stressed that the cost of entering foreign markets is high. New players need to establish new representatives, subsidiaries or branches (Walter, 1988). It also takes a long time to understand lenders' and borrowers' behaviour in those markets. Employing domestic workers helps non-interest or interest banks to attract large numbers of local investors and to diversify their earnings.

New technological tools give market dealers daily access to the prices of banking products. Individuals and investors have greater choice and superior information about the market. Thus it is crucial to improve the public image of the bank in new markets. Banks can do this by making all delivery channels available to customers: the branch, the telephone, the Internet, automatic teller machines, etc. Creating new delivery channels also improves banks' earnings and shareholder value (Bardfield, 1998).⁹⁸

Political risks, taxes and transaction costs are the main barriers confronting interest and non-interest banks operating in foreign markets (Walter and Smith, 1999). Exchange rate risks also lower banks' return on investments and thus lower depositors' share in banks' net profits. Removing foreign exchange control

⁹⁸ Closing unprofitable branches and reducing the number of staff helps banks to cut their costs and boost their profit margin.

constraints is a way to encourage non-interest and interest banks to increase their foreign currency trading and to boost their net profit.

As we have already seen, a large proportion of non-interest banks' revenues are generated from financing trade and small businesses. This is because non-interest banks are new in the market and have limited capital to finance large investments. Existing financial products are also unsuitable for long-term financing. Accordingly, co-operation between non-interest and interest banks boosts Islamic banking assets and transforms non-interest banks' approach to handling risk. This helps non-interest banks to raise their revenues, which automatically results in an increased profit margin.

4.5. The evaluation of banking competition

Non-interest banks face two types of competitor: other non-interest banks and interest banks. Examples of direct competition between non-interest banks can be found in Pakistan, Iran and Malaysia, where the financial system has been almost entirely converted to non-interest banking. In those countries, primary lenders and ultimate borrowers are obliged to use Islamic financial products instead of conventional ones. On the other hand, in markets with mixed Western and Islamic banking models, depositors and investors are more sensitive to the quality of services offered by a particular bank than to the religious suitability of its financial products.

Non-interest banks, like interest banks, try to evade price competition and focus on cost competition and cost cutting. "In the bazaar or *souk* economy there is perhaps more stress on non-price than price competition" (Wilson, 1990: 32). This is because

Islamic law lacks a clear method for calculating mark-up.⁹⁹ In practice, most non-interest banks prefer to calculate their mark-up on a percentage basis. For this reason, non-interest banks' clients find it difficult to make price comparisons between different banks' financial products.

Monopolies and price fixing of financial products are unacceptable under *sharia* rules. Financial markets have to be totally open to foreign and local players. Investors need to be free in making decisions, but must not use manipulation to reach their objectives. In the present competitive environment, interest banks are also allowed to change the price of their financial products.

Non-interest banks are less competitive than interest banks in attracting public savings. This is because funds deposited in non-interest banks' investment account are not guaranteed, whereas interest banks guarantee deposits in current and savings accounts. Islamic financial practices are also unclear about the distribution of banking earnings. In addition, interest banks offer many more savings instruments than non-interest banks.

There is a positive correlation between the number of non-interest banks in the domestic market and the amount of banking competition. In markets such as Algeria, where there is only one Islamic bank, non-interest bank competes with interest banks, whether they are local or foreign. Consequently, the prices of Islamic financial products are higher than the price of conventional financial instruments.¹⁰⁰ Therefore, an increase in the number of banks offering Islamic financial products can boost

⁹⁹ The mark-up is the margin added as profit in addition to the real cost of the goods sold.

¹⁰⁰ In markets such as Bahrain and Egypt, where there is more than one Islamic bank, the competition is between non-interest banks themselves.

banking competition in markets dominated by interest banks. This leads to a decline in the price of Islamic lending and borrowing instruments.

Another determinant of banking competition in the Islamic world¹⁰¹ is the religious acceptability of the financial products. Muslims usually take into account whether the financial product is *halal* (allowed by Islamic law) or *haram* (forbidden by the *sharia* board). However, in regions such as North Africa depositors consider market criteria when selecting their financial products (interview notes, 2001).

The capital strength and size of assets of most non-interest banks are small (see Table 4.1). As a result, non-interest banks are less competitive than interest banks in funding large or long-term investments. To solve this problem, non-interest banks need to merge and to operate in markets where the demand for non-interest financial products is high in certain sectors of the domestic economy. For instance, in the North African region non-interest banks are advised to finance agriculture and small industries because of high demand for credit in the two sectors.

Table 4.1: Capital strength and assets size of selected non-interest banks in 2001

	Capital Strength (\$m)	Assets Size (\$m)
<i>Al Rajhi</i> Banking & Investment Corporation	1,729	12,999
Kuwait Finance House	614	6,628
Dubai Islamic Bank	297	3,206
<i>Shamil</i> Bank of Bahrain	248	1,316
<i>Faisal</i> Islamic Bank of Egypt	93	2,473
Qatar Islamic Bank	92	1,115
Bahrain Saudi Bank	84	514

Source: Banker, November 2001

¹⁰¹ The Islamic world includes fifty-nine countries: Afghanistan, Albania, Algeria, Azerbaijan, Bahrain, Bangladesh, Benin, Brunei, Burkina Faso, Cameroon, Chad, Comoros, Djibouti, Egypt, Gabon, Gambia, Guinea, Guinea-Bissau, Guyana, Indonesia, Iran, Iraq, Jordan, Kazakhstan, Kuwait, Kyrgyzstan, Lebanon, Libya, Malaysia, Maldives, Mali, Mauritania, Morocco, Mozambique, Niger, Nigeria, Oman, Pakistan, Palestine, Qatar, Saudi Arabia, Senegal, Sierra Leone, Somalia, Sudan, Surinam, Syria, Tajikistan, Tunisia, Turkey, Turkmenistan, Uganda, United Arab Emirates, Uzbekistan, Western Sahara, Yemen (Islamic World Online, 2003).

Due to the lack of experience by managers of non-interest banks and the absence of clear Islamic evaluation techniques for investments, non-interest banks are less effective than interest banks in managing their assets and liabilities. The *sharia* board needs to introduce explicit and implicit investment appraisal methods so that non-interest banks can accurately assess their portfolios. Managers of non-interest banks also need further training in Islamic finance to improve their administrative skills and knowledge of Islamic banking.

It has been argued that the taxation policy within the host country directly affects banking competition (Claessens, Demirgüç-Kunt and Huizinga, 1998). Foreign banking entry increases when financial authorities reduce corporate income taxes. Lower tax rates help foreign banks to achieve high profit margins (Demirgüç-Kunt and Huizinga, 2001). Local banks, whether interest or non-interest banks, also respond to the foreign banks' entry by reducing the price of their financial products. They do so to avoid large declines in their net profit because of intense competition from foreign banks.

The size of the banking network also impacts banking competition in the host country. In markets where information technology is less developed, individuals and investors prefer to open accounts with banks that have many branches. This gives interest banks a competitive advantage because they have sizeable banking networks. By contrast, most non-interest banks have a small number of branches, which prevents them from attracting new lenders and borrowers.

In a highly competitive environment, local banks tend to extend credit to risky projects, which contributes to increased banking losses (Walter and Smith, 1999). The failure of existing borrowers to repay their loans regularly causes dramatic

declines in local banks' profit margins and thus diminishes their ability to compete with foreign banks. Reducing the spread between the lending and deposit rates allows local banks to boost their efficiency and to recover from their increased losses.¹⁰²

Increased banking competition can help develop existing financial services and boost investments in the national economy. Removing regulatory constraints forces small non-interest banks to specialise in areas where they have competitive advantage. Such specialisation helps non-interest banks reduce their operating expenses. Focusing on few businesses also allows non-interest banks to reduce risks associated with their operations because they have substantial information and expertise available about the selected industries. Moreover, specialised banks can keep a closer watch over their borrowers (interview notes, 2001).

4.6. Conclusion

This chapter has shown that Islamic financial products are only suitable for financing medium- and short-term investments (Duncan, 1996). Non-interest banks have a lack of experience in equity investment and corporate finance. To improve the non-interest investment banking services, scholars suggest converting interest-bearing financial instruments into Islamic financial products. Examples of new Islamic financial instruments are letters of credit, foreign currency related swaps, futures and letters of guarantee (The National Commercial Bank, 2003). However, in short-term financing,

¹⁰² Several methods can be used to measure banking efficiency. The first method is to compare bank spread before and after financial liberalisation. The second is to contrast bank spreads of different countries. The third method compares banking indexes such as total deposits and total assets of different banks and markets. It is worth mentioning that those indexes cannot adequately evaluate banking services. Valued added can be a good indicator of the size of the bank. For example, banks with high valued added provide their services at low cost. Another method of measuring banking efficiency is the evaluation of costs, profits and bank margins (Claassen, 1996).

non-interest banks are required to place emphasis on collateral and to provide management assistance to their entrepreneurs. It is also important not to force traders to accept contracts.

It has been stated that non-interest banks are tightly restricted in both their lending and borrowing. On the lending side, non-interest banks have minimal trust in existing products. It is illegitimate under Islamic law for non-interest banks to finance companies involved in prohibited activities such as production of wine, tobacco and drugs. Islamic financial law also prevents non-interest banks from accessing conventional financial markets and central bank funds due to constraints associated with interest rates. In addition, speculation and trading highly priced shares are unacceptable practices under *sharia* guidelines. This has resulted in an underdeveloped Islamic secondary market for financial products.

Non-interest banks' mode of receiving funds and financing is underdeveloped, as reflected by difficulties they face in managing their assets and liabilities. Deposits are not guaranteed because of the high credit risk associated with non-interest banks' projects. To reduce their amount of bad debts, non-interest banks like interest banks are advised to assess their borrowers continuously. On the other hand, entrepreneurs are required to disclose costs and revenues associated with the venture (Hamat, 1994). The accounting standards of non-interest banks are inadequate and this has negatively affected market transparency and integration (Baydoun and Willet, 2000). Additionally, the absence of a real inter-bank Islamic market and limitations on securitisation activities have contributed to a decline in the liquidity of non-interest banks. It has been noted that creating a uniform *sharia* board should harmonise Islamic financial rules. On the other hand, adopting good risk management tools

would help non-interest banks reduce their exposure to uncertain ventures and will reduce volatility in financial markets. Finally, non-interest banks are recommended to co-operate with interest banks, which have long-term experience in global financial markets.

The chapter stressed that the income generated from a business venture is shared according to the agreement among non-interest banks, depositors and entrepreneurs. However, the amount of cash received from entrepreneurs and the cost of entering new markets alter the method used by non-interest banks to distribute their profit. To minimise banking costs, non-interest banks need to assess their loan portfolios, to identify market risks, to record all transactions, and to improve the quality of credit portfolio by making larger provisions for bad debts. Bardfield (1998) also recommended offering non-traditional financial instruments to boost non-interest banks' profit margins.

The last section of this chapter showed that non-interest banks are facing severe competition from interest banks. Interest banks appear to be more competitive than non-interest banks in both lending and borrowing because, as mentioned in the chapter's first section, depositors' funds are not guaranteed under non-interest banking model and Islamic banks have unclear rules governing the allocation of profit. Unlike interest banks, non-interest banks have limited financial products and this has made them unable to meet the demand of their customers (Ingram, 1985). It has also been stressed that tax regulation affects the banking competition between interest banks and non-interest banks. Lower tax rates encourage foreign entry and increase competition between domestic and foreign players. However, the decline in lending and borrowing rates because of the increase in banking competition makes

banks willing to finance high-risk projects. This can produce financial crises. Therefore, non-interest banks are required to improve the quality of their products and focus on financing high-yield industries. Cost shifting also enables non-interest banks to reduce the price of their products and enhance their competitive position in the market.

The next chapter examines the research methodology and problems encountered during the survey. Quantitative and qualitative research methods are discussed in detail, with reference to the literature on structured interviews and dispatch of questionnaires. The link between the questionnaire and the four main questions of the research is analysed thoroughly as well.

Chapter 5:

RESEARCH METHODOLOGY

5.1. Structure of the research methodology

This study uses quantitative and qualitative research methods to analyse the effects of globalisation of financial services on the banking industry and stock market in Algeria. It aims at understanding the cause of banking failures and to outline the prerequisites of an efficient banking sector. To do so, we examine factors that affect banks and stock market operations either directly or indirectly, during the transition from a centrally planned economy to a market-based one. We also analyse the responses of banks to financial liberalisation, financial innovation and the Internet in terms of competition, profitability and efficiency. We do so because we believe that these factors explain the success of Algerian integration with international markets. They remove many constraints on domestic and foreign banks, and also reduce the government's role in the financial sector.

Previous studies such as those of Jbili *et al* (1997) have been considered in this study. They noted that structural reforms and fiscal policies affect savings, investments and economic growth. This argument is also based on a study by Gurley and Shaw (1960), in which they pointed out that economic development is a means to increase the availability of capitals in the financial sector. Jbili *et al* (1997) assessed the quantitative side of financial reforms by measuring the relationship between indicators, which are applicable to the process of reform and examining the non-government savings rate. They also evaluated each indicator before and after the reform. Their aim was to analyse if the reforms had positive

effects on non-government savings, rather than evaluate the country saving rate as this was subject to other indicators such as per capita income and demographic aspects.

The research methodologies used by Jbili *et al* (1997) differ from those adopted in this study in two main ways. We used structured interviews and questionnaires instead of mathematical models to assess the implications of financial reforms on the performance of the selected banks. Besides, banks are divided into two groups: conventional and Islamic, to determine the operational constraints facing each banking model in collecting public savings and financing investments.

We have selected fourteen banks for this investigation: six state-owned banks; four Algerian private banks; three foreign banks and one non-interest bank. The criteria used in this division are: (i) ownership; (ii) mode of financing; and (iii) country of origin. We excluded banks that are small in terms of capital assets or size. State-owned banks, Algerian private banks and foreign banks are included in the same category as interest banks. The purpose of this division is to make analytical comparisons between interest and non-interest banks.

The source of quantitative data used in this study consists of banks annual reports, central bank monthly review, *Office Nationale des Statistics* (National Statistics Office), government publications and statistics published by international organisations, such as the International Monetary Fund and the World Bank. The aim of statistical analyses is to find relationships between variables and then interpret the data. Financial indicators are used to measure banks' assets, interest rates and credit allocation. Fielding and Gilbert (2000) said that validity and reliability of the indicators are the determinant of the quality of

the quantitative analyses. Validity reflects to what degree the indicators measure the concepts, which are the key components of the theory. Reliability focuses on the consistency of the event subject to investigation. Continuous variables are used to measure quantities such as profitability.

In the qualitative method we administered questionnaires and conducted interviews. "Survey research is a powerful tool for gathering accurate and useful information" (Salant and Dillman, 1994: 9). We interviewed senior managers from banks and the Algiers stock exchange. Interviews were held face-to-face with each respondent in Algeria. Altogether, we dispatched twenty-two questionnaires and conducted eighteen interviews. We held six interviews with state-owned banks, four with Algerian private banks, four with foreign banks and four with the non-interest bank. This gave equal weighting to each banking group. The reason for having six interviews with state-owned banks is because the sample included six banks from the category as they have the largest market share.

Salant and Dillman (1994) set four requirements to achieve a high level of accuracy within the human samples. First, the sample needs to be significant to maintain the expected level of accuracy. Second, the researcher must give equal chance to people included in the sample. Third, the people selected for the sample should answer questions willingly and with a high level of precision. Finally, the characteristics of the group selected to answer the question, but which did not participate in the survey, are similar to those who answered the questions and did participate.

All people selected for the survey were senior managers. The questionnaires were given by hand to each respondent. Questions were also translated into French and Arabic to help managers understand the exact meaning of each question.

Confidentiality was assured throughout the survey, but senior managers were encouraged to answer the questions with accuracy. “Any time you ask people to participate in a survey, it is your responsibility to respect both their privacy and the voluntary nature of their involvement” (Salant and Dillman, 1994: 9).

The answers were recorded in tapes to enable us examine each response. A second appointment was also made when the interview with the respondent was incomplete. The ‘evaluation survey’ was adopted to produce useful information about the development of the Algerian banking industry and stock market within the past five years.

We used face-to-face rather than telephone and mail surveys to avoid problems, which can be attributed to the wording of the questions. “Telephone surveys are very sensitive to errors caused by interviewers who do not read questions exactly as they are worded in the questionnaire” (Salant and Dillman, 1994). On the other hand, interviews in-person are suitable for unknown population samples when respondents are reluctant to answer questions through the mail or over the telephone. Salant and Dillman (1994) also noted that the survey enables interviewers to explain the significance of the research and to ensure respondents’ confidentiality. They concluded that face-to-face interviews produce high response rate compared with other survey methods.

Fink (1995) pointed out that questions included in a research survey need to be structured in a way that does not influence the respondents’ answer pattern. Questions should have the same meaning for both the surveyor and the respondent. This results in a good communication and also reduces data errors. Fink (1995) sets the following points to ensure that questions are properly worded:

- (1) the subject of questions is based on the research aims and objectives;
- (2)

questions are clear to respondents; (3) the link between previous and subsequent questions is sound; (4) wording of questions is neutral; (5) each question refers to a single concept; (6) the concept is measured by the specified question; (7) non-substantive responses to questions are minimised; (8) different options for answering the questions are available; (9) questions are designed for a specified group of respondents; (10) the researcher is able to administer the questionnaire without any difficulty; and (11) the codes used for data entry are clear to respondents.

Questions need to be short and comprehensive for respondents (Fink, 1995). However, the simplified question should not influence the respondent's opinion. Response categories should be vast and meaningful to help respondents answer the questions without facing difficulties in data input. This can be achieved by using visual aids in which each question is divided into small components. Besides, the number of options available for each question is reduced. The split question technique enables the researcher to cut response categories for each question by identifying the question key components. As a result, the responses can be applied to different components of the question.

Visual aids were introduced to assist respondents in dealing with scale and other forms of estimation. This is obtained by providing a list of options, items that facilitate recall, scale of items, an information pack to educate the respondent, and a keyword summary to assist respondents in making their opinions and priority choices.

The split question technique is used to rank items, which is done by placing items in descending order. The criterion used in the ranking can be the importance of the item to the topic under investigation. Usually, the researcher asks the

respondent to make a general ranking and then a specific ranking of the items. Fink (1995) said that the ranking appears to be difficult without the use of visual aids. The split technique enables respondents to write the ranking in the relevant box of the questionnaire.

In the 'funnel technique', questions are also made in descending order from general to more specific. Usually, it starts with open-ended questions and ends with close-ended multiple choice questions. Concepts introduced in the open-ended questions are new to respondents. However, the researcher becomes more focused on specific aspects of the subject as the surveyor becomes aware of the real context of concepts introduced in the former questions (Fink, 1995).

Inverted funnel techniques are used when respondents cannot express their opinions because of lack of knowledge of the concepts introduced in the question. This technique aims to make the respondent concentrate more on the topic under investigation. General questions are presented after the specific ones to fulfil the purpose (Fink, 1995).

Aided recall and bounded recall are applied to improve response accuracy. In 'aided recall', respondents are asked to select items relevant to a specific event. Respondents are also reminded of major events throughout the questionnaire. The interviewer also clarifies reference points to the respondents when necessary. Another method used in in-person interviews is to show landmark events to enable respondents to consider the timing of each event. In 'bounded recall', the respondent is also asked for a second interview to cover events that occurred during the two interviews.

Fink (1995) emphasised two key criteria in organising questionnaires: (i) the order of questions; and (ii) the flexibility of the questionnaire. Moving from one

question to another should meet the aims of the interviewer and the respondent. The surveyor needs to consider how the order of questions affects the answers of the respondent. Good question sequence facilitates the process of conducting interviews and reduces errors, which may affect the accuracy of the results obtained from the questionnaire and enhance the response rate.

In this study, the average number of visits to each bank was five as some senior managers were on holiday and some were reluctant to be part of the survey. Some of the senior managers also used my questions to tell their own stories about their current or former employer. For example, most senior managers in Algerian private banks did not hesitate to say that the working conditions with state-owned banks for which they worked were poor, and because of that they had joined a private bank. They also noted that their earnings at private banks were higher than at state-owned banks.

Table 5.1: Number of appointments made with senior managers in each selected bank

Name of the bank	Number of Appointments
<i>Banque Nationale d'Algérie</i>	5
<i>Banque Extérieure d'Algérie</i>	4
<i>Crédit Populaire d'Algérie</i>	4
<i>Crédit Nationale d'Épargne et de Prévoyance</i>	4
<i>Banque de l'Agriculture et de Développement Rural</i>	3
<i>Banque Algérienne de Développement</i>	2
Union Bank	5
<i>Banque Commerciale et Industrielle d'Algérie</i>	4
<i>El-Khalifa Bank</i>	4
<i>Sofinance</i>	2
Citibank of Algeria	4
<i>Société Générale d'Algérie</i>	3
Arab Banking Corporation	4
<i>El-Baraka Bank</i>	6
Total	54

The variations in the number of appointments made with each bank's senior managers is attributed to the time taken to answer the interview questions and to complete the questionnaires. The net total time spent with respondents was 116 hours; 72 hours for interviews and 44 hours for questionnaires.

The response rate of the survey was 100 per cent. This high response rate was achieved by making several appointments with each senior manager so as to complete the questionnaires and to conduct the face-to-face interview. Respondents were also given enough time to complete the questionnaires. Because interviews were held with senior managers who had worked for their banks for many years, it is believed that the accuracy of the results obtained in this study is significant.

Salant and Dillman (1994) stressed three key steps to reduce sampling errors: (1) describe the extent of sample population; (2) receive a complete population list; and (3) identify the sample. The source of the information is the sample drawn from the population under investigation (Fielding and Gilbert, 2000). However, the sample must be representative of the relevant population to achieve sound conclusions. Because qualitative research uses open-ended studies, it makes some of the conclusions unpredictable by the researcher (Holliday, 2002). In this study the sample population included highly ranked managers within each bank. The population list was inclusive of at least one senior manager from each bank. Finally, the sample was clearly identified in terms of size and knowledge of the respondents of the topics under investigation.

This study answers four main questions:

1. What are the factors that drive the phenomenon of globalisation of financial services in Algeria?

2. How does globalisation of financial services affect banking competition, profitability and efficiency in the Algerian financial market?
3. What obstacles confront banks and stock markets during the transition from a centrally planned to a market-based financial system?
4. What are the possible solutions to problems encountered by conventional and Islamic banks under the new “free market economy”?

5.2. Structure of the questionnaires

The questionnaires were dispatched on the basis of the research four main questions. The order followed in the questionnaire was based on the ownership and activities of each banking group. This was done on purpose to examine in-depth each component of globalisation of financial services and also to assess the performance of all banking groups. In the interviews, senior managers were asked further questions in order to make critical assessments of the developments achieved within the Algerian banking industry and stock market during and after financial liberalisation.

The first three questions of the questionnaire considered banking competition. Respondents were first asked to assess the impact of financial liberalisation, which is one of the main components of globalisation of financial services, on banking competition (open-ended question). The increase in competition in the banking sector was said to be ‘minimal’ when the bank faced competition from banks in one banking category, ‘small’ when the bank faced competition from banks in two banking categories, and ‘dramatic’ when the bank faced competition with all banking groups. In the second question, senior managers were asked to identify the banking category with which their bank was facing competition. The

percentages presented in 'Q2, Appendix V' reflect the level of competition with each banking group. For example, 25 per cent of state-owned banks' senior managers believe that they were facing competition with the same banking category. Twenty-five per cent believed that state-owned banks were facing competition from Algerian private banks. Thirty-one per cent of managers said that foreign banks were the main competitors of state-owned banks. The remaining nineteen per cent of managers noted that state-owned banks were facing competition from the non-interest bank. The third question identified the mechanisms used by banks to deal with the new competitors (close-ended question). Aided recall was used in this question to select items relevant to the event (banking competition). The items were made in descending order from most important to least important (split question technique). The same method was applied in question four to determine factors affecting banking performance in Algeria. Respondents were made aware that new competitors and change in banking regulations are caused by the process of financial liberalisation.

To ensure a good order of questions, we started with questions relevant to financial liberalisation. In question five, senior managers were asked if the removal of financial restrictions had enabled banks to make good lending decisions. This was a double choice question: 'yes' or 'no'. For example, 70 per cent of state-owned banks' senior managers answered 'yes' to the question and the remaining 30 per cent answered 'no'. The same method was applied to other banking groups. Then the results were averaged for all banking categories. The result was 81 per cent 'yes' and 11 per cent 'no'.

Question six was open-ended. Senior managers were asked to rank five major sectors financed by banks. This was then followed with two more specific

questions. In question seven, senior managers were asked to classify banks' loans into three categories: short, medium and long term. In each category, senior managers could select between small, medium and large. If fewer than 25 per cent of loans were short-term, then the senior manager should tick small. If short-term loans account for between 25 and 50 per cent senior managers should tick medium. Finally, if more than 50 per cent of loans were short-term, senior managers should tick large.

In question eight, senior managers were asked how the bank's market share had changed during the previous five years. Three options were given: 'increase', 'decrease' or 'stagnant'. Under each option, senior managers could select between: 'minimal', 'small' or 'dramatic'. The increase or decrease was considered to be minimal if market share changed by less than 5 per cent. If the market share changed between 5 to 10 per cent, it was considered small. Finally, a dramatic increase or decrease occurred when the market share changed by more than 10 per cent.

Question nine showed the number of banks involved in the trading of shares on the Algiers Stock Exchange. This question was followed by another general question (question ten) to assess the growth prospects of the Algerian financial market after the transition from a centrally planned economy to a market-oriented one. Growth prospects were set into five scales: (1) very good; (2) good; (3) average; (4) poor; and (5) really poor. The benchmarks used in making this order were savings rate, level of intermediation and efficiency of the Algerian financial market.

The split technique was used in question eleven to show the practical constraints that confront banks' activities in Algeria. It was believed that eight

main factors would influence banking operations after the financial liberalisation: (1) financial regulations; (2) market size; (3) economic weakness; (4) cultural barriers; (5) certainty; (6) security; (7) accounting standards; and (8) the range of financial products. Respondents were asked to select some or all the components that applied to the bank.

The funnel technique was used in question twelve. We started with an open-ended question, 'yes' or 'no'. If the respondent answered 'yes' then he had to select between three different scales: some, many and most. These three scales reflected the breadth of the services offered by the bank through Internet channels. Finally, respondents were asked to indicate the response to banking services offered through the Internet. The split question technique was used in ranking the items into high, medium and low.

The inverted funnel technique was applied in question thirteen. This focused respondents on the issue of Internet banking. Respondents were asked if the Internet helped the bank to strengthen the link with customers, 'internally' and 'externally'. 'Internally' referred to customers based in the home country and 'externally' referred to customers based abroad. For each category, respondents had three options: 'no', 'yes', and 'I do not know' (open-ended question).

In question fourteen we used the 'aided recall' technique to increase the accuracy of the survey. Senior managers were given a list of items that could be achieved by Internet banking. These items are: (1) market penetration; (2) low costs; (3) high speed; (4) low risk; and (5) large package of services. For each item respondents selected between three possibilities: 'yes', 'no' and 'I do not know' (open-ended question).

Question fifteen considered if the opening of the market to both private and foreign banks would contribute to the emergence of new products. Visual aids were used to enable senior managers to select the appropriate questionnaire box. The scale of emerged products was in three categories: 'some', 'many' and 'most'. 'Some' reflected that only a few products had emerged after the opening of the market to new players. 'Many' was used when several new products were created, but they were not significant compared with existing ones. Finally, senior managers selected 'most' when various new products were offered by the bank.

Visual aids were also used in question sixteen to show if 'going global' had changed the financial environment in Algeria. Financial environment reflected the scope of intermediation, investments and asset growth of the bank. Respondents could choose between 'no' and 'yes', but those who selected 'yes' had to indicate the extent of the change: 'minimal', 'small' or 'dramatic'. 'Minimal' change meant that there was insignificant increase or decrease in investments, intermediation and asset growth. 'Small' change occurred when the three components of financial environment experienced a gradual, but not sizeable, increase or decrease. Finally, the scale of change was said to be dramatic when the bank's assets, investments and its role as intermediary between lenders and borrowers had become significant or insignificant within the recent years.

Question seventeen assessed whether there had been an increase in banking efficiency in the past five years. Senior managers were allowed to select between three options: 'no'; 'yes' and 'I do not know'. If the respondent selected 'yes', then he had to indicate if the increase was 'minimal', 'small' or 'dramatic'. The benchmarks used to evaluate banking efficiency were 'net interest income' and 'total assets'. If net interest income and total assets had risen by less 5 per cent

then the increase was minimal. The increase was considered to be small when net interest income and total assets rose between 5 and 10 per cent. Banking efficiency was said to have increased dramatically if net interest income and total assets rise by more than 10 per cent.

Question eighteen identified any increase in banking profitability in the past five years. Senior managers were given three options: 'no', 'yes' and 'I do not know'. If a senior manager answered 'yes' then he had to choose between three categories that indicated the scale of the increase: 'minimal', 'small' and 'dramatic'. The benchmarks used to measure the banking profitability were before-tax profits and earnings. The increase in banking profitability was said to be minimal when there had been a rise of less than 5 per cent in both before-tax profit and earnings. If the rise in before-tax profit and earnings was more than 5 per cent, but less than 10 per cent, then the increase in the bank's profitability was considered small. Finally, if the rise in before-tax profits and earnings was more than 10 per cent, then the bank profitability was said to be dramatic.

Question nineteen compared the number of clients for each banking group. Senior managers were asked to choose between five different scales: 'from 1 to 100'; 'from 101 to 500'; 'from 501 to 1,000'; 'from 1,001 to 10,000' and 'more than 10,001'. These benchmarks were used because of the small number of clients operating with new banks. In question twenty senior managers were asked to classify those clients from 1 to 6. The clients comprised six groups: (1) large enterprises; (2) medium enterprises; (3) small enterprises; (4) wealthy individuals; (5) average income individuals; and (6) small income individuals. The criterion used in the classification is the size of the sector rather than the number of clients.

In questions twenty-one and twenty-two, senior managers were asked to declare the total number of their employees and how many of them were entering and leaving the bank every year. This was to find the change in banks' employment plans after financial liberalisation. Globalisation of financial services may contribute to an increase or decrease in the number of employees in each banking category. If the number of employees entering the bank was higher than those who had left the bank, then globalisation of financial services was said to bring more benefits to banks' employment plans.

Questions twenty-three to thirty were designed only for state-owned banks, which have the largest market share. In question-twenty three we aimed to find evidence about the role of the government in the banking sector after the initiation of financial liberalisation. Respondents chose between 'no' and 'yes'. Those who believed that the role of the government had declined after financial liberalisation had to indicate if the decline was 'minimal', 'small' or 'dramatic'. The benchmarks used to assess the decline in the role of the government were: (i) lending restrictions; (ii) reserve requirements imposed by the central bank; and (iii) the autonomy in selecting financial products.

Another result expected from financial liberalisation is steady improvement in state-owned banks' internal and external management. Internal management includes the control and making decisions within the branch. External management reflects how banks operate in the financial market. Respondents chose between 'no' and 'yes', but those who selected 'yes' indicated if the improvement was 'minimal', 'little' or 'dramatic'. The benchmarks used to evaluate the improvement in banks' internal and external management were lending policy and the quality of banking services.

Question twenty-five aimed to find if foreign banking entry had encouraged state-owned banks to promote their services. This was a close ended question, with two options, 'no' or 'yes'. In this study, we argue that the entry of foreign banks is due to the globalisation of financial services. The current financial position of state-owned banks was identified in question twenty-six. The bank's financial position could be 'strong', 'moderate' or 'weak'. The volume of bad debts, loans granted and service of debts by debtors were the benchmarks used to assess the financial position of state-owned banks. Respondent are also asked in question twenty-seven to mark the factors that weaken the financial position of state-owned banks. These factors were: (1) government interventions; (2) mismanagement; (3) poor lending policy; (4) interest rate margin; (5) the range of financial products; (6) underdeveloped payment system; and (7) untrained staff.

Practical reasons that make state-owned banks not ready for privatisation were included in question twenty-eight. Senior managers were asked to choose between three factors that influence the decision of banking privatisation in Algeria: large amount of debts, underdeveloped information systems, and management complexity of current activities. In the structured interview, senior managers were asked how to quicken the process of privatisation. In question twenty-nine, respondents were asked if the privatisation of state-owned banks would improve the following factors: (1) improve financial resource allocations; (2) develop information systems; (3) boost market certainty; (4) ameliorate their financial services and strengthen their financial position. This was to find if privatisation of state-owned banks was supported by senior managers. All the factors were given equal weighting.

Finally, state-owned bank managers were asked if the liberalisation of interest rate had an impact on the bank's earnings (question thirty). They could answer 'no' or 'yes'. Those who answered 'yes' indicated if the scope of change in bank's earnings was 'minimal', 'small' or 'dramatic'. If the change in the bank's earnings was less than 5 per cent then it was minimal. The change in banking earnings was said to be 'small' when there was rise or decrease in the bank's earnings of between 5 and 10 per cent. If the increase or decrease in the bank's earnings was above 10 per cent, then the change was considered 'dramatic'.

Questions thirty-one to thirty-three were designed only for foreign banks. Question thirty-one asked what were the criteria followed by foreign banks in deciding to enter the Algerian financial market. Respondents were given five items to select from: (1) market size; (2) the presence of many foreign companies; (3) suitable financial regulations; (4) low taxes; and (5) enhance the link with customers. These items were equally weighted. The aim of this question was to find the driving forces of foreign banking entry into Algeria.

Similarly, in question thirty-two, managers were asked to determine the bank's operations in the Algerian financial market. This was because of the positive correlation between banking operations and the growth of their market share. Respondents were given six factors to choose from: financing large companies; financing medium size enterprises; financing small enterprises; financing trade; trading of shares in the Algiers Stock Exchange; or receiving funds from the public. The six elements were also equally weighted as in question thirty-one.

Question thirty-three aimed to find evidence about the response of savers and borrowers to the services provided by foreign banks. Respondents could select between three categories: (i) satisfactory; (2) indifferent; or (3) poor. The response

was said to be 'satisfactory' when the demand for the bank services was increasing. If the demand for the existing financial products was stagnant, then the response was considered to be 'indifferent'. Finally, decline in demand for the bank's services meant that the response was 'poor'.

Questions thirty-four, thirty-five and thirty-six were deliberately posed for the senior managers of the non-interest bank. First, they were asked if the response of the bank's customers to services provided was 'satisfactory', 'indifferent' or 'poor'. The benchmark used to assess the response to services provided was the demand for the bank's financial products. If the demand for the current services was growing, then the response was considered to be 'satisfactory'. The response was 'indifferent' when the demand was stagnant. The response was 'poor' when the demand was declining. Second, respondents were given a list of items reflecting the practical problems that may face the non-interest bank in Algeria. The list included the following factors: (1) asset evaluation; (2) risk assessment; (3) taxation; (4) liquidity; (5) absence of uniform accounting standards; (6) limited financial products; and (7) public trust. These items were equally weighted. If the factor was causing negative effects on the bank's operations, then the answer was 'yes'. If the factor had no direct impact on the bank's activities, then the answer was said to be 'no'. Third, senior managers were asked to give an example of how the bank distributed the profit generated from its operations between the money owner, the entrepreneur and the bank. The money owner under Islamic banking does not receive interest, but shares the profit or risk with the bank.

The final question addressed whether globalisation of financial services had changed the shape of the Algerian financial market positively or negatively. It was a close-ended question with two possible answers: 'positive' or 'negative'. The

question was designed to assess the overall implications of globalisation on the banking industry and stock market. If real progress had been made at both micro- and macro-levels of the financial sector, since the initiation of financial liberalisation, then the change was said to be positive. This would be reflected by an increase in the quality and number of services offered to savers and investors.

5.3. The limitations of research methodology

The study used Algeria as a case study rather than a group of selected countries. This had significant implications on our results as Algeria has distinctive political, economic and social conditions. At micro-level, state-owned banks still have the monopoly in collecting public savings and financing domestic investment. The securities market is also underdeveloped and includes few financial instruments. At macro-level, economic growth is more sensitive to the change in oil price rather than the development within the financial sector. The hydrocarbon sector accounts more than 90 per cent of Algeria's foreign exports.

Classifying banks into interest and non-interest, based on their mode of financing, is another factor that has a direct effect on the results achieved in this research investigation. In the study of Jbili *et al* (1997), banks were classified as state and non-state, using ownership criteria. The same approach was followed by Shaw and McKinnon (1973) to assess the financial repression in developing countries before and after the financial reforms. Moving from administrative to real interest rates has significant consequences on interest banks rather than on non-interest banks, which use profit and loss sharing as a benchmark in the allocation of their financial resources.

Globalisation is defined under the assumption that financial liberalisation, financial innovation and the Internet are the main drivers of the phenomenon. The Internet is considered as a separate factor to financial innovation because of its role in penetrating new financial markets. It enables banks to offer their services in foreign markets without a physical presence. Financial innovation refers to new products, which help financial institutions expand their market share in domestic and foreign markets, but with a physical presence of the bank in the host country.

The study links banking performance with competition, profitability and efficiency. The three factors have a common objective, which is to enhance the performance of existing banks. The aim of financial reforms initiated by the Algerian government is to improve savings and investments through an active banking system. The removal of barriers on banking activities and opening the domestic market to foreign banks has contributed to an increase in banking competition. This has an effect on banking profitability and efficiency as banks are developing sound practices in both of their lending and borrowing. The study focuses on analysing the changes in lending practices, interest rates, network, employment and information technology. These factors have a positive correlation with banking competition, profitability and efficiency.

Algeria is still in the process of making the transition from a centrally planned to a market-oriented economy. Unclear privatisation plans and concerns about social conflicts delayed the selling of state-owned banks' assets to private and foreign investors. The relationship between state-owned banks and public enterprises also remains strong as large enterprises have not been privatised yet.

The study is based on a sample of fourteen banks categorised on the basis of ownership, mode of financing and country of origin. State-owned banks still

dominate the Algerian banking industry, with a 90 per cent market share. In second place, we find private and foreign banks with market share ranging between 1 and 9 per cent. The non-interest bank has a market share of less than 1 per cent. The variation in the market share of each banking group has influenced the conclusions reached in this research investigation.

The restructuring of the central bank as part of the financial reforms has been excluded from this study. This was done on purpose to focus the analyses on the progress made by commercial banks in managing their portfolios and in developing their information technology. Analysing the development of commercial banks independently from the central bank enabled us to examine the factors that drive their performance.

Finally, I excluded non-banking institutions from this study, as they are very small compared with banking institutions. Foreign institutions offering similar products are also absent in the market. Additionally, the scope of reforms and innovation within insurance and pension fund industries is inadequate considering that globalisation of financial services is taking place within the sector.

5.4. Difficulties of the study

- As noted by Jbili *et al* (1997:23) “the scope for quantitative analysis is severely limited by data constraints”. This is more apparent when using financial indicators, which measure financial market development at the micro-level. For example, banks rarely provide continuous data on their net profit, overhead costs and interest margins. Therefore, we decided to use qualitative research in parallel with quantitative research to explain the impact of financial liberalisation on financial sector developments.

- Most of the interviewees were non-English speakers. Therefore, questions were translated into Arabic and French to enable respondents to complete the questionnaires with accuracy. We found that the dual-language focus made managers comfortable about discussing developments in the Algerian banking industry in before and after financial liberalisation.
- Some of the state-owned banks' senior managers were hesitant in giving fully detailed answer to the questions. Therefore, we made a second appointment to clarify those issues. In general, managers in private and foreign banks were more open to questions than managers in state-owned banks.
- Banks failed to provide me with their annual reports for consecutive years. This strengthens the argument that the financial reporting system used by banks is weak. In the absence of figures about some banks' net profit, total assets, etc., we relied on other sources of information such as interview notes and questionnaires.
- Finally, it was very difficult to make face-to-face appointments with senior managers, as most of them tried to avoid disclosing information about the financial performance of the bank. We were obliged to stay in the capital, Algiers, for two months, in the summers 2001 and 2002, to conduct all the interviews and to administer the questionnaires. This also made the cost of the survey very high.

The next chapter analyses the effects of globalisation of financial services on the Algerian banking industry and the Algiers Stock Exchange after the financial liberalisation of the 1990s. Quantitative and qualitative research approaches are used to examine the changes in banking competition, profitability and efficiency. The performance of the Algiers Stock Exchange and its role in financial resource mobilisation are also examined.

Chapter 6:

THE EFFECTS OF GLOBALISATION OF FINANCIAL SERVICES ON THE ALGERIAN BANKING INDUSTRY AND STOCK MARKET: AN EMPIRICAL STUDY

6.1. Introduction

This chapter analyses the responses of the banking industry and the Algiers Stock Exchange to the effects of globalisation of financial services in Algeria. To do this, we examined the methods used by interest and non-interest banks in the protection of their market share from increased banking competition.¹⁰³ Banking profitability and efficiency are also examined by identifying velocity and quality of financial services, employment plans and network expansions of each banking group. Constraints inhibiting the development of the Algiers Stock Exchange are analysed to find direct or indirect forces that impact market capitalisation, and to determine the cause of the market's negative growth.¹⁰⁴

We refer to the interviews conducted and to the questionnaires as they are the primary source of the information. Senior managers are quoted when it is necessary to strengthen the argument. Interviewees selected for the survey are occupied high-ranking positions within their institutions. This improves the reliability of the data included in the analyses. Statistical data are also used to show the trends of real

¹⁰³ Usually, foreign banks use their advanced technology, long-term experience, good worldwide reputation and financial strength to increase their market share (Focarelli and Pozzolo, 2000). On the other hand, state-owned banks rely on government support and on preferential regulations to protect themselves from new competitors.

interest rates, inflation, foreign direct investments, etc. These are indicators of the developments attained within the financial sector during and after the reforms.

The analyses enable us answer the four research questions. To achieve the desired results, we have examined separately the role of financial liberalisation, financial innovations and the Internet in the elimination of barriers on each banking group. The three factors enable banks to penetrate new markets and to have more autonomy in their activities. To answer the second research question, we assessed the impact of the removal of various constraints, which is a result of globalisation, on banking competition, profitability and efficiency. Banking competition, profitability and efficiency are positively correlated with financial liberalisation, the emergence of new products and with advances in information technology such as the Internet. To answer the third research question, we examined the impact of foreign banking entry on the national banking industry and the role of the stock market in the mobilisation of financial resources. To answer the final research question, we have analysed the alteration in financial regulations which can be attributed to the transition from a centrally planned economy to a market-oriented one. The financial reforms are having direct effects on the users of the financial system including lenders and borrowers.

This chapter is divided into eight sections. The first section measures the performance of interest banks including state-owned banks, Algerian private banks and foreign banks. (The division of interest banks is made on the basis of three criteria: ownership, operations and country of origin. These criteria are endorsed because of the difference observed in the investment and savings strategies of state-

¹⁰⁴ See Hargis (1998) on the evolution of the stock market in developing countries.

owned banks, Algerian private banks and foreign banks.) The second section evaluates non-interest banks' performance.¹⁰⁵ The third section addresses banking competition, which is one of the goals of financial liberalisation (see Nashashibi *et al*, 1998). The fourth section assesses the development of Internet banking in Algeria. Citibank and *El-Khalifa* Bank use electronic banking to attract new customers and to conduct cross-border financial transactions. The Internet has enabled these banks to offer a vast range of services to domestic and foreign investors. It has also helped newly emerging banks to attract creditworthy customers. The fifth section examines the role of financial innovations in the foreign banking entry into the Algerian financial market. The sixth section measures the effects of globalisation on banking profitability in Algeria. The seventh section evaluates the performance of the Algiers Stock Exchange since 1999, focusing on obstacles that confront stock market development. The eighth and final section presents the concluding remarks and provides policy recommendations for banking and Algiers Stock Exchange restructuring.

6.2. Measuring the performance of interest banks

6.2.1. State-owned banks

The reasoning followed to examine the performance of state-owned banks is based on the argument that globalisation of financial services alleviates interest rate ceilings, improves credit rationing and allows banks to strengthen their financial position and to offer various financial services. The benchmarks used to assess state-owned banks performance include: lending policy, number of financial products, information

¹⁰⁵ See Chapter 4 for the evaluation of conventional and Islamic banks profitability and competition.

technology, privatisation and banking network. A similar approach is applied to Algerian private banks in section three, foreign banks in section four and non-interest bank in section five. The examination focuses on credit allocation, number of clients, types of financial products, ownership and payment system as the main areas of change under the phenomenon of globalisation of financial services in Algeria.

Chapter 3 showed that the Algerian government nationalised most foreign banks during the 1960s (Benissad, 1980), giving the state control over all banking operations through the Ministry of Finance. Banks' funds were mainly used to finance government expenditures and state-owned enterprises (Rossignoli, 1973). The government also obliged households to deposit their funds at CNEP. This bank collected savings through a large post office network and its agencies, which were established in almost all municipalities; Algerian emigrants could also open an account, on the spot or at a distance with CNEP. Savings were mainly used to finance housing under three categories: housing funded under mortgage-type schemes; housing produced by local investors; and housing built by local groups, by individuals or in cooperation with private investors (CNEP Annual Report, 1994).¹⁰⁶

The questionnaire shows that the relationship between state-owned banks and state-owned enterprises remained strong even after financial liberalisation (see Appendix V, Q.6).¹⁰⁷ This is because the government persisted in protecting state-owned enterprises, which remain the main source of employment for the Algerian population (IMF, 1998). Algeria's working population increases by four per cent per year. Sixty-eight per cent of unemployed workers are considered not to be qualified

¹⁰⁶ See Chapter 3 for more explanations about the national financial resources mobilisation during the socialist economic regime.

for employment; this includes fifty-four per cent of people aged 15–24. The privatisation programme implemented in the 1990s liquidated thousands of small and medium-sized state-owned enterprises between 1995 and 1998, resulting in the loss of 450,000 jobs (EU Online, 2002). On the other hand, private and foreign investments are small due to the scarcity of domestic capital and high country risk.

“Most of state-owned banks funds are used in financing state-owned enterprises and government expenditures. Financial authorities are reluctant to privatise state-owned banks because small and medium size state-owned enterprises are unable to raise funds outside the national banking sector in order to finance their expansion or at list to pay their current employees. The closure of these enterprises will result in a large job losses and the unemployment rate is already high, around 30 per cent. Therefore, it is preferred to continue using state-owned banks’ funds in financing the economic programme of the government. Labour organisations are also against the idea of selling state-owned banks to foreign and private investors. They still believe that protection against foreign interests is a means of not losing further jobs and achieving high economic growth. There is an agreement that financial liberalisation only caused deterioration in the economic performance of state-owned enterprises as many of them are struggling under the new financial regulations. Moreover, the market potential of Algeria had little influence on the private investments and also job creation (senior manager, BEA).”

Table 6.1: Market potential in selected countries in 2000

Country	Market Potential Points out of 500	Market Type
Morocco	250 points	Medium-sized market
Algeria	229 points	Medium-sized market
Tunisia	206 points	Small, expanding market
Saudi Arabia	301 points	Rich market
Turkey	382 points	Large market
Yemen	93 points	Market in infancy

Source: Nord Sud Export, 2000, cited by Algeria Interface Online, 2000

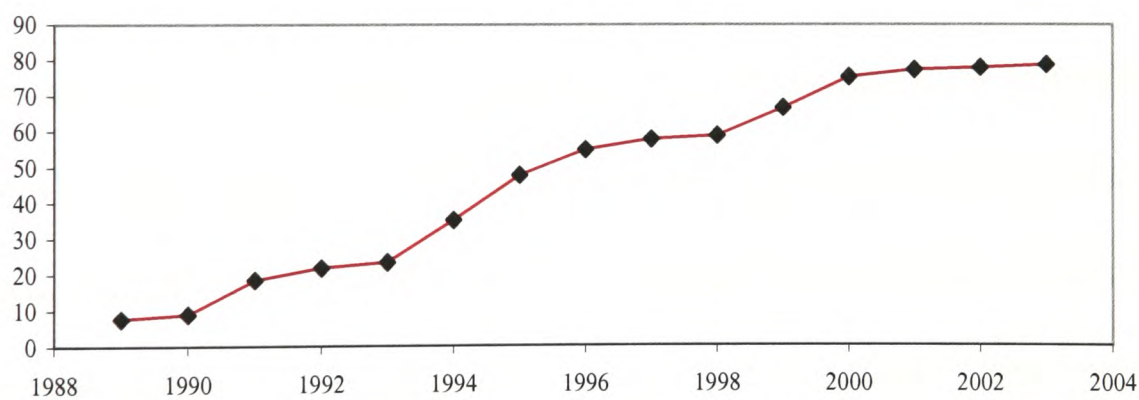
The statistical data indicate that commercial banks’ assets declined significantly during financial liberalisation, from USD48,595 million in 1989 to USD28,887 million in 1999. The balance sheet of state-owned banks shows that the decrease was due to declining claims on the government, on the private sector, and on other public institutions. This disagrees with Pill and Pradhan’s (1995) argument that the sharp

¹⁰⁷ See Benhalima (1998) for more details on state-owned banks lending policy in the 1990s.

increase in the inflation rate was the main reason for banks' declining assets during financial liberalisation. Other items such as reserves and foreign assets constitute a small proportion of state-owned banks' assets. On the other hand, time and savings deposits, demand deposits, and credit from the central bank form the largest proportion of commercial banks' liabilities (state-owned banks balance sheet).

Commercial banks' assets are denominated in US dollars rather than the Algerian dinar using the current exchange rate. This is done on purpose because the value of the Algerian dinar has fallen sharply towards US dollars since the start of trade and payment liberalisation. The current exchange rate of domestic currency, which considers economic forces, demonstrates the real value of commercial banks' assets rather than the nominal counterpart. The following chart shows the Algerian dinar exchange rate versus the US dollar from 1989 to 2003.

Chart 6.1 : The Algerian dinar exchange rate with the US dollars, 1989-2003



Source: International Financial Statistics and Bank of Algeria.

As shown in Q.6 (Appendix V), the mobilisation of financial resources is poor because of the persistence in using large amounts of state-owned banks' funds to finance state-owned enterprises. As in McKinnon (1973), banks' managers stressed that the default rate on expensive loans is significant. The obligatory holding of

government papers and absence of a developed equity market also contributed to scarcity of capital. The result is slow growth in private investments. However, the share of total loans in both sectors has grown steadily since 1996. For example, CPA lending to the private sector increased from 5.4 per cent in 1990 to 42 per cent in 2000 (CPA Annual Reports). Trade is ranked third in terms of the volume of loans used in funding the sector. Interviewees noted that state-owned banks also extend credit to young people under a government programme that helps individuals create small enterprises or build their own houses. Many of those loans are not repaid by the agreed time and banks cannot take action against the borrowers, who exploit the weakness of the current financial regulations.¹⁰⁸

“There is no doubt that the government is still intervening within state-owned banks activities. For example, we are obliged to co-operate with the government in the creation of small enterprises. This, however, does not help us to improve our financial position. The financed projects are not productive because of lack of investment strategy. The return obtained in the capital invested is low because of poor allocation of resources” (senior manager, BEA, 2001).

The structure of state-owned banks credit shows that short- and medium-term loans account for the largest proportion of their lending (see Appendix V, Q.7). For example, CPA medium term loans were 81 per cent of total credit in 1999 (CPA Annual Report, 1999). The scarcity of capital has prevented banks from extending long-term loans.¹⁰⁹ To repay their loans by the agreed time, state-owned banks’ borrowers must invest in projects with high yields and quick returns.¹¹⁰

¹⁰⁸ The criteria for classification as bad loans are the size and the maturity of the loan. This is because medium- and long-term loans tend to be more risky than short-term loans.

¹⁰⁹ See Shaw (1973) and McKinnon (1973) for more explanations about the impact of scarcity of capitals on bank lending.

¹¹⁰ CNEP and BAD have considerably sizeable medium and long-term loans. BNA also has a sizeable volume of medium-term loans (see Appendix V, Q.7).

“Long and medium term loans make up about one-third of bank portfolios. It is true that now concentrating less on attracting financial resources and more on investment, which means we are more wary of credit risks. The state has told us that once we are back on a sound footing, it will no longer guarantee our loan. The problem is that many entrepreneurs submit ill-thought business plans without studying the market. They have to understand we are no longer in a supply driven economy, but in a demand driven one. A good idea is not enough. Entrepreneurs have to prove that their projects are worthwhile for investments. Nevertheless, banks and private businesses are now beginning to work together. Some banks like BNA, Al-Khalifa Bank and the CPA have created customer advice departments and most are now putting in place credit guarantees structures. They are setting up consortia for large loans. For example, four state-owned banks have been consolidated to finance Orascom’s cement business in Algeria” (Benkhalfa, the General Secretary of the Association of Banks and Finance Establishments, 2002).

The centrally planned economy has substantially influenced state-owned banks’ savings policy. Low-income individuals constitute the greatest number of state-owned banks’ clients.¹¹¹ On the other hand, CPA is the main provider of banking services to middle income and wealthy individuals. In the second place we find small and medium enterprises among state-owned banks’ clients. As we have seen in Chapter 2, this has harmed banking competition considerably because of the limited business opportunities that are available to state-owned banks.¹¹²

Table 6.2: Distribution of credit to the national economy by sector, 1993–2002

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
In billions of Dinars; end of period										
Public sector	142.0	208.0	462.0	637.8	632.6	601.9	767.1	521.0	740.3	715.5
Private sector	77.1	96.7	102.5	137.8	108.6	129.1	167.9	242.7	337.9	551.0
Local administration	1.1	1.1	1.1	1.1	1.2	0.1	0.1	0.2	0.2	0.3
Annual percentage change										
Public sector	-57.2	46.5	122.1	-0.8	38.1	-0.8	27.4	-32.1	5.5	-3.3
Private sector	1.4	25.4	6.0	34.4	-21.2	18.9	28.9	45.9	15.8	63.1
Local administration	-46.6	38.9	85.0	9.1	-91.7	0.0	0.0	100.0	0.0	50.0
In per cent of total credits										
Public sector	64.5	68.0	81.7	82.1	85.3	82.3	82.0	68.2	68.6	56.5
Private sector	35.0	31.6	18.1	17.7	14.6	17.7	18.0	31.8	31.3	43.5
Local administration	0.5	0.4	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0

Source: Bank of Algeria

¹¹¹ BADR grants a large portion of its loans to farmers.

¹¹² For more explanations on banking specialisation see McKinnon (1973).

Table 6.2 shows a sharp decline in the amount of credit extended to the public sector from 1995 to 1999. This was incurred because of the extensive use of state-owned banks' funds in clearing up debts of state-owned enterprises. The privatisation of small- and medium-sized state-owned enterprises was accelerated during this period under the IMF programme to help the Algerian government in its economic reforms. The IMF stabilisation programme helped to curtail monetary and fiscal imbalances through exchange rate management, tightened monetary policy, depreciation of domestic currency and subsidised cuts. In 2001, however, the credit to the private sector rose by almost twofold to reach 31.8 per cent of total credits. This was a result of the increase in the number of small-sized private enterprises and slow privatisation programme.

CNEP is the leading financial institution in collecting public savings. It generates about five billion USD of deposits through a network comprising 200 branches and 3,000 post offices (CNEP Annual Reports). The savings bank extends on average four billion USD to the housing sector; this represents 92 per cent of the housing market. The remaining one billion USD goes to the inter-bank market.¹¹³ However, large amounts of public funds are still kept outside the national financial market (IMF, 2000). The underdeveloped payment systems used by state-owned banks and the lack of public trust mean that individuals prefer to keep their savings under mattresses. For instance, depositors cannot withdraw their funds during the weekends because banks are closed (senior manager, BEA, 2001). Stores do not accept credit cards and cash is the only means of payment used in almost all businesses.

¹¹³ See CNEP Annual Reports

Additionally, there are only a few automated teller machines, many of which are not functioning.

One financial manager stressed that after financial liberalisation, state-owned banks have *de jure* autonomy in selecting their own borrowers, public or private. State-owned banks have restricted their direct lending to state-owned enterprises and improved their credit assessments. This has contributed to a decline in the amount of credit extended to bad debtors.¹¹⁴ Many bankers, however, believe that the relationship between state-owned banks and their borrowers differs from bank to bank. For example, state-owned banks that were financing foreign trade (BEA) gained more autonomy from the state than those (such as BNA) that were funding the agricultural sector. BEA senior manager stressed that:

“Before 1990 our credit went mostly to finance state-owned enterprises. However, after 1990, we used our loans to finance large enterprises, both public and private, without discrimination. Our employees can also be granted credit. But, we are obliged to fund certain enterprises to keep social peace and because of that we have large deficit. We are obliged to support government policies. Nevertheless, in the last two years we have been given more autonomy in our lending and borrowing practices. For instance, BEA has the right to refuse granting loans to poorly performed SOEs. We can also reduce the amount and duration of credit. In general, after 1990, loans towards state-owned enterprises that do not have big impact on the national economy and society have decreased significantly” (senior manager, BEA, 2001).

In Q.24 of the questionnaire, eighty-six per cent of state-owned banks' managers interviewed believe that financial liberalisation has contributed to a marginal improvement in state-owned banks' internal and external management. They noted that mismanagement of state-owned enterprises is due to poor lending policies,

¹¹⁴ See IMF (2000)

underdeveloped telecommunication systems, untrained staff, bureaucracy and direct control over investments.¹¹⁵

Internal management refers to soundness of operations within the bank through effective supervision and auditing systems. Comprehensive internal management requires adequate risk management tools and advanced information systems. External management is used to reflect the relationship between the bank and its clients. Good banking practices and well-functioning financial systems improve external management and thus allow banks to generate high income on their lending. Internal and external management are compatible in making banks capable of producing first-class financial services.

It has been claimed that the entry of foreign banks into the national financial market stimulated state-owned banks to promote the quality of their services as to protect their market share (interview notes, 2001). Usually, foreign banks are more effective than state-owned banks in terms of the speed and the high standard of services they provide to their customers. State-owned banks have responded positively to foreign banks' entry by increasing the number of facilities offered to their customers. This supports the argument that globalisation of financial services brings more advantages than disadvantages to the national financial market.

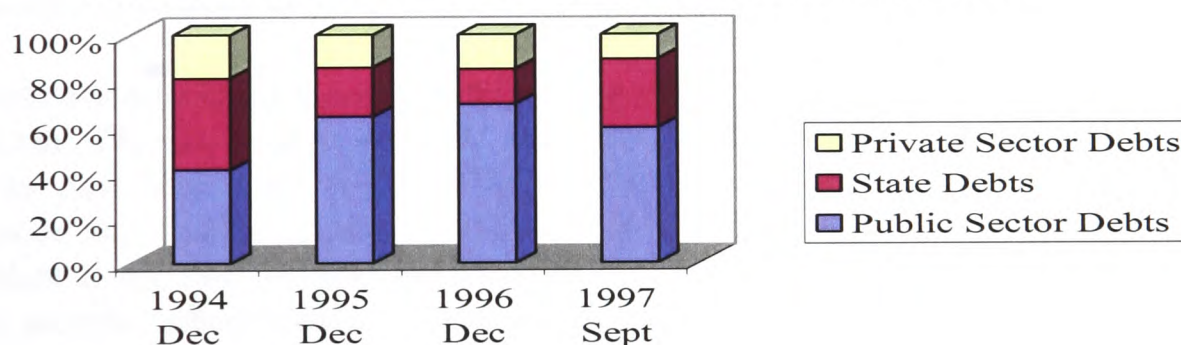
In contrast to Oxelheim's (1995) findings, the number of local banks has increased steadily since financial liberalisation.¹¹⁶ The delay in the banking privatisation programme has enabled state-owned banks to remain in the market. On the other hand, domestic private investors opened several Algerian private banks after the law

¹¹⁵ See Chapter 2, pp. 31–4 for a discussion of the impact of financial liberalisation on lending and borrowing mechanisms of developing countries' banks.

changed on money and credit. Despite this, Algerian private banks still have few branches compared with state-owned banks.

The largest proportion of state-owned banks' debts remained unpaid because of the failure of state-owned enterprises in servicing their outstanding debts.¹¹⁷ In 1996, for example, they amounted to 69.6 per cent of state-owned banks' total debts (Bank of Algeria, 1996). The credit risk on those loans is extremely high because of state-owned enterprises' low productivity. State-owned banks' second largest debtor is the government. In 1994, for instance, state debts towards state-owned banks amounted to AD204,633 million, or 40.10 per cent of state-owned banks' debts (see Chart 6.2). The private sector receives a small proportion of state-owned banks' funds — 15 per cent in 1995 (Bank of Algeria, 1995). Chart 6.2 illustrates state-owned banks' debtors by sector from 1994 to 1997.

Chart 6.2 : State-owned banks debts by Sector, 1994-1997



Source: Bank of Algeria

State-owned banks still hold large amounts of non-performing loans in their portfolio. This is because their main customers, state-owned enterprises, are unable to service their debts regularly. Many state-owned enterprises also went bankrupt in the past ten years because of an increase in their losses and a decline in government

¹¹⁶ See Chapter 2, p. 35 for more details about Oxelheim's findings.

subsidisation. The recapitalisation programme initiated by the government in 1990, and the decline in the amount of loans that were granted to poorly performing state-owned enterprises, have helped state-owned banks reduce the amount of their non-performing loans (interview notes, 2001). However, the amount of capital injected into state-owned banks was less than the size of non-performing loans (Nashashibi *et al*, 1998).¹¹⁸ The only bad debts removed were those extended by state-owned banks to state-owned enterprises or incurred because of devaluation in the national currency. It is necessary, therefore, to sever the relationship between state-owned banks and the remaining defective state-owned enterprises — this is the only way to stop the increase in bad debts. On the other hand, state-owned banks need to be cautious in lending to private investors. In the past, several affairs contributed to large banking losses because borrowers provided state-owned banks with false documents. For example, in 2001 a businessman failed to repay a large amount of his debts to the regional development bank, BADR.

“Banks are now much more circumspect and their checks and controls work perfectly. The law courts and debt recovery services deal with people who fail to pay back their debts. What matter is to modernise rather than moralise the banking system. I refute that it is riddled with corruption. Our problem is not dud cheques but cheques that still have not been paid after three months” (Benkhalfa, the General Secretary of the Association of Banks and Finance Establishments, 2002).

Another component of poor finance in Algeria is that there is a long delay in state-owned banks’ financial transactions. Customers of state-owned bank usually queue for two to four hours to conduct their daily banking services (senior manager, BNA,

¹¹⁷ According to the National Economic and Social Council estimate, state-owned banks remaining bad debts are between 300 and 500 million Algerian dinars.

¹¹⁸ CNEP has adopted a good approach to banking recapitalisation. It has used its own funds to clean its bad debts. To ensure the success of the process, CNEP has also acquired special assistance from foreign banks.

2001). Moreover, many individuals are obliged to travel long distances to have access to their funds. It has been noted that increasing banking networks throughout the country and establishing automated teller machines services in highly populated areas have resulted in increased public savings (senior managers, BEA, 2001).

The General Secretary of the *Association des Banques et des Etablissement Financier* (Association of Banks and Finance Establishments) (2002) stressed that modernisation of the national banking industry requires three main initiatives. First, the payment system should be computerised by the end of 2005. Second, banks are urged to improve their credit risk assessments and investment evaluations. Finally, banks are asked to boost managers' information technology skills through training and by adopting a good strategy for human resource management.

The range of financial products provided by state-owned banks to their customers is limited. The capital market is also underdeveloped; because of this, direct lending is a common type of funding investment. In addition, almost all forms of derivatives — such as swaps and options contracts — are entirely absent from the market. As a result, investors have few options for financing their projects and individuals have few options for saving their earnings.

Banks find various problems in obtaining information about the financial position of their debtors.¹¹⁹ The reason is that most borrowers do not regularly display figures about their assets and liabilities. As a consequence, state-owned banks need to reinforce their relationship with their borrowers to gain a clear picture about how those borrowers are using their funds.

¹¹⁹ See Appendix V, Q.26 on the current financial position of state-owned banks.

A financial executive pointed out that the actual social costs of the privatisation of state-owned banks are high because most state-owned banks branches are overstaffed and poorly equipped with computers and direct telephone lines (financial executive, BEA, 2001).¹²⁰ Privatisation should force state-owned banks to reduce the number of their workers and thus pay a high amount in redundancy.¹²¹ State-owned banks also use underdeveloped information technology. Therefore, state-owned banks require substantial investment in computerisation. However, the crucial factor that makes banking privatisation in Algeria expensive is the large amount non-performing loans from state-owned banks. Accordingly, the Algerian government is obliged to sacrifice a large proportion of its budget to bail out the bad debts of state-owned banks. Table 6.3 presents BEA and BAD long- and medium-term debts from 1997 to 1999.

Table 6.3: BEA and BAD long and medium-term debts, 1997–1999

	1997	1998	1999
BEA	522,524,462.20	458,59,285.70	299,068,129.80
BAD	na	2,104,833.98	1,830,782.90

Source: BEA and BAD annual reports

It has been agreed that gradual privatisation of state-owned banks is more effective than quick privatisation.¹²² In Poland, for example, the government has successfully implemented step-by-step banking privatisation (see Bonin and Wachtel, 1999). Financial authorities have focused on promoting the financial position of state-owned banks by eliminating their bad debts and improving their internal management before

¹²⁰ BEA senior managers stressed that privatisation will enhance the financial position of state-owned banks. This allows privatised banks to keep their existing staff.

¹²¹ See Appendix V, Q.28 on the practical reasons that make state-owned banks not ready for privatisation.

¹²² See Kornai (2000)

opening their capital to private ownership.¹²³ Foreign partners have also been invited to take a stake in the capital of state-owned banks.

On the other hand, the experience of countries such as Hungary¹²⁴ shows that a shock-therapy privatisation is more effective than a gradual one (Bonin and Wachtel, 1999). In such a mass privatisation, assets of state-owned banks are sold at a low price, which helps the government easily find private and foreign bidders. The new owners focus on improving the internal management of privatised banks and enhancing their financial position. The result is an increase in the liquidity and profitability of state-owned banks.

Selling the assets of state-owned banks to foreign banks usually facilitates the process of privatisation because foreign banks have sufficient funds to remove the debts of state-owned banks and to develop their information technology. Foreign banks also have the expertise to restructure privatised banks quickly and effectively. However, the decision to sell state-owned banks' assets to foreigners is motivated more by political than by economic considerations (senior manager, BEA, 2001). The Algerian government is still not convinced that it should sell state-owned banks to foreign investors because policymakers think that state-owned banks are not ready for privatisation.

A 'big bang' banking privatisation cannot be successful in Algeria because of the absence of large domestic investors who could purchase the assets of state-owned banks (senior manager, CNEP, 2001). Likewise, state-owned banks have many

¹²³ See Appendix V, Q.24 on the impact of financial liberalisation on state-owned banks internal and external management.

¹²⁴ We presented the case of Hungary's banking sector privatisation because Hungary is another former socialist country that implemented a successful programme of banking privatisation.

difficulties in finding foreign partners because of high political risk and the absence of a clear privatisation plan by the government. Algeria requires technical assistance from international organisations such as the IMF and the World Bank to ensure the success of the banking privatisation programme. This technical assistance includes ensuring that banks are solvent, evaluating the market value of state-owned banks' book assets, and selecting the privatisation plan.

Bank managers believe that banking privatisation will help state-owned banks to develop their information systems by investing in computerisation, Internet banking, telephone banking and other technological tools. It will also assist state-owned banks to improve their current services by introducing new financial instruments into the market and finding new ways to assess their borrowers. The most important point is that state-owned banks become more aware of the profitability of the projects they finance — in particular, state-owned banks should not concern themselves with protecting unproductive state-owned enterprises (see: Appendix V, Q.29 on the benefits of banking privatisation). BADR's financial manager noted that 'The privatisation of state-owned banks is the best way to accelerate the development of the Algerian economy'. However, policymakers believe that privatisation will reduce the number of workers employed at banking branches. Staff at state-owned banks also oppose banking privatisation because of the fear of large job losses (interview notes, 2001).

CPA is a leading state-owned bank searching for foreign partners. It plans to sell 40 per cent of its shares to SGA, with the objective of benefiting from foreign funds and improving current services. CPA also aims to develop its management and information systems, and to boost its profitability (financial manager, CPA, 2001).

CPA senior managers noted that foreign banks will bring high technology, first-class management mechanisms and capital into the Algerian financial market. An example is Poland, where foreign banks have helped state-owned banks to develop their information technology and to create new financial instruments.

At the same time, high unemployment (more than 30 per cent nationally and 50 per cent among young people) has put great pressure on the government to privatise either state-owned banks or state-owned enterprises. Hamid Temmar, Minister of Participation and Co-ordinator of Reforms, stated that 'Our objective is to save our enterprises, whether they remain public or private, our aim is obviously to maintain our productive capacity and modernise it. If a state company can fly on its own, or with a bank, then no problem, the company may remain public' (Arab Communication Consult Online, 2002).

The new privatisation code gives foreign and local investors many incentives to purchase the assets of state-owned enterprises. These comprise exemption from VAT payments on goods and services purchased domestically or abroad for three years, cuts in the amount paid to social security, no corporate income tax payments for two to five years, and exemption from property tax (Ministry of Finance, 2000). The government has also created the Promotional and Surveillance Investment Agency, *Agence de Promotion de Soutien et de Suivi des Investissements*, whose role is to collect information about state-owned enterprises subject to privatisation in order to assist foreign and private investors who have an interest in those enterprises. This assistance includes setting the rules that regulate the relationship between foreign investors and state-owned enterprises (Ministry of Finance, 2000).

During the 1990s, the Algerian government focused on privatising small and medium state-owned enterprises because of fear of social conflict. A BEA senior manager noted that selling assets of state-owned enterprises to private investors must be gradual to assure the success of their privatisation. The government is responsible for ensuring that the new owners are capable of enhancing profitability of privatised state-owned enterprises.

To facilitate the process of privatisation, assets of state-owned enterprises are governed by legislation issued in August 2001. Joint ventures were created between state-owned enterprises and private or foreign partners. State equity management entities were also established to hasten the opening of state-owned enterprises' capital to private and foreign investors and to reduce their overall debt burden (Temlali, 2002b). On the other hand, the state has stopped subsidising commercially oriented state enterprises. Many enterprises are sold to employees to avoid large job losses.

In 2002, the government used three criteria to determine state-owned enterprises for privatisation: financial health, market position and size (Temlali, 2002b).¹²⁵ Enterprises operating in constructions, hotels and textiles were considered to be in a bad financial position and, hence, had to be privatised in the first instance. Boukrouh, Minister of Privatisation and Planning, noted that financial authorities are preparing to sell companies operating in less profitable sectors such as the chemical, pharmaceutical and cement industries (Temlali, 2002b). Nevertheless, the government is still unclear about what type of companies will be privatised in the first

¹²⁵ It is predicted that 250,000 state-owned enterprises will be affected because of the privatisation process.

place. In fact, the government has given no indication how many enterprises fulfil its criteria for 'size', 'financial health' or 'market position'.

The Algerian government has obtained substantial technical and financial assistance from its foreign partners, such as the European Union. A management unit has been established between the government and the European Union to control the process of privatisation of state-owned enterprises. Financially, the European Union decided to extend 38 million Euros to privatise Algerian industry during 2001–2004, to clear the debts of state-owned enterprises and to modernise their operations (Temlali, 2002a).

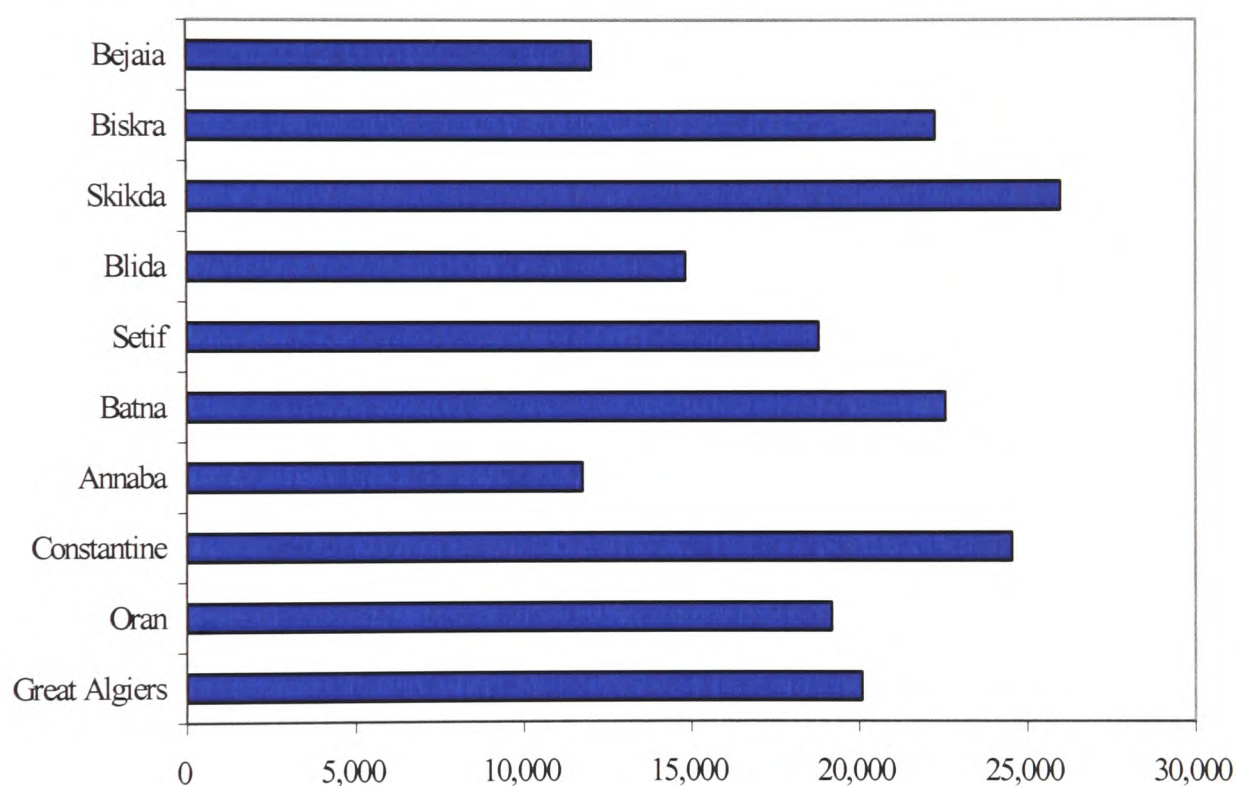
Another important way to improve banking performance during the transition from a centrally planned economy to a market-oriented one is to improve the banking delivery system. Managers of state-owned banks noted that the branch remains the main delivery channel. This study examines the structure of the Algerian banking network in rural and urban areas to discover regions with less representation of state-owned banks. State-owned banks inherited a large network of more than 1,000 branches nationwide, and have a network of numerous corresponding banks in Europe, America, Asia and the Middle East. The banking network was based on the administrative division of the country.¹²⁶ In 1993, 14 counties situated in northern Algeria had 492 state-owned bank branches (Bank of Algeria, 1993). By contrast, there were 25 branches in five counties in the south, where only seven per cent of the Algerian population lives.¹²⁷

¹²⁶ In 1984 the national territory divided into 48 counties, and 1,541 municipalities.

¹²⁷ CPA is totally absent in 4 counties in southern of Algeria.

Taking into account the number of inhabitants per branch, Algeria has too few banks, both in large cities and in municipalities. Eighty per cent of municipalities are not covered by the national banking network (Bank of Algeria, 1993). On the other hand, there are 306 banking branches in 20 counties with more than 100,000 inhabitants; this represents 33 per cent of the banking network. The two largest cities in the south have 15 branches and this represents one branch per 19,012 inhabitants.

Chart 6.3 : Number of inhabitants per branch in ten large cities in Algeria

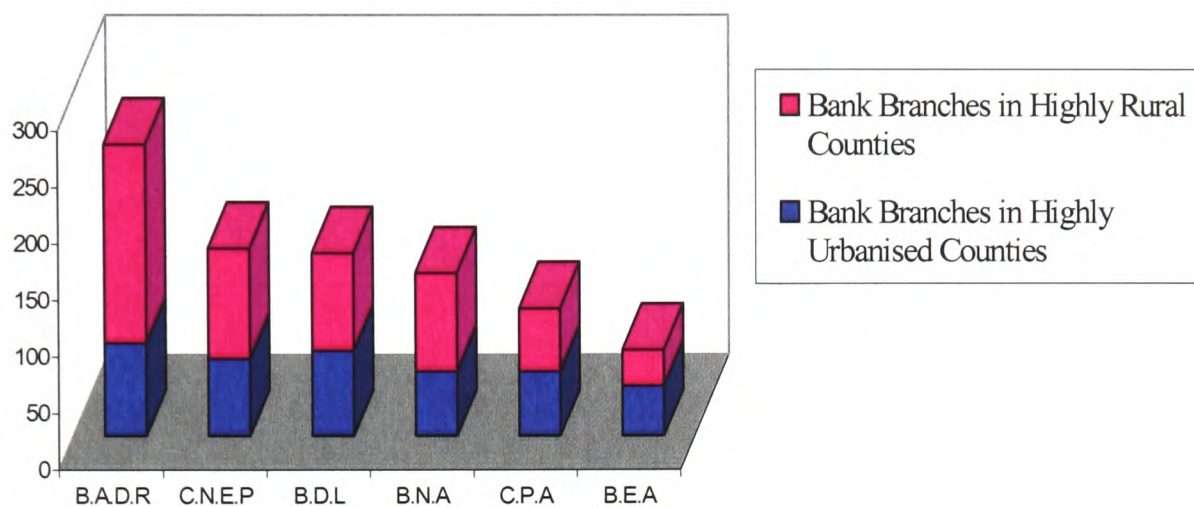


Source: Bank of Algeria

The number of state-owned banks' branches in highly urbanised counties was 379, or 41 per cent of the national banking network (Bank of Algeria, 1995). On the other hand, there were 544 branches in counties dominated by rural activities, 59 per cent of the national banking network. This indicates that rural regions account for the largest part of the national territory covered by the national banking network.

Therefore, it is essential to increase the banking network in urban regions, where most financial activities take place.

Chart 6.4: Bank branches in urban and rural counties



Source: Bank of Algeria

There is still a high concentration of operations in the Algerian banking industry.¹²⁸ BEA collects 40 per cent of deposits, followed by CNEP with 24 per cent of the market share (see Table 6.4). BNA is ranked third, with 11 per cent of the total financial resources. BADR and CPA share fourth place with 10 per cent of the market (Bank of Algeria, 1999). The high banking specialisation has caused a direct impact on each of the banks' market share of financial resources. For example, BEA is the only state-owned bank that deals with companies in the hydrocarbon sector.¹²⁹ Consequently, earnings of state-owned banks are highly sensitive to the development of each economic sector they finance.

There is a negative correlation between the number of branches and the amount of financial resources collected by state-owned banks (see Table 6.4). For example, BADR collects only 10 per cent of resources despite its large (28 per cent) share of

¹²⁸ See McKinnon, 1973: 69 for more details on market concentration.

¹²⁹ Oil constitutes more than 80 per cent of Algerian foreign exports.

the network (BADR Annual Reports). Public savings depend on the disposable personal income and consumption rather than on the size of the banking network. Table 6.4 shows the share of the market of state-owned banks in terms of network and financial resources.

Table 6.4: State-owned banks' share of network and financial resources

	Share of the Network	Resources in billions AD	Share of the Financial Resources
BADR	28,0%	47.88	10%
CNEP	18,0%	113.68	24%
BNA	17,5%	53.57	11%
BDL	16,0%	24.30	5%
CPA	12,5%	45.57	10%
BEA	8,0%	192.00	40%

Source: Bank of Algeria

During the socialist economic regime, mobilisation by state-owned banks of financial resources, collection of funds and credit allocation was based on their network organisation.¹³⁰ The differentiation in the form of the banking network was due to the nature of state-owned banks' activities and the number of their customers. Banks such as BADR that specialised in funding the agricultural sector had more branches than banks such as BEA and CPA that specialised in financing commerce (state-owned banks' Annual Reports).

To meet the challenge of the globalisation of financial services, state-owned banks should upgrade their network organisation by promoting links between their branches. This can be achieved by using advanced information technology. State-owned banks' network expansion should also be in line with developments in the national economy, characteristics of financial products offered by the bank, financial resources capacity, and social and political features of the country.

Banks are advised to search for new forms of network expansion to encourage public savings and investments. This is achieved by increasing the number of state-owned bank branches in areas with high population densities. It is less costly to set up banking branches in urban regions than in rural areas. Telecommunications facilities such as telephone lines and the Internet are available, and the infrastructure is well developed in high-density areas (senior manager, BEA, 2001).¹³¹

Table 6.5: State-owned banks' capital share by economic sector

State-owned banks	Industry	Credit allocation by economic sector
BADR	<ul style="list-style-type: none"> • Industry and agribusiness. • Capital equipment. • Miscellaneous industries. • Services. 	35% 35% 20% 10%
BNA	<ul style="list-style-type: none"> • Capital equipment. • Mine, hydrocarbon, hydraulic. • Food industry. • Miscellaneous industries. 	35% 35% 20% 10%
BDL	<ul style="list-style-type: none"> • Mine. • Chemistry. • Miscellaneous industries. • Constructions. 	35% 35% 20% 10%
BEA	<ul style="list-style-type: none"> • Constructions. • Electronic, telecommunication, computing. • Services. • Chemistry, petrol-chemistry, pharmacy. 	35% 35% 20% 10%
CPA	<ul style="list-style-type: none"> • Miscellaneous industries. • Chemistry, petrol-chemistry, pharmacy. • Food industry. • Services. 	31% 31% 18% 18%

Source: Bank of Algeria.

During the centrally planned economy, state-owned banks' credit went to finance few industries, which were highly protected by the government (Benhalima, 1998).¹³² However, even after financial liberalisation, state-owned banks persist in financing

¹³⁰ BADR's network is divided into branches, central agencies and local agencies. BEA and BDL have local agencies and a directory. BNA's network comprises directorates, principal agencies and local agencies.

¹³¹ The number of telephone lines in use in 1998 was 2.3 million, 5 telephones per 100 persons (Ministry of Information, 1998).

¹³² See Shaw (1973) on the mobilisation of financial resources in the former socialist countries.

sectors similar to those with which they worked under the previous regime (see Table 6.5). BADR has the largest stake in food industry and capital equipment. BNA's main interests are in capital equipment, agribusiness and mining, whereas BDL specialises in funding chemistry and mine industries. CPA has the highest market share in chemistry, pharmacy and miscellaneous businesses (Bank of Algeria, 1993). Thus, it is necessary that state-owned banks diversify their portfolios by engaging in other enterprises, such as mechanical industries and tourism. Table 6.5 illustrates the capital share of state-owned banks in each sector of the national economy.

State-owned banks adopt new lending mechanisms to protect their market share because of high competition from Algerian private banks and foreign banks. For instance, BEA's lending strategy includes modernising its payment system and offering a range of financial products to meet the needs of local and foreign investors. It also focuses on improving the quality and credibility of its risk assessment.¹³³

CNEP's lending strategy after financial liberalisation is to improve its mortgage services. Many low- and middle-income families have no access to housing loans because of the small size of the mortgage market. The non-existence of developed capital markets makes matters worse. The stock market can be used to raise funds to build dwellings and, hence, overcome the shortage of housing in Algeria. This is done by listing the construction companies on the Algiers Stock Exchange. Shares are to be

¹³³ Geographically, BEA's overseas financial operations are mainly with the European community and North America. The small volume of financial transactions with Africa and Latin America is due to the absence of dynamism between Algerian traders and investors in those regions.

sold to local and foreign investors to raise more capital from the Algiers Stock Exchange.¹³⁴

The underdeveloped mortgage market contributes to irregular income data, uncertain property possession and the absence of guarantees from households.¹³⁵ The first factor is due to unavailability of recent information about households' financial positions. The value of personal assets offered as guarantees for mortgage loans has also declined because of the increased inflation rate.¹³⁶ The second and third factors are caused by unclear property rights.

The only mortgage product available on the national financial market is a standard 20-year fixed rate. In 1999, mortgage loan rates ranged between 8 and 10 per cent (CNEP Annual Report). This has restricted the ability of individuals and families to access the mortgage market. Accordingly, offering a variety of mortgage products helps CNEP satisfy its customers' needs.¹³⁷

The number of financial products offered by the saving bank is very limited. This does not allow us to diversify our portfolios. Our customers want cheap mortgage rates with possibility of long-term repayments. The current mortgage products, unfortunately, do not offer this option. Therefore, we need to learn lessons from countries, which have already established a developed mortgage markets (Marketing Direct, CNEP, 2001)."

A CNEP senior manager stated that low credit risk is obtained by avoiding the granting of mortgages to customers with financial difficulties. High transparency within the mortgage market has enabled CNEP to upgrade its loan recuperation.

¹³⁴ Other obstacles facing the development of mortgage market in Algeria include the high information costs of credit risk evaluation and the absence of a legal framework for clarifying claims and rehabilitating defaults.

¹³⁵ The government grants between 10 and 15 per cent of home purchase price. Borrowers make annual repayments of less than 40 per cent of their salary (Nashashibi *et al*, 1998).

¹³⁶ The sharp increase in inflation rates during the 1990s contributed to accelerating interest rates on loans, which in turn lowered the demand for mortgages (Nashashibi *et al*, 1998).

However, bankers stressed that easing constraints dissuades private and foreign players from entering the market and thus lowers the price of mortgage products.¹³⁸

It has been pointed out in Chapter 3 that financial liberalisation aims at boosting the efficiency of state-owned banks.¹³⁹ In our survey, fifty-seven per cent of the state-owned bank managers interviewed reported a small increase in banking efficiency after financial liberalisation. The most compelling reasons for low efficiency are high lending costs and slow financial transactions. However, BDA and CPA administrators believe that banking efficiency has increased substantially because of recent developments in banking technology and the emergence of a variety of financial products. Modern technologies such as computer systems have enabled banks to reduce their high running costs. The removal of many regulatory constraints also allowed state-owned banks to improve their services and to diversify their portfolio.

The analyses demonstrated the positive relationship between the performance of state-owned banks and financial liberalisation. The views of the managers of state-owned banks, presented in this section, agree that many constraints on state-owned banks were removed after the financial reforms. This has contributed to an increase in the efficiency of state-owned banks, which is one of the key components used in the research methodology to indicate the level of banking performance. But, the degree of such an increase in banking efficiency varies from one bank to another, depending on type of operations. The interviewees share the opinion that there is small increase

¹³⁷ The government has created a housing credit refinancing institution and a mortgage guarantee company to encourage the financing of housing. However, the demand for mortgages still far exceeds supply because of capital scarcity.

¹³⁸ Buckley (1989) noted that using private commercial banks as a means to grant loans to households is more effective than channelling funds through state-owned housing authorities.

in savings and investments. The problems facing state-owned banks are not attributed to globalisation, but to mismanagement and bureaucracy. The delay in the privatisation of state-owned banks has also undermined the efforts of the government to improve mobilisation of the national financial resources. Additionally, the delivery system of state-owned banks is poor, and this has caused disintermediation between savers and borrowers.

6.2.2. Algerian private banks

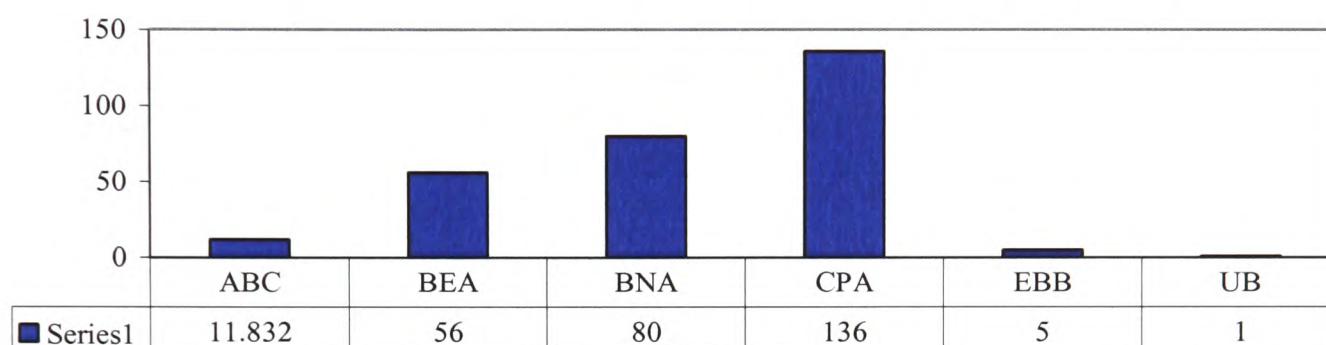
The purpose of segregating banking groups from each other is because of the direct influence of ownership, mode of financing and country of origin on banking performance. This section analyses how financial liberalisation alleviated barriers on Algerian private banks and boosted their operational efficiency. The survey covered the four major Algerian private banks: *El-Khalifa Bank (EKB)*, *Banque Commerciale et Industrielle d'Algérie (BCIA)*, the Union Bank (UB) and *Sofinance*. The remaining three Algerian private banks are excluded because they are too small in terms of capital, credit potential and number of branches, or simply because they are very new to market. We focused our analyses on the following: Algerian private banks' lending and borrowing mechanisms, constraints facing Algerian private banks in the marketplace, and measures undertaken by senior managers to improve the efficiency of Algerian private banks.

On the lending side, it was found that Algerian private banks have insufficient financial resources to finance large projects or long-term investments. This is because most Algerian private banks have small amounts of deposits held within saving

¹³⁹ See Nashashibi *et al* (1998)

accounts. Shareholders' funds are the main source used by Algerian private banks to meet their clients' demand for credit. Another reason is that Algerian private banks prefer to engage in activities such as international trade that yields high returns (senior manager, the Union Bank, 2001).

Chart 6.5 : Capital of selected banks in million Algerian dinar, 2003



Source: Banks Annual Reports, 2003.

Chart 6.5 demonstrates the fact that Algerian private banks, such as the Union Bank, have less capital than other banking categories, particularly state-owned banks. For example, the CPA's capital is 136 times the capital of Union Bank. Foreign banks, such as ABC, also have higher capital than the newly established private banks. Therefore, we suggest increasing the ownership interest of private banks by inviting new shareholders or by raising the capital contributed by existing shareholders.

The survey shows that Algerian private banks serve different groups of clients. The greatest numbers of BCIA and *Sofinance* clients are small and medium private enterprises. Union Bank principally serves wealthy individuals, private businesses, and foreign trade. It also trades shares in the stock market and invests in infrastructure and service sectors.¹⁴⁰ *El-Khalifa* Bank offers its services to individuals and private

¹⁴⁰ Inter-bank market operations and interest rate margins on loans constitute the main source of the Union Bank revenues.

companies. It also involves brokerage activities in the stock exchange and offers financial engineering to its customers. In general, Algerian private banks need a long time to understand the market and to build strong relationships with their customers. Algerian private banks are advised to increase the range of their financial products to satisfy the financial needs of large investors.

Table 6.6: El-Khalifa Bank's range of financial products

Opening accounts	Current accounts, cheque accounts, foreign currency accounts and saving accounts.
Financing	Short, medium and long-term investments.
Banking services	Portfolio, foreign trades, exchange and cash.
Placement	Cash voucher and fixed term deposits.
Electronic banking	Electronic payment of bills, control of recent financial transactions and to order check books, etc.

Source: El-Khalifa Bank's Annual Report

The demand for new financial products is low because the public lacks confidence in the benefits of using them to deposit or borrow funds from Algerian private banks. "The Algerians have only low trust in new products. They need time to become familiar with new instruments. We have to change this attitude" (senior manager, BCIA, 2001). Therefore, we propose that individuals and investors are informed regularly about the characteristics of new financial products.

As noted by Blake (2000) the increase in the number of financial products would stimulate savers and borrowers to use the banking system for their daily financial transactions. The demand for new products can be accelerated under the long-term strategy of Algerian private banks. As mentioned by the senior manager of Union Bank "banks need to have a long-term view to build a strong relationship with their customers rather than considering the current situation of the Algerian financial market, which is under reform" (senior manager, the Union Bank, 2001).

Under the programme of economic liberalisation, the Algerian government offers various incentives to private and foreign banks that fund priority sectors of the national economy. Those priority sectors include agriculture and agribusiness, capital goods, electricity production and distribution, minerals, petrochemicals, hydrocarbons and tourism (Ministry of Finance, 2002). Similar results were found in a study conducted by Peek and Rosengren (2000), who noted that the lending policies of local and foreign banks depend on the annual financial plan of the government in the particular country. The state government offers special tax schemes to banks that finance priority industries and removes several restrictions that apply only to foreign banks.

Tax exemptions enable banks to cut their costs and as a consequence boost their profit after tax. This also encourages banks to increase their output levels. The rise in production output translates into a decline in the unit cost of banks as some elements of their inputs are fixed, overhead costs. A proof of good performance of Algerian private banks is quality of management, which drives up both their operating efficiency and profitability.

Technologically, developments in information systems have enabled Algerian private banks to earn higher returns on their equity (interview notes, 2001). An example of this is the Union Bank, which had a return on equity equivalent to 86.93 per cent in 1997. Algerian private banks cut their costs by investing in electronic equipment and developing their information technology. Computer systems help Algerian private banks to provide large packages of services in short periods of time.

Financially, interviewees argued that the ability of domestic investors to repay their debts to Algerian private banks depends on the type of business in which they

are involved. Experience has shown that investors who are engaged in foreign trade repay the full amount of their loans, as stated in the agreement with Algerian private banks (senior manager, BEA, 2001). Whereas, investors operating in the industrial sector cannot quickly repay their debts and this leaves Algerian private banks bearing high credit risk.

The lending and borrowing market for Algerian private banks is very small compared with that of state-owned banks for three main reasons. First, Algerian private banks have limited financial funds and this negatively affects their credit potential. Second, the central bank places borrowing restrictions on private and foreign banks. Third, the high lending rate has led to an increase in the cost of capital and to a decline in the amount borrowed by Algerian private banks.

The banking network of Algerian private banks is very small.¹⁴¹ *El-Khalifa* Bank is the largest private bank in Algeria, but it had only twenty branches in the year 2002. Similarly, BEA had fourteen branches across the country, seven of them in the capital, Algiers, and four in the second largest city, Oran. It is necessary for Algerian private banks to open new branches in other regions, in particular areas with high population densities, where most financial transactions take place.¹⁴²

After having strengthened its skills in the market, Union Bank become involved in creating a diversified and complementary of subsidiaries including Union Pêche, Union Immobilier, Union Bank Brokerage, Air Fret Services, Algeria Aviation Services, Union Santé and Union Li Industry. The brokerage house deals with corporation valuation, privatisation, stock exchange introductions, specialising training, portfolio management, secondary market operations, etc. Union Bank also participates in developing the Algerian trade relations with China

¹⁴¹ Algerian private banks open their branches in large cities and industrial regions such as Hassi Messoud in the south of Algeria.

¹⁴² Algerian private banks have no branches abroad, but certain banks (such as *El-Khalifa* Bank) are planning to open new branches in countries with high numbers of Algerian immigrants (e.g. France).

and the USA. For example, Union Santé is built in partnership with Adam and Associates based in Boston. China Trading is another subsidiary created to promote trade with Chinese investors (senior manager, the Union Bank, 2001).

Respondents noted that despite the small size of the Algerian private banks' network, their operations have contributed positively to the development of the national economy. For instance, *Sofinance* assesses the process of takeover and recovery of private enterprises. It also advises enterprises in the domains of financial engineering and managerial tasks, ameliorates leasing activities, and plays a part in the privatisation programme of state-owned enterprises (financial manager, *Sofinance*, 2001). Senior managers of Algerian private banks said that "new banks can play an effective role in creating and developing private enterprises if authorities allow them to offer a variety of business solutions to their customers" (senior manager, the Union Bank, 2001).

Banks' senior managers agree that the co-operation between Algerian private banks and foreign banks will boost private investments and enhance market certainty in Algeria. On the one hand, Algerian private banks have more information than foreign banks about domestic investors' financial behaviour. On the other hand, foreign banks have access to international financial markets and have substantial knowledge of finance. Therefore, the collaboration of Algerian private banks and foreign banks will benefit private investors by conducting their investment evaluations and meeting their financial needs.

To have control over investments, *Sofinance* accepts equity ownership only in private enterprises (*Sofinance* leaflets, 2001).¹⁴³ It follows four market criteria when selecting projects: profitability, first class managerial tools, medium-term dependability of the project, and co-partnering with shareholders in investment decisions. The bank's business plan for every project comprises three phases: examining and evaluating the project, determining terms and conditions for external and internal sources of funds, and making agreements with shareholders (interview notes, 2001). To maintain high transparency, Algerian private banks are asked to produce periodic reports, to instruct project management, and to introduce clear external and internal audits.¹⁴⁴

Another criterion used to assess the response of Algerian private banks to financial liberalisation is by evaluating their business plans. It has been stressed that the first objective of Algerian private banks is to offer first-class financial products. Penetrating new markets comes as second priority in their agenda. As a third priority, they consolidate, to boost their borrowing potential to private enterprises. Finally, they offer attractive interest rates to satisfy their depositors. The savings rate offered by Algerian private banks exceeds those of state-owned enterprises by an average of 1 per cent (senior manager, BEA, 2001). Mergers and acquisitions are totally absent among private banks. This is due to the absence of clear rules that govern mergers and acquisitions in the national financial market. As indicated in Q.3 (Appendix V),

¹⁴³ The project dossier should meet the following requirements: administrative documents, 5-year plan of action, technique and economic study examination (*Sofinance* leaflets, 2001).

¹⁴⁴ *Sofinance*, for example, contributes to financial engineering, consulting, financial planning and remodelling of the project.

bankers are also not aware of the opportunities that can be gained through mergers and acquisitions.

Advances in information technology and staff training are two major forces that help Algerian private banks to achieve high efficiency. The *Sofinance* managing director said that computer systems have enabled private banks to reduce their operating expenses and to achieve economies of scale and scope. Skilled managers have also contributed positively to the modernisation of *Sofinance*. This has been realised by offering good customer services within the branch and providing first-class credit assessments.

Senior managers agree that the removal of financial constraints made banks able to use the right level of inputs to produce the right level of outputs. It has been emphasised that financial liberalisation allows banks to change their input and output mix and therefore improve their productivity. This argument is in line with Leightner and Lovell's (1998) findings that financial liberalisation contributes to improvement in banking efficiency and productivity. The relative success of Algerian private banks is attributed to their technological and managerial abilities to take advantage of change in regulations to improve their outputs. Whereas, state-owned banks are experiencing low efficiency due to the high level of outputs and negative technological progress.

6.2.3 Foreign banks

The third category of banks operating in the Algerian financial market after financial liberalisation is foreign banks. The survey included three foreign banks: Citibank,

SGA and ABC. This study examines their financial products and business plans. The analyses also include the regulatory, technological and cultural barriers that confront foreign banks in Algeria. Additionally, proposals are made to help foreign banks to overcome these obstacles.

As stated in Chapter 3, the Law on Money and Credit of 1990 allowed several foreign banks to open their branches in Algeria. The aim of this section is to show the response of foreign banks to the programme of financial liberalisation. This enables us to confirm if financial reforms do eliminate obstacles facing foreign banks and if this is having positive effects on their efficiency, and finally if Algerian lenders and borrowers are benefiting from their entry into the Algerian financial market.

The first criterion used to assess the performance of foreign banks is customer grouping. It is interesting to note that most foreign companies hold accounts with banks originating from their home country (senior managers, foreign banks, 2001). For example, almost all American companies deal with Citibank (financial executive, Citibank, 2001). The Algerian private sector also receives some funds from foreign banks (senior manager, SGA, 2001). The expected rate of return on those investments is usually high and investors offer a share certificate as a guarantee to foreign banks. Nonetheless, foreign banks have no ties with state-owned enterprises due to the high credit risk associated with those enterprises.

Type of financial product is the second criterion used in examining the response of foreign banks to financial reforms. The survey shows that foreign banks offer innovative financial products to increase their market share in Algeria.¹⁴⁵ Citibank's activities comprise: (1) cash management; (2) advisory; (3) funding investments; (4)

commerce; and (5) treasury (financial executive, Citibank, 2001). On the other hand, SGA offers leasing, certificates of deposit, portfolio management, savings certificates, micro-credit to purchase cars, credit card services, etc.¹⁴⁶ These services are designed to satisfy the financial needs of investors, wealthy individuals and immigrants (see: Appendix V, Q.20). SGA also collects funds from the public and uses them to trade shares in the stock market.¹⁴⁷ Respondents agree that foreign banks are successful in attracting local and foreign investors. Foreign banks use their efficiency advantage to reduce their operation costs and thus offer their services at lower price. The result is an increase in the loan growth of foreign banks to local and foreign enterprises. Interviewees stressed that foreign companies react optimally to the relative price of foreign banks' services.

Foreign banks bring capital into the national financial market. ABC's senior manager noted that foreign bank capital is used to finance national industry and commerce. Foreign banks can raise large amount of funds from the international financial markets and meet the financial needs of large companies. They also provide first-class financial advice to foreign and domestic companies about issues such as risk assessment, investment appraisal and business plans.

The questionnaire shows that foreign banks mainly serve medium and large enterprises. They also perform banking activities for various wealthy individuals. The methods followed by foreign banks in selecting their clients are the size of financial transaction, the ability of borrower to service its debts and guarantees, and profit

¹⁴⁵ See Appendix V, Q.8 on the change in banks market share after the financial liberalisation.

¹⁴⁶ See Davis (1983) and Walter (1988) on foreign banks' operations in global financial markets.

¹⁴⁷ All foreign banks offer telephone banking and electronic card facilities. SWIFT is the payment method utilised by foreign banks in financing foreign trade.

forecasting (financial executive, ABC, 2001). ABC extends small amounts of credit to individuals with average incomes and small private enterprises.

Foreign banks determine their future business plan in Algeria in accordance with four criteria (see: Appendix V, Q.31). First, they study the political and economic climate of the host country. Usually, the economic examination includes the size of the market, the number of foreign companies operating in each sector of the national economy¹⁴⁸, and privatisation of state-owned enterprises. The political assessment constitutes the strength of Algeria's foreign policy (especially with America and the European Union), and country's stability (senior manager, SGA, 2001). Second, foreign banks study the suitability of national financial regulations and other rules imposed by the central bank on foreign financial institutions. Third, they examine the behaviour of Algerian investors and individuals towards banking services.¹⁴⁹ Finally, foreign banks consider the market potential of the host country as an indicator for their expansion. A report by the consulting firm Nord Sud Export shows that Algeria has a medium-sized market. Countries are classified according to the A–E system of evaluating market potential, and Algeria was given a C with a score of 229 out of 500. The A–E system comprises concerns about economic strength, size, market dynamism, economic liberalisation and privatisation (Algeria-Interface Online, 1999). The major weaknesses of the Algerian economy are its high unemployment and political uncertainty.

SGA's financial manager noted that the bank has implemented a new policy to expand its business in Algeria. First, SGA offers competitive interest rates on its

¹⁴⁸ For example, most foreign banks prefer to open at least one branch near the giant oil companies.

lending and borrowings. Second, it has increased the number of its branches in industrialised zones and large cities. Third, it introduces new financial instruments to the Algerian market. Finally, it gives a variety of facilities to its customers such as electronic cards and other means of payment (see Appendix V, Q.32).

Considering the problems that face foreign banks in Algeria, Citibank's financial executive said that local investors have inadequate business knowledge, and because of this, the bank has extended the largest proportion of its loans to foreign companies. SGA's financial manager pointed out that the return from long-term investments is uncertain and that SGA is unwilling to take high risks. Accordingly, borrowers are required to give full guarantees on their loans and to produce a professional budget for the past three years if the project already exists. The professional budgets show the trends in the financial position of the business over the past years. This is to avoid extending loans to low-performing projects and to improve the bank's portfolios.

The level of credit risk is another criterion used by foreign banks when selecting their borrowers. They grant credit to companies that are in a good financial position and that have a decent reputation in the market. Foreign banks also assess liquidity and exchange rate risks during the period over which the project is financed.¹⁵⁰ Individuals with small incomes have no access to foreign banks' funds because of uncertainty about their ability to service their debts. SGA's senior manager stressed that 'foreign banks are forcing their borrowers to give guarantees on any extended loan and most individuals fail to do so'. The guarantees are in the form of tangible assets and earned income.

¹⁴⁹ The ABC undertook a country study from 1992 to 1998 to assess the strengths and weaknesses of the Algerian financial market (financial director, ABC, 2001).

Managers of foreign banks claimed that the response of the Algerian customers to their services is satisfactory (see Appendix V, Q.33). The competitive advantage of foreign banks is that they have a large banking network throughout the world and this allows their customers to have access to their funds internally and externally. For instance, Citibank's clients can withdraw their funds in more than 100 countries. Their branches are also equipped with many facilities such as cash dispensers, Internet and telephone banking. Foreign banks' advanced technology allows them to hasten their financial transactions (interview notes, 2001). In addition, foreign banks have a long experience in advisory roles, cash management and other banking activities. Most importantly, investors are now in a position to raise more capital by accessing foreign banks' funds.¹⁵¹

The market share of foreign banks has grown minimally during the past five years (see Appendix V, Q.8). It has been emphasised that banks' market share is directly correlated with the size of public and private sector (interview notes, 2001). The public sector is still mainly financed by state-owned banks. ABC's senior manager noted that foreign banks cover less than 5 per cent of the total bank lending in Algeria. This is because foreign banks mainly engage in funding large foreign companies and in foreign trade. The high political risk and small size of their banking network makes foreign banks conservative in lending to state-owned enterprises and private enterprises. Similar results were found in the study by Engwall *et al* (2001).¹⁵²

Foreign banks employed local staff to facilitate contact with their Algerian clients. Local employees have the advantage of speaking local languages: French, Arabic and

¹⁵⁰ See Walter and Smith (1999) on risks associated with foreign banks' lending in the host country.

¹⁵¹ See Levine (1996) on the benefit of foreign banks' entry into the foreign financial markets.

Berber. On this issue, SGA's financial manager (2001) stressed that "foreign banks need time to train their staff on new banking technologies and one of the methods used to improve their skills is by sending them abroad for training".

Table 6.7: Estimated average net monthly wages paid by large state-owned enterprises, local government-owned firms and the private sector in Algerian Dinar, September 1996–September 1997

	Senior Managers	Supervisors	Workers	Average
National Enterprises	17,016	12,153	10,500	12,103
Local Government-Owned Firms	13,420	9,906	7,274	8,094
Private Enterprises	17,844	11,784	8,678	8,896
Average	16,847	11,986	9,218	10,782

Source: Ministère des Finance

In the early years of financial liberalisation, foreign banks benefited substantially from the wide interest rate margin in Algeria. The interest rate margin reached a peak of 7 per cent in 1994. This was not the case for BAD, BEA, BNA, BADR, CNEP and CPA (see: Appendix V, Q.30). The devaluation in the local currency because of the high inflation rate has caused a decline in state-owned banks' earnings and thus affected their ability to repay their debts in the agreed time. However, the interest rate margin declined steadily from 1997 onwards because of a decrease in the inflation rate and an improvement in national macroeconomic indicators.

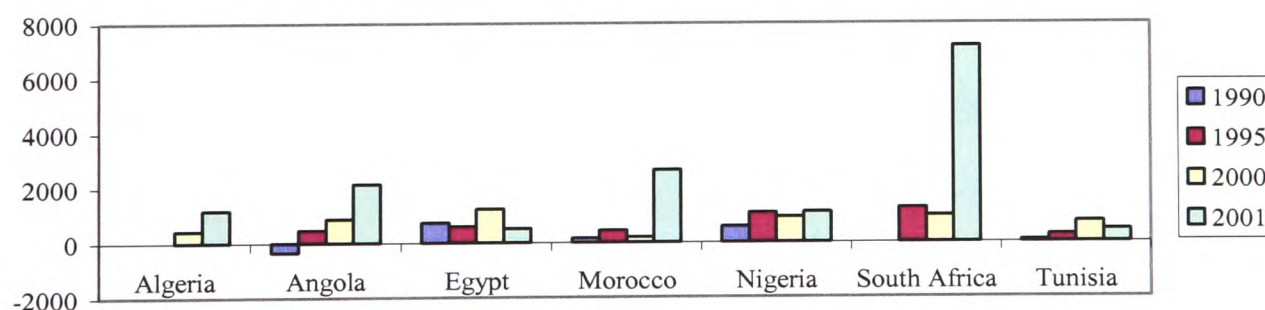
ABC's senior manager stated that there has been a dramatic increase in ABC's efficiency due to the decline in the bank's aggregate costs and an increase in the return on its financial assets. It is a normal consequence of ABC's good lending strategy (senior manager, ABC, 2001). Conversely, Citibank and SGA's managers noted that banking efficiency has increased minimally because of poor telecommunication systems, which have prevented banks from reducing their expenses. The underdeveloped telecommunication system made foreign banks unable

¹⁵² Engwall *et al* (2000) said that foreign banks gain large market share in the long term.

to offer their services via electronic channels, which cost less than face-to-face banking. Citibank’s senior manager also stated that the Internet has given businesses instant access to banking services at lower costs than branch-based banking.

The physical presence of foreign banks has stimulated foreign companies to expand their investments in Algeria (see chart 6.6). *“Directors viewed the increased private activity and the rise in foreign direct investment as welcome signs that past reforms are bearing fruits...Directors therefore urged the authorities to redouble their reform efforts, with special emphasis on privatization and public sector restructuring, and steps to further open up the economy and improve the business environment”* (IMF Concludes 2002 Article IV Consultation with Algeria, 2003). Kandiero and Chitiga (2003) also found that liberalisation of services sector boosted foreign direct investments in Africa, including Algeria. The total foreign direct investments increased from 0 in 1990 to USD438 million in 2000 and to USD1,196 million in 2001 (Kandiero and Chitiga, 2003). They emphasised that further liberalisation of the financial sector would make African countries gain in attracting foreign direct investments. Chart 6.6 shows foreign direct investments in Algeria, Angola, Egypt, Morocco, Nigeria, South Africa and Tunisia from 1990 to 2001.

Chart 6.6 : Foreign direct investments of selected African countries, 1990-2001 (USD millions)



Source: Kandiero and Chitiga, 2003

Foreign banks enhance investors' confidence in the Algerian financial market. In fact, SGA's financial executive noted that the credit volume to foreign investors has increased steadily in the past five years (financial executive, SGA, 2001). However, the amount of loans to local investors has grown only slightly because of the high credit risk associated with their projects.

Citibank Algeria offers its clients many advantages, including a highly trained staff that can help find creative financing solutions, solve problems and reduce the costs to our customers. These services reinforce the quality image of our Algerian clients in the international marketplace...Citibank's approach is focused on trade, foreign investment, cash management and treasury services, all of which involve close collaboration with Algeria's leading banks.... Citibank offers a range of banking services to companies, notably in the following areas: commercial finance, inter-bank transactions, investment services, deposits, cash management and electronic banking... It makes available an assortment of services to help its customers better manage their budgets, increase the value of their investments, and finance their projects. The excellent quality of Citibank's services can compete with the services offered by any bank anywhere in the world (Managing Director, Citibank, 2001).

Interviewees pointed out that foreign banks did not have a significant impact on domestic savings and borrowings. Foreign banks are prevented from receiving public funds in an effort to avoid capital outflows from Algeria to abroad (see Appendix V, Q.11). In addition, as has been demonstrated in section one, state-owned enterprises still hold their accounts with state-owned banks. Therefore, foreign banks rely on their own funds to meet the financial needs of their private and foreign customers.

As we have already mentioned in Chapter 3, the foreign banks brought many benefits to the Algerian financial market. First, foreign banks provide foreign and domestic companies with advanced technological means of payment. Second, their global reputation attracts foreign direct investments into the country. Finally, the increased competition caused by their entry encourages local banks to improve their

activities.¹⁵³ This indicates that the Algerian government should open the market widely to foreign banks by removing the obstacles affecting their operations.

In contrast to what Claessens, Demirgüç-Kunt and Huizinga (1998) found,¹⁵⁴ overhead expenses of foreign banks are low in Algeria due to several factors. Foreign banks have few branches, and this has enabled them to cut their running costs. They also have a small workforce and this has resulted in low wage costs. In addition, foreign banks pay less in taxes in Algeria than in their home countries (the Union Bank Annual Report, 1999). However, our findings about the impact of national income on the asset share of foreign banks are similar to those of Claessens, Demirgüç-Kunt and Huizinga (1998). There is a negative correlation between the national income and the assets of foreign banks. The asset share of foreign banks depends on the size of foreign investments rather than on the national income (interview notes, 2001). This is because foreign companies constitute the largest proportion of foreign banks' customers. Table 6.8 summarises the magnitude of foreign banks' overhead costs, interest margins, tax payments and profitability in developing and developed countries compared with Algeria.¹⁵⁵

As a measure of bank profitability, we used before-tax profit over total assets to enable comparisons with the findings of Claessens, Demirgüç-Kunt and Huizinga (1998). Interviewees stressed that the increase in before tax-profit is due to low overhead costs and high interest margin. The return from their assets has been also accelerated because of improved labour and technology, and high capital

¹⁵³ Peek and Rosengren (2000) also said that foreign banks offer numerous benefits to the host country financial market.

¹⁵⁴ See Chapter 2, p. 45

¹⁵⁵ See Claessens, Demirgüç-Kunt, and Huizinga (1998: 7–10) to compare their results in selected developing and developed countries with our findings.

productivity. Interviewees emphasised that the low overhead costs and tax payments combined with high interest margin enabled foreign banks to achieve high profitability.

Table 6.8: Extent of foreign banks' overhead costs, interest margins, tax payments and profitability

	Overhead costs	Interest margins	Tax payments	Profitability
Foreign banks in developing countries	High	High	High	High
Foreign banks in developed countries	Low	Low	Low	Low
Foreign banks in Algeria	Low	High	Low	High

Source: Claessens, Demirgüç-Kunt and Huizinga (1998) and foreign banks' annual reports

The low overhead costs, wide interest margins and low tax rate payments have encouraged other foreign banks such as *Credit Lyonnais* to open their representatives in the capital. The role of those representatives is to make a preliminary assessment of the investment opportunities available in the Algerian financial market before banks start their initial activities.

Foreign banks gain competitive advantage from the quality of their services rather than from differences in lending rates between themselves and local banks. Annual reports show that the lending rates offered by foreign banks are similar to those of local banks. For example, Citibank's lending rate was around 9 per cent in 2001 (financial executive, Citibank, 2001). The lending rate of local banks was between 8.50 and 11.20 per cent (state-owned banks Annual Reports).

At first, foreign banks were offering basic financial products such as trade financing and time deposits (interview notes, 2001). Those products were designed specifically to meet the demand of foreign investors. Nevertheless, the gradual

removal of regulatory barriers and the increased demand for innovative financial products have encouraged foreign banks to enhance their presence in Algeria.

Most bank managers believe that clients have responded positively to the new financial products. Financial transactions may be conducted rapidly by means of those products. They also allow banks to cut their costs and to diversify their portfolios. But a few managers claimed that the demand for those products is minimal because customers are not well informed, or they are uncertain about the benefits of using those instruments (interview notes, 2001).¹⁵⁶

Citibank's financial manager stressed that the major problem facing foreign banks is local regulations that lead to limitations in financial products. For example, foreign banks cannot invest in local currency because of restrictions by the central bank (senior manager, ABC, 2001).¹⁵⁷ The purpose of imposing this constraint is to protect the external value of the national currency. The volatility in foreign exchange rates has caused a decline in the value of foreign banks' financial assets. The current financial rules are also unclear about some financial transactions, such as transferring funds abroad.¹⁵⁸

This section has shown that foreign banks hold a strong competitive position in the quality of their services and managerial tools. Foreign banks also have the technological advantage over local banks. However, local financial rules and political instability have discouraged foreign banks from expanding their business in Algeria. Therefore, it is necessary to reduce the country risk and to introduce clear rules that

¹⁵⁶ See Appendix V, Q.15 on the correlation between foreign banking entry and emergence of new financial products.

¹⁵⁷ See Appendix V, Q.5 on the relationship between the removal of financial restrictions and banking lending decision in Algeria.

regulate the Algerian financial market. This would stimulate foreign banks to engage in other financial activities such as mortgages and share trading.

6.3. Measuring the performance of the non-interest bank

The *El Baraka* Bank of Algeria was established on May 20, 1991 after the introduction of the new Law on Money and Credit (1990). Its capital in 2002 was USD6,250,000 and is divided equally between *Banque Algérienne de développement Rurale* and *Dallah El Baraka* Group Company of Jeddah. The bank offers four principal instruments: *taadjir* (leasing), *musharaka* (equity participation), *murabaha* (profit sharing agreement) and *salam* (deferred delivery payment).¹⁵⁹ The bank's capital base comprises equity capital, provision (contingent liability), reserves, currency deposits from foreign investors and other institutions (mainly Arabic and Islamic banks). The difference between the capital base of *El-Baraka* Bank and interest banks is in the profit, which is shared with entrepreneurs and depositors.

Taadjir is used by *El-Baraka* Bank to finance the acquisition of products such as vehicles, machinery and other equipment. The most important form is a lease where a proportion of the instalment goes towards the final purchaser. The transfer of ownership of products from the bank to the lessee should be the last stage of the lease operation, when the lessee has met all terms and conditions. This instrument accounts for about 10 per cent of *El-Baraka* Bank's financial transactions. Another product offered by the bank is *musharaka*, which is similar to a classic joint venture. This product has two main characteristics. First, entrepreneurs contribute to the capital

¹⁵⁸ See Chapter 2, pp. 56–8, for more information about risks confronting foreign banks in the host country.

(assets, technical and managerial expertise, working capital, etc.) of the business venture. Then returns and risks are shared according to an agreement. This product is designed to finance working capital of medium- and long-term duration.¹⁶⁰

The third financial instrument that can be purchased by *El-Baraka* Bank's customers is *murabaha*. It is similar to an investment fund in conventional banking.¹⁶¹ The fourth product offered by *El-Baraka* Bank is *salam*. It encompasses two types of financial instrument: *bay' muadjal* (differed payment sale) and *bay' salam* (differed delivery sale).¹⁶² *Bay' muadjal* is designed for spot sales as well as managing credit sales. In *bay' salam*, the commodity is delivered immediately, but the payment is delayed for an agreed period. The price of the commodity can be paid in instalments or in full. There is no extra charge for the delay. In the *bay' salam* contract, the payment is made instantly though the product is delivered at future date (*El-Baraka* Bank Managerial Reports, 2001).

In a *murabaha*¹⁶³ transaction, the bank has an agreement with the managing trustee. The agreement shows that *El-Baraka* Bank purchases the product from the first supplier and then resells it to the contracting party. In *musharaka* transactions, the bank owns a proportion of the existing company's capital or of its new projects. *Musharaka* can be subdivided into definitive and sliding *musharaka*. In definitive *musharaka*, the bank has a stake in the company and receives part of its profit on the basis of the money invested. In sliding *musharaka*, *El-Baraka* Bank finances new projects, which are expected to be profitable. The profit earned from the project is

¹⁵⁹ See Siddiqi (1993) and Aggrawal and Tariq (2000) on Islamic financial instruments.

¹⁶⁰ For an extensive and comparative review see Warde (2000).

¹⁶¹ See Warde (2000) on Islamic mode of financing.

¹⁶² See Wilson (1990)

¹⁶³ See Chapter 4, p. 112-3 for more details about *murabaha* contract.

used to cover the initial capital invested in the project and the rest is shared between shareholders.¹⁶⁴

There are five types of short-term financial product: (1) *murabaha*; (2) *salam*; (3) *débiteurs divers* (divers debit); (4) *istisna'a*; and (5) securities. *Murabaha* is *El-Baraka* Bank's main product, accounting for 87 per cent of its financial transactions (*El Baraka* Bank Annual Report, 2001). It is a favoured product for financing domestic and foreign trade (interview notes, 2001).¹⁶⁵ *Salam* is the second most popular financial instrument, with 8 per cent of financial transactions. Other financial products are used in less than 5 per cent of financial transactions. *El-Baraka* Bank also offers five financial products to facilitate medium-term financing: leasing, *murabaha*, *musharaka*, *istisna'a* and *salam*. In 1999, leasing was the main product used in medium-term lending with 99 per cent of loans extended. In long-term financing there is one available financial product, which is leasing; the amount granted is 3 million AD in 2000.

El-Baraka Bank offers two types of investment account: the non-committed participative accounts and the committed participative accounts. The holder of a committed participative account has the right to invest his savings in one or several specified projects.¹⁶⁶ The project earnings are shared as stated in the agreement. The holder of a non-committed participative account can choose where to invest his funds in accordance with the amount of capital required for each project. Profit is allocated in proportion to the duration and amount of deposits (*El-Baraka* Bank Managerial Reports, 2001).

¹⁶⁴ For a theoretical view on Islamic finance see Mills and Presley (1999)

¹⁶⁵ Most of the loans used in financing commerce are short-term.

Profit is determined after the business venture financial position becomes strong (see: Appendix V, Q.36 on how *El-Baraka* Bank distributes profit generated under *musharaka* contract). It is related to the earning capacity of projects, which is also connected to the amount, the currency and the duration of the deposit. To satisfy depositors, the bank always strives to select good projects for investment. However, depositors' funds are also at risk if the projects financed yield negative returns. *El-Baraka* Bank shares the losses incurred with entrepreneurs and depositors as stated in the agreement.¹⁶⁷

El Baraka Bank's approach is to improve the standard of its current services to satisfy its depositors, the entrepreneur and the supplier (interview notes, 2001). Its plan of action also includes improving personal contact with customers, expanding its network, introducing new products (such as insurance), and penetrating new markets (see Appendix V, Q.3).

Customers are assured that all services comply with Islamic banking principles. It is unacceptable for the bank to charge or receive interest rate from its customers.¹⁶⁸ For example, when placing excess funds with the central bank or other banks, *El-Baraka* Bank receives back the principle plus a service charge. This process aims to keep the spare liquidity in the market. Moreover, conventional bank funds cannot be used in *El-Baraka* Bank's operations because they involve interest, which is forbidden by Islamic law. It also borrows money from the Bank of Algeria without interest. In the Law on Money and Credit of 1990 there is no explicit legal regulation

¹⁶⁶ See Gafoor (1995) on types of Islamic banking accounts.

¹⁶⁷ On the issue of Islamic banking and investments see Aggrawal and Tariq (2000)

¹⁶⁸ *El-Baraka* Bank provides deposit accounts for individuals and legal entities that are not interested in generating additional return. Holders of this account can withdraw their money at any time. The savings account is for every individual who wants to invest money with *El-Baraka* Bank.

that indicates the relationship between the Bank of Algeria and non-interest banks. However, non-interest banks, like other banks, are allowed to use facilities offered by the central bank, but without interest rate restrictions (financial director, *El-Baraka Bank*, 2001).

El-Baraka Bank activities are highly concentrated due to the absence of financial products geared towards medium- and long-term financing. The largest proportions of the bank loans are used to finance trade.¹⁶⁹ For instance, in 1997 87 per cent of the bank's loans were used to finance the trade. The industry sector received 12 per cent of bank loans and one per cent only of the bank loans went to finance transport, agriculture and public works (*El-Baraka Bank Annual Report*, 1997).

The bank considers three criteria in selecting its investments: the level of risk, the expected rate of return, and the duration of the project (interview notes, 2001). Accordingly, *El-Baraka Bank* uses its funds to finance medium-sized enterprises and to grant credit to wealthy individuals. Average income individuals and large enterprises receive only a small proportion of the bank funds. The bank also extends a small amount of credits to individuals with small-incomes in the form of consumer loans (see Appendix V, Q.7).

El-Baraka Bank's senior manager pointed out that Islamic financial products are widely accepted by individuals and investors in Algeria, as shown by the steady increase in the demand for the bank financial solutions over the past five years (see Appendix V, Q.34). Depositors are also satisfied because *El-Baraka Bank* practically guarantees deposits in both current and investment accounts.

¹⁶⁹ See Wilson (1990) on the Islamic banking method of financing trade.

As we have seen in Chapter 2, non-interest banks should improve their management to face increasing banking competition. *El-Baraka* Bank has introduced a series of organisational reforms to motivate its staff and reinforce discipline within the bank (*El-Baraka* Bank Annual Report, 2000). For example, a new salary scale has been introduced for directors to motivate them. The bank has also invested heavily in modern technologies such as automated teller machines (financial director, *El-Baraka* Bank, 2001).

El-Baraka Bank has introduced strict working methods to improve the allocation of its financial resources. Managers provide full details of loans extended to different sectors of the national economy. The financial information is used to make appropriate provisions for bad debts and to classify credits according to their size and maturity.

About 76 per cent of *El-Baraka* Bank's operations take place in two branches, *Birkhadem* (district in the capital Algiers) and *Sétif* (city located to the east of Algiers) (*El-Baraka* Bank Annual Report, 2000). This reflects a high concentration on a small number of customers. Accordingly, it is necessary to establish other branches in those two cities and in other regions where *El-Baraka* Bank is totally absent to diversify the bank's portfolio, minimise credit risk, enlarge its market share and increase its earnings.

Most of *El-Baraka* Bank's doubtful debts derive from financing by *murabaha* and leasing — these accounted for 71.6 per cent of doubtful debts in 1999 and 84 per cent in 2000 (*El-Baraka* Bank Annual Reports, 1999–2000). The bank uses the two products to fund a large portion of its activities — commerce in particular. Bad debts incurred because of securities trading accounted for 14.9 per cent of total debts.

Doubtful debts related to other forms of financing such as *Salam* and *Istisna'a* amounted to less than 5 per cent.

El Baraka Bank has three types of bad debt provision (*El-Baraka* Bank Annual Report, 2001). It constitutes 100 per cent provisions for debts without real guarantees, for projects that are in jeopardy or for entrepreneurs who are unable to service their debts. The provision on high-risk loans is 50 per cent. Loans are considered highly risky when the repayment is delayed by six months to one year from the date of maturity (*El-Baraka* Bank Annual Report, 2001).¹⁷⁰ The bank allows 30 per cent provisions for debtors who are in slight financial difficulties.

Non-interest banks require high transparency because depositors are highly apprehensive about their funds.¹⁷¹ To improve market transparency, *El-Baraka* Bank is urged to keep its records according to international accounting standards and to disclose details of its lending and borrowing on a quarterly interval basis (financial director, *El-Baraka* Bank, 2001). Appropriate practices of book-keeping and other administrative tasks boost confidence about the bank services.

6.4. Evaluation of banking competition

One of the main objectives of opening the Algerian financial market to foreign participation and allowing private ownership was to boost banking competition. In a highly competitive environment, the cost of borrowing declines and this allows many

¹⁷⁰ In the legal regulations “Banks and financial institutions are compelled – under the terms by the Council – to comply with the management rules aiming at guaranteeing their liquidity and solvency *vis-à-vis* third parties, notably depositors, and ensuring the balance of their financial structure. They should comply, in particular, with the cover and division ratios and risks...” (Art. 159, Law on Money and Credit, 1990).

¹⁷¹ See Duncan (1996)

investors to fund their projects at low price (Shaw, 1973). Depositors also receive high rates on their savings.¹⁷² This empirical study analyses determinants of imperfect competition between state-owned banks, Algeria private banks, foreign banks and non-interest bank.

The survey indicates that state-owned banks are facing moderate competition from other banking groups (see Appendix V, Q.2). State-owned banks finance the largest proportion of state-owned enterprises' projects and government expenditures; as a result, the only segment in which other banks can compete with state-owned banks is in funding small private enterprises and foreign trade.

The interest rates on lending and borrowings are more sensitive to national macroeconomic indicators than to microeconomic ones such as banking competition. The inflation rate rose sharply during the early years of financial liberalisation and this led to negative interest rates.¹⁷³ Mohamed Belfodil, president and director general of bank BADR, said that *'at the time inflation was 40 per cent and interest rates reached 18 per cent to 20 per cent. But now inflation has fallen to 5 per cent. Today we give credit at 10.25 per cent for current use and 8.5 per cent for capital investment, which is excessive, compared with the rate of inflation'* (The Washington Times, 1999: 30). The result was a decline in the total deposits / GDP ratio from 34 per cent in 1993 to 25 per cent in 1998 (Bank of Algeria, 1998).

The sequence of financial sector reforms had been influenced by issues of macroeconomic stabilisation including strengthening the fiscal budget. As stated by Jbili *et al* (1997), the substantial amount of fiscal losses generated by state-owned

¹⁷² See McKinnon (1973) and Shaw (1973)

enterprises made state-owned banks continue to use preferential credit financing. It also resulted in negative effects on the liberalisation of interest rates and banking competition. However, Algeria's macroeconomic stabilisation has been improved from 1998 because of the decline in the inflation rate and an increase in state revenues from oil exports.

Mobilisation of financial resources is progressively determined according to market mechanisms. This was achieved by removal of constraints on foreign exchange resources, trade liberalisation, privatisation and elimination of controls on bank lending and borrowing. The capital account was liberalised by the closing stages of financial reforms to ensure the stability of the financial sector. Other objectives of capital account liberalisation are: (1) to boost foreign direct investments; (2) to enhance foreign exchange resources distribution; and (3) to increase competition among financial institutions.

As noted in Chapter 3, the Algerian government moved to more market-based instruments to finance its expenditures. It created an auction system, which allows the selling of negotiable treasury bonds to banking and non-banking institutions on the money market. The market-based instruments replaced banking financing of the state budget deficit. But, non-banking institutions are still holding a large proportion of treasury bills in their books. The role of the central bank in financing government deficits is also very limited in Algeria.

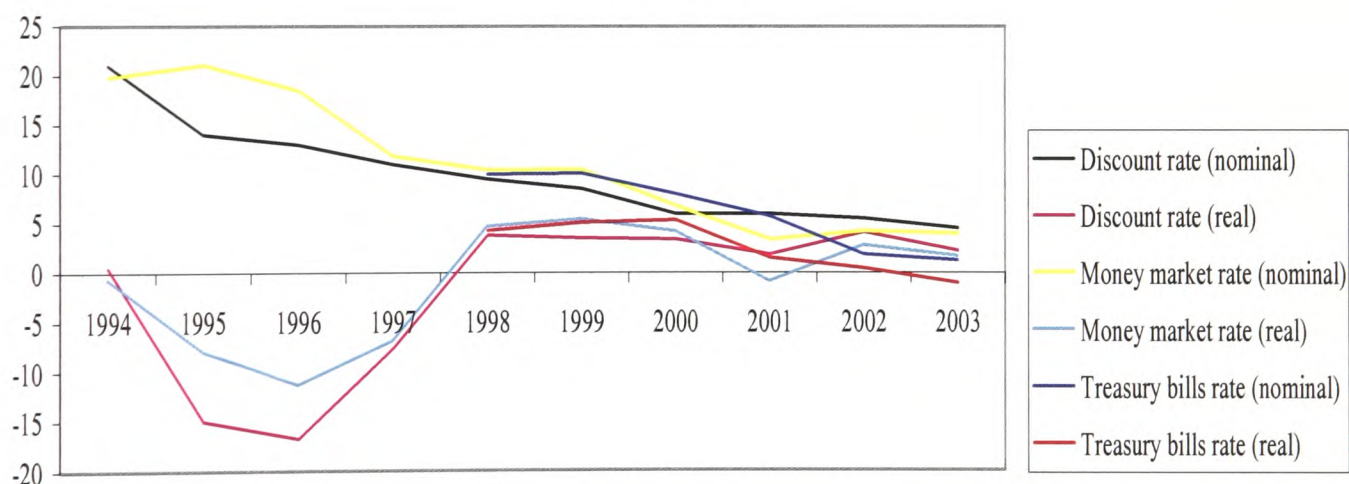
Macroeconomic imbalances forced the Algerian government to initiate the financial sector reforms to reduce the effects caused by fiscal and current account

¹⁷³ Nashashibi *et al* (1998) stressed that movements in money supply (M2), change in world oil prices and nominal effective exchange rate were the main determinants of inflation rate in Algeria.

deficit. Financial authorities removed price controls and restrictions on foreign trade in the 1990s. This, however, resulted in an increase in the cost of capital because of soaring inflation rates (interview notes, 2001). Likewise, the monetary imbalances were not restored because of large monetised fiscal deficits.

The removal of monetary constraints contributed to decline in M2/GDP during the financial reforms. Restriction imposed on the state budget caused a decline in the credit extended to non-government sector. Real interest rates remained negative until 1995 due to a sharp increase in inflation after the liberalisation of price controls. However, the ratios measuring the efficiency of intermediation increased steadily during the reforms (Jbili *et al*, 1997). Chart 6.7 shows the nominal and real discount, money market and treasury bill rates from 1994 to 2003.

Chart 6.7: Nominal and real discount, money market and treasury bills rates, Algeria, 1994-2003



Source: Bank of Algeria, IMF and World Bank statistics (collected by author)

After the financial reforms, state budget financing was met by using market-based financial instruments. Authorities also implemented market-based mechanisms of monetary policy to manage liquidity more effectively. Besides, the role of banks as intermediary has been reinforced, as shown in this study.

The improvements in macroeconomic indicators such as M2/GDP and M1/M2 ratios have almost no impact on non-government savings. This can be explained by the size of public sector before the reforms and the dominance of other related savings factors such as investments outside the hydrocarbon sector. The negative correlation of real interest rates with non-government savings is also due to the influence of public sector mode of savings. On the other hand, the ratio of reserve money to deposits increased after the financial reforms (Jbili *et al*, 1997).

Macroeconomic financial variables such as those of fiscal sustainability and economic growth had minimal influence on non-government savings before the reforms. However, this has been improved after the financial reforms due to the removal of liquidity barriers on commercial banks. Jbili *et al* (1997) found that almost all financial indicators had negative effects on savings in Algeria. The exception was the ratio of money to deposits, which increased from 0.12 to 0.61 after the reforms.

The change in the oil prices has significant impact on growth performance in Algeria. As noted in Chapter 3, oil exports remain the main source of income for the Algerian government and therefore have a direct impact on the scope of financial reforms. For example, the increase in oil prices during the past five years has enabled the government to reduce its fiscal deficit and also to boost economic growth.

Table 6.9: Interest rate and monetary indicators, Algeria, 1992–2000

	1992	1995	1996	1997	1998	1999	2000
Real Deposit Rate	-15.8	-6.6	-3	-4.2	-0.3	5.5	4
Gross Interest Rate Margin	10.0	7.5	4.5	2.8	3.5	3	2.8
M2 / GDP Ratio	53	40.5	35.6	39.2	46.1	42.7	40.9
M1 / M2 Ratio	78.4	64.9	64.4	62.2	63.8	60.6	60.2

Source: International Financial Statistics, IMF.

The decline in M1/M2 ratio was in parallel to the increase in real deposit rate (see Table 6.9). The ratio tends to rise as the financial system develops and new saving instruments appear in the market. This supports the argument that M1/M2 aggregate and savings are positively correlated when financial liberalisation is completed (McKinnon, 1973). Meanwhile, the M2/GDP ratio is more sensitive to oil sector developments than scope of financial sector reforms in the case of Algerian economy.

Table 6.10: The changes in nominal interest rates since the initiation of financial liberalisation, 1991–2002

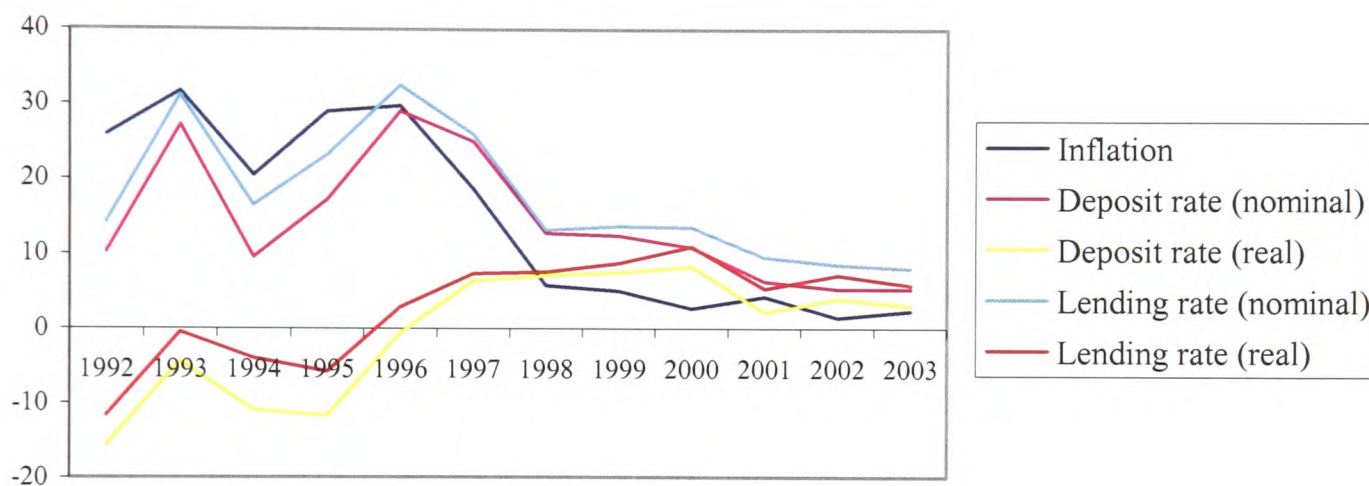
	Commercial banks' deposit rate	Commercial banks lending rate	<i>Caisse Nationale d'Épargne et de Prévoyance</i>		Lending rate (Housing):	
			Savings	Housing	Individuals	Developers
Oct. 1991 Apr. 1994	12.00-16.00	15.00-20.00	8.00	5.00	7.00-14.00	14.00
As of Dec 1994	16.50-18.00	18.00-25.00	14.00	10.00	12.00-22.00	16.00-20.00
As of Dec 1995	16.50-18.00	19.00-24.00	16.00	12.00	12.00-22.00	16.00-20.00
As of Dec 1996	16.50-18.00	17.00-21.50	16.00	12.00	12.00-22.00	16.00-20.00
As of Dec 1997	8.50-12.00	9.00-13.00	16.00	12.00	10.00-17.50	10.00-17.50
As of Dec 1998	8.50-12.00	8.50-12.50	12.00	10.00	8.50-10.00	8.50-10.00
As of Dec 1999	8.50-10.00	8.50-12.50	7.50-9.00	7.00-9.00	8.50-10.30	8.50-10.30
As of Dec 2000	7.00-8.50	8.50-11.20	6.50-7.00	6.00-6.50	10.50-10.20	10.50-10.20
As of Dec 2001	5.50-6.75	8.0-11.0	5.0-6.0	5.50	8.00-9.75	8.0
As of Dec 2002	4.50-9.00	8.00-9.75	5.0-6.0	5.50	7.5-8.0	7.5

Source: Algerian authorities, Central Bank of Algeria, and Ministry of Finance.

From Table 6.10, it appears that in the early years of financial liberalisation the nominal interest rate on both deposits and loans rose dramatically. Nonetheless, a few years later the nominal interest rate seems to be declining because of the increase in monetary aggregates such as the M1 and M2. For example, the interest rate on loans

dropped from 18.5 per cent in 1995 to 8 per cent in 2001 (*Agence Algérienne d'Information Online*, 2001). However, these changes are not uniform and depend on the risk and maturity of the loan. The falling interest rate reflects the decline in the inflation rate and the stabilisation of exchange rates. Analysts expect that interest rates will decline further in the years to come because of improving macro- and microeconomic indicators.¹⁷⁴

Chart 6.8: Inflation, nominal and real deposit and lending rates, Algeria
1992-2003



Source: Bank of Algeria, IMF and World Bank statistics (collected by author)

Chart 6.8 shows that the inflation rate increased considerably in the early years of financial liberalisation. This was due to the removal of price control and the liberalisation of foreign exchange. This resulted in negative real deposit and lending rates, with the lowest rates occurring in 1992 and 1995. The real lending rates become positive from 1996 and for real deposit rates from 1997. This is explained by the macroeconomic stabilisation, which was achieved after the full liberalisation of foreign exchange and the creation of market-based instruments to finance the government budget.

¹⁷⁴ The low interest rate margin is essential for both savings and investments.

The increase in real interest rate (nominal interest rate minus inflation rate) boosts return on savings, which augments long-term income and consequently fosters current consumption. This increase in current consumption results in better return on savings, which contributes automatically to an increase in savings. It is expected that the correlation between the M2/GDP ratio and savings is positive as monetisation and financial savings increase because of the financial deepening (Shaw and McKinnon, 1973).

The liberalisation of interest rates did not result in a decline in the number of commercial banks, which instead has increased by 280 per cent over the past ten years. Altogether, there are 19 commercial banks operating in the market, one for every 1,615,793 citizens (Bank of Algeria, 2003). The consequence is an increase in banking competition between the former and emerged banks as they try to attract large numbers of depositors and investors.

The methods used by state-owned banks to avoid large decline in their market share include promoting their payment systems, improving personal contact with their current customers, and developing their information technology (see Appendix V, Q.3). Nonetheless, despite the amount of money invested in those fields, the market share of state-owned banks has declined steadily in the last five years (senior manager, BEA, 2001).

Another outcome of increased banking competition is the emergence of new financial products launched by state-owned banks (interview notes, 2001). An example of innovative behaviour of state-owned banks is the use of micro-credit to finance small businesses. Nevertheless, state-owned banks pay little attention to

consolidation, mergers and acquisitions, which we believe are necessary to strengthen their financial position.

Questionnaires show that Algerian private banks face high competition from banks of the same category, low competition from *El-Baraka* Bank, and moderate competition from state-owned banks and foreign banks (see Appendix V, Q.2). The reason for this is that Algerian private banks extend most of their credit to private enterprises and commerce. However, senior managers agree that there is no real competition between their private banks and the non-interest bank because *El Baraka* Bank's operations are in Islamic finance.

The credit potential of state-owned banks is higher than Algerian private banks. They have a sizeable amount of deposits compared with other banking groups. State-owned enterprises are depositing their collected funds with state-owned banks because of the restrictions imposed on other banking categories. For example, CPA has capital equivalent to 13,600 million AD, 136 times the capital of Union Bank (CPA and the Union Bank Annual Reports, 2002). The increase in Algerian private banks' capital is required to enhance competition between them and state-owned banks.

The present financial rules prevent banks from engaging in a variety of activities. For example, banks are not allowed to transfer funds abroad without informing the central bank. Letters of credit and payments by the bank to local or foreign traders are also confirmed on a cash collateral basis. *'We have many restrictions from the central bank. We need more freedom to perform effectively in our lending and borrowing activities. The support we need from the government has to be in the form of technical*

assistance and establishing co-operation with foreign financial institutions' (senior bank manager, BEA, 2001).

BAD, BADR, BEA and BNA managers state that their banks' market share decreased after financial liberalisation because new banks have opened only a few branches in Algeria (see: Appendix V, Q.8). However, *El-Khalifa Bank* and BCIA managers claim a dramatic increase in market share of new banks. This has been reflected by the increased numbers of depositors and borrowers who left state-owned banks and opened their accounts with new players.¹⁷⁵ It has been noted that Algerian private banks offer a vast range of financial instruments compared with state-owned banks (senior managers, Algerian private banks, 2001). Depositors with Algerian private banks also receive a higher savings rate than with state-owned banks.

The products of state-owned banks do not fulfil standards required by large domestic and foreign companies, high-speed financial transactions and advanced consulting services. Banks are also confronted by the problem of market uncertainty and high country risk.¹⁷⁶ As a consequence, many large companies prefer to meet their financial needs through international financial markets rather than by using bank loans.

El-Baraka Bank faces several difficulties in placing its funds in the money market. In the Algerian financial market, the same rules are applied for all banks, interest or non-interest. Banks are obliged to pay interest on funds borrowed through the money market. *El-Baraka Bank's* senior manager recommended implementing another set of

¹⁷⁵ There are no official figures about the number of clients of foreign banks or Algerian private banks.

¹⁷⁶ The only bank that finds difficulties in terms of accounting standards is *El-Baraka Bank*. This is because of its mode of financing and savings sometimes causes confusion in the allocation of profit.

financial rules that deal with funds invested according to *sharia* principles (interview notes, 2001).

El-Baraka Bank's mode of financing and savings causes confusion in the calculation and distribution of profit. *El-Baraka* Bank uses traditional accounting standards in recording its financial transactions, particularly when it comes to financing foreign trade and large businesses (see: Appendix V, Q.35 on the practical constraints that face *El-Baraka* Bank in the Algerian financial market). The non-existence of clear rules about '*halal*' financial products also prevents the bank from funding certain projects. Financial instruments are considered '*halal*' when Islamic financial practices are adopted instead of conventional banking methods. It is worth noting that few Western banking products fulfil Islamic law requirements (one such product is equity financing). In all circumstances, the *sharia* board decides what is acceptable and what is forbidden for Islamic investors.

The survey indicates that clear financial rules determine interest and non-interest banks' activities in Algeria. 'There are commercial and economic criteria that permit *El-Baraka* Bank to have its market share in the Algerian financial market' (financial manager, *El-Baraka* Bank, 2001). Many individuals and investors want their funds to be invested on the basis of Islamic codes of financing (senior manager, *El-Baraka* Bank, 2001). Those investments appear to be profitable and generate high return.¹⁷⁷

A uniform regulatory and legal framework supportive of an Islamic financial system has not been fully developed. *El-Baraka* Bank's approach of registering off-balance sheet items differs from those of other non-interest banks. Financial

¹⁷⁷ *El-Baraka* Bank' total revenues / total assets ratio was equivalent to 8.29 per cent and 7.06 per cent in 1999 and 2000, respectively (*El-Baraka* Bank Annual Reports).

instruments used by the bank — such as *murabaha* and *musharaka* — are still traditional and need further development to meet the demand of Algerian and foreign investors, especially those involved in large projects. In fact, since its foundation, *El-Baraka* Bank has persisted in offering the same financial products, all of which are geared towards short- and medium-term maturity (see Appendix V, Q.7).

El-Baraka Bank can use financial instruments launched by other major non-interest banks — such as *Faysal* Islamic Bank of Bahrain and Jordan Islamic Bank — to improve its lending and borrowing capabilities (managing director, *El-Baraka* Bank, 2001). Examples of innovative Islamic financial products are syndication and revolving finance.¹⁷⁸ These instruments enable the bank to diversify its portfolio and to hedge against market risks. *El-Baraka* Bank can also create new financial instruments by making conventional banking products comply with Islamic modes of financing by eliminating the interest rate.¹⁷⁹

The study shows that financial liberalisation has contributed to a steady increase in banking competition (see: Appendix V, Q.1). The result is the shift of many depositors and borrowers from state-owned banks into *El-Baraka* Bank. The emerged banks have launched various financial products and invested heavily in information technologies to increase their market share. State-owned banks have responded positively to these new developments by improving their managerial and technological tools.

¹⁷⁸ Syndication is subject to a credit or the issue of a security to management or underwriting by a syndicate. Revolving credit is a loan facility that is renewed as it is repaid and which may, therefore, be used repeatedly. In Islamic banking, a service charge is applied rather than the payment of interest rate on a revolving credit facility.

¹⁷⁹ *El-Baraka* Bank cannot trade bonds because they include an interest rate.

6.5. Evaluation of Internet banking

The research has demonstrated that most banks operating in Algeria have their own Web sites on the Internet (see Appendix V, Q.12). However, these are used principally for publicity purposes, which include informing the public about the characteristics of financial products offered by the bank (e.g., commission rate, type of accounts available within the bank, interest rate on lending and borrowing, etc.). Citibank is the only bank that offers various financial services through the Internet. Its customers are mostly large foreign and local companies. Citibank offers on-line issuance services to traders and cross-border finance facilities to foreign investors. The response to those Internet services tends to be high.¹⁸⁰

Thirty-seven per cent of bankers surveyed in this research believe that the Internet is a means to boost the relationship between providers and users of financial services in the marketplace. The Internet allows market participants to access all the standard banking services at a low price. This motivates individuals and investors to purchase large packages of banking services through the Internet.¹⁸¹

The survey indicates that the Internet plays three main roles in the domain of banking services (see Appendix V, Q.14). First, bankers noted that the high speed of the Internet enables banks to conduct their financial transactions more quickly. Second, the Internet reduces the cost of financial products due to a decline in banks'

¹⁸⁰ In the long term, other banks are planning to launch Web sites that allow customers to purchase products through the Internet (interview notes, 2001).

¹⁸¹ Fifty per cent of managers surveyed think that the Internet allows banks to penetrate new markets and allows banks to reinforce relationships with customers abroad (see: Appendix V, Q.14).

operating expenses, such as wages and maintenance. Third, the Internet allows banks to offer many financial products through a single window.¹⁸²

The demand for electronic banking services is minimal in Algeria. Most households have no access to the Internet and those who have the opportunity to use e-banking technology have no intention of purchasing financial products through the Internet (senior manager, the Union Bank, 2001). Users believe that e-banking is an unsafe business. This is because of lack of knowledge and experience in dealing with computerised banking services.¹⁸³

Another dilemma that confronts the growth of electronic banking in Algeria is the small number of providers and associated safety measures (interview notes, 2001). CERIST is the main supplier of Internet services in the country. A limited number of servers give poor access to online banking products. In addition, the design of banks' Web sites is below international standards and therefore Internet users feel less secure. As a consequence, investors fear losing their funds to hackers (senior manager, BEA, 2001). It has been stressed that the experience of foreign companies in computer engineering will help local banks take extensive safety precautions when launching their products through the Internet.

Bank managers stressed that the Internet enhances the global competitiveness of financial institutions by increasing their output level.¹⁸⁴ The Internet is also a means to manage business-to-business (B2B)¹⁸⁵ or business-to-customer transactions

¹⁸² See Chapter 2, pp. 64–69, for more details about the benefits of Internet banking in developed and developing countries.

¹⁸³ Most Algerian investors prefer face-to-face banking to the Internet when buying banking products (senior manager, Arab Banking Corporation, 2001).

¹⁸⁴ See Aladwani (2001)

¹⁸⁵ A developed B2B infrastructure helps small- and medium-sized enterprises to obtain electronic business capabilities and to understand its practices.

effectively. A strong Internet infrastructure is necessary to allow banks to improve their electronic data interchange.¹⁸⁶ Co-operation between telecommunication firms and financial institutions facilitates the modernisation of online banking. Increased capital investments and clear rules for online banking also foster the growth of e-business activities and enhance market transparency (senior manager, Citibank, 2001).

Opening the national market to foreign Internet providers can produce a redesign of the systems that manage online banking. This can be achieved by establishing joint ventures between foreign and local companies. The Taiwanese experience shows that the fast growth of e-commerce contributed to the large amount of private sector investments in electronic technologies (Currie, 2000).¹⁸⁷

Usually, banks use the Internet to improve their image and competitive position in the market (Aladwani, 2001). Currie (2000) also noted that the Internet boosts market competitiveness and enables banks to reduce their costs. The administrative and operational expenses are curtailed by using online banking (Aladwani, 2001). Nevertheless, the shortfall in financial funds prevents small banks from developing their own Web sites (senior manager, BCIA, 2001). Aladwani (2001) said that the transformation in electronic banking requires support from the policymakers.

In developing countries, online technology is underdeveloped because of a limited number of Internet specialists (Daniel, 1999). Support from computer experts and acceleration of innovations are vital for developing electronic banking. Daniel (1999) stated that the absence of incentives from senior managers constitutes the major

¹⁸⁶ On this issue, see Trappey and Trappey (2001)

obstacle inhibiting the development of online banking. Senior managers believe that the presence of foreign Internet specialists will help local banks to offer innovative financial products and to increase their market share over non-banking financial institutions.

Senior managers believe that banks' customers require substantial experience of online banking to understand the use of computers for paying bills and ordering financial statements. They also agree that developed Internet security can enhance trust between banks and end-users.¹⁸⁸ Fitzgerald and Dennis (1996) revealed that the absence of advanced Internet security tools such as call-back modems and encryption prevents the growth of online shopping. Banks are advised to use a firewall system, which is one of the most secure Internet technologies to improve the security of online banking in Algeria.

Information about banks' services should be displayed in three languages: Arabic, French and English (senior managers, foreign banks, 2001). Another factor to improve electronic banking in Algeria is to simplify all information on banks' Web sites by showing all types and features of products used to conduct e-business. It has also been pointed out that banks need to offer e-business solutions to large, medium and small enterprises.

6.6. Measuring banking profitability

Bank profitability has been affected by new waves of financial liberalisation in the last five years. First, the net profits of BEA and BADR have decreased after financial

¹⁸⁷ Despite of the differences in industry structure between countries, it is important to learn from the experience of successful programmes of investments in new technologies, such as the Internet.

liberalisation (see Appendix V, Q.18). BEA's profit before tax declined from USD7.77 million in 1997 to USD5.31 million in 1999. The decline is due to liberalisation of interest rates,¹⁸⁹ large amount of bad debts, liquidation of state-owned enterprises, and the elimination of government subsidies (interview notes, 2001). Certain banks, such as CNEP, saw their profitability increase (CNEP Annual Reports). The reason is that CNEP is the only provider of mortgage services in Algeria and the margin between the saving and lending rate is very high.

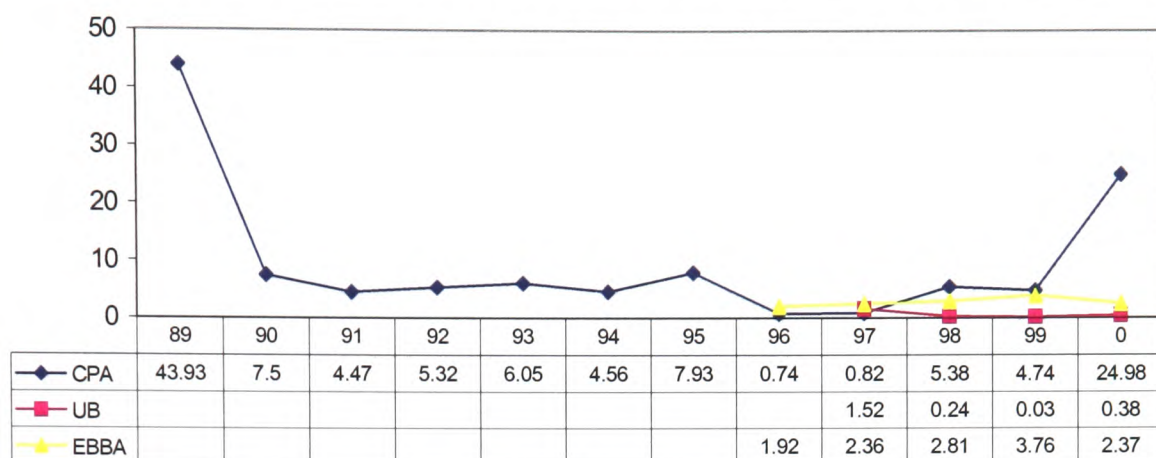
Second, almost all Algerian private banks' profitability has increased in the past five years (see Appendix V, Q.18 on the change in banking profitability in the past three years). This is because most projects financed by Algerian private banks have low risk, the return from those projects is usually high, the cost of managing their funds is low¹⁹⁰ and they have a good auditing system. The demand for banking services is also high and this allows new banks attract many customers. SGA's financial managers stressed a slight increase in banking profitability (interview notes, 2001). The bank is focusing on promoting the current services in order to attract new customers, particularly foreign companies and local private enterprises. It is also attempting to increase its banking network. Fourth, there is a fluctuation in *El-Baraka* Bank's profitability. The bank achieved a high profit margin in its early years of operations, thanks to a good lending policy and small amount of bad debts. But, in 2000, the bank's profitability declined because of an increase in doubtful debts.

¹⁸⁸ Internet security tools comprise: authentication; biometrics; call-back modems; encryption on circuits; encryption on servers; firewalls; PC hardware security; and smart cards (Aladwani, 2001).

¹⁸⁹ The interest rate decreased from 16 per cent to 6.5 per cent and this had negative effects on banking profitability.

¹⁹⁰ Algerian private banks' funds are utilised in financing few projects compared with state-owned banks, which have large amount of capitals.

Chart 6.9: CPA, the Union Bank and *El-Baraka* Bank net profit, 1989-2000, Million USD



Source: CPA, the Union Bank and *El-Baraka* Bank Annual Reports

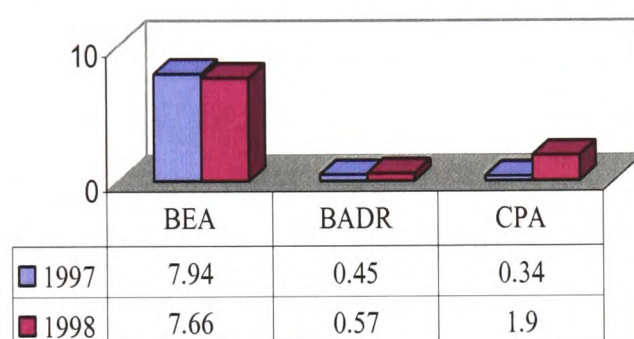
The low profitability of state-owned banks has happened for three main reasons. First, state-owned banks continue to finance state-owned enterprise projects, which yield low returns on their assets. The value of state-owned banks' assets declined dramatically during financial liberalisation because of the high inflation rate and the increase in lending rates. The commercial lending rates increased from 15 per cent in 1991 to a maximum of 25 per cent in 1994 (Bank of Algeria).¹⁹¹ The second cause of decline in state-owned banks profitability was the sharp increase in the savings rate during the 1990s. The deposit rate of commercial banks increased from 12 per cent in 1991 to 18 per cent in 1994 (Bank of Algeria). Finally, the IMF and the World Bank found that state-owned banks' cost of refinancing was greater than the yield generated from its assets (IMF, 2000). The widespread use of the overdraft facility led to an increase in the refinancing rate to 19 per cent in 1999.

BEA's and BADR's managers stated that interest rate liberalisation had a dramatic impact on the profitability of state-owned banks. Effects were negative at the

¹⁹¹ The response of state-owned banks to the decline in credit to state-owned enterprises took two forms: accelerations in banks' lending to the private sector and increases in off-balance sheet assets.

beginning and positive at the end of financial liberalisation. The sharp increase in the lending rate during the early years of financial liberalisation (25 per cent in 1994 and 24 per cent in 1995) made state-owned enterprises unable to service their debts, and this led to a decrease in the profit margin of some state-owned banks. However, the interest rate margin declined significantly after 1997 (13 per cent) and this produced an increased return on the equity of state-owned banks such as BADR and CPA.¹⁹²

Chart 6.10: BEA, BADR, and CPA return on equity, 1997-1998



Source: BEA, BADR, and CPA annual reports.

Deposits are the main source of banks' funds in Algeria. For example, CPA's deposits account for 48.69 per cent of the bank's total funds in 1999 (CPA Annual Report, 1999). This study shows that almost all state-owned banks have more than 10,000 clients (see Appendix V, Q.19).¹⁹³ BAD is the only state-owned bank with fewer than 10,000 clients. Most new banks have fewer than 10,000 clients. The exceptions are BCIA and *El-Khalifa Bank*. Two foreign banks and the non-interest bank have between 1,000 and 10,000 clients. Other foreign and private banks have between 100 and 500 customers. *Sofinance*, a private investment bank, has fewer than

¹⁹² BAD, and BNA managers stressed that their client numbers had increased during the past ten years, and therefore the impact of interest rate liberalisation on banks' profit margins was small.

¹⁹³ The threshold of 10,000 clients is used as a reference because many of new banks that have been tested in this study have small numbers of clients, usually less than 10,000. Both institutional and private customers are also included in this sample.

100 clients. Despite state-owned banks' advantage in having many customers, their profitability has been hit negatively by mismanagement and lack of discipline.

Salaries paid by Algerian private banks and foreign banks are higher — sometimes more than double — than those of state-owned banks.¹⁹⁴ Because of this, many senior managers left state-owned banks to join the new banks.¹⁹⁵ The consequence is an increase in the salary level of bank managers. Those managers perform to reduce risks and maximise profits by accelerating the efficiency of their bank's financial operations (interview notes, 2001).

Financial liberalisation led to a decline in the profitability of some state-owned banks because of a sharp increase in interest rates and the increase in banking competition from private and foreign banks. State-owned banks also bore large losses because of poor lending decisions, mismanagement, and an increase in the amount of non-performing loans. On the other hand, the profitability of Algerian private banks and foreign banks has increased steadily because of prudent lending policies and the use of developed information technology (interview notes, 2001).

6.7. Measuring the performance of the Algiers Stock Exchange

As we have seen in Chapter 3, the stock market was non-existent during the socialist economic regime in Algeria. The state bank, *Banque Centrale d'Algérie*, was in control of financial resource mobilisation. In 1998, the financial authorities decided to

¹⁹⁴ State-owned banks pay low salaries to their workers and this has enabled them to cut their costs. The average monthly bankers' wages are less than AD15,000, equivalent to £135 (senior manager, BEA, 2001).

¹⁹⁵ There are no data available on staff turnover for selected banks.

place state-owned enterprise shares on the Algiers Stock Exchange.¹⁹⁶ However, the lack of information on developments in enterprise operations has made the evaluation of their share price difficult. The senior manager of the Algiers Stock Exchange noted that investment analysts need information about firms' earnings and dividend policies so that they can examine the movement of share prices of listed companies and thus smooth the trading of shares in the stock market.

The use of international accounting standards is relatively new in Algeria. In fact, the four quoted companies are still using traditional methods of accounting. The senior managers of the Algiers Stock Exchange noted that to comply with the market-oriented financial system, listed companies should use international accounting standards in preparing their balance sheets, profit and loss accounts, and cash flow statements (senior manager, Algiers Stock Exchange, 2001).

Regulations governing the activities of the Algiers Stock Exchange are not clear. La Porta, Lopez-De-Silanes and Vishny (1997, 1998) stressed that poor governance contributes to slow growth in the equity market and concentration in the property of listed companies. A sound legal system is required to ensure that large and small shareholders are protected; this, in turn, will boost market certainty (senior manager, Algiers Stock Exchange, 2001).¹⁹⁷

Removing regulatory barriers to the entry of foreign players boosts competition in the Algiers Stock Exchange. Increased competition between market participants also fosters discipline and financial innovation in it. Competition is a means to achieve its

¹⁹⁶ See Appendix V, Q.9 to find out the number of banks from each banking category, which operate as brokers in the Algiers Stock Exchange.

¹⁹⁷ Fairness in equity trading means that local and foreign participants are treated equally in terms of taxation and other regulatory issues.

objective of instituting an alternative mode of financing that serves domestic investors' needs and allows state-owned enterprises to recycle their portfolios in good market conditions because of increased trading (senior manager, Algiers Stock Exchange, 2001).

Usually, there are three fundamental courses of action that enable a stock market's performance to be improved. The first is to strengthen the market's legal framework. The second is to introduce modern management mechanisms. The third is to adopt three levels of control to ensure security and transparency of financial transactions. This includes the following: (i) assure that all orders are covered by IOB; (ii) examine prudential rules managing the IOB; (iii) provide guarantees to shareholders and maintain a high level of liquidity (*Société de Gestion de la Bourse des Valeurs*, 1998).

It has been stated that reducing political risk will boost equity trading in the Algiers Stock Exchange (senior manager, Algiers Stock Exchange, 2001). Reduced political risk stimulates foreign companies to issue their shares on the Algiers Stock Exchange, and the market's liquidity escalates as a result. The presence of foreign companies in the Algiers Stock Exchange would also increase market capitalisation and growth.

Individuals are unable to purchase shares at the current price because of their low income. The average Algerian working-class man had a monthly salary of AD10,000, (around £90 in 2003). The hyperinflation of the past decade contributed to fast increase in the price of goods and services. Accordingly, individuals become more concerned about covering their expenses rather than trading shares in the Algiers Stock Exchange (senior manager, Algiers Stock Exchange, 2001).

The Algiers Stock Exchange also suffers from the absence of a clear privatisation plan by the government. One financial manager at the stock exchange noted that ‘if privatisation goes ahead we will have high liquidity’. The acceleration of privatisation means an increase in the number of listed state-owned enterprises on the Algiers Stock Exchange. This boosts the trading volume on the stock exchange and consequently increases the market liquidity and recapitalisation.¹⁹⁸ Market capitalisation increases because of the rising number of shares that are traded in the market. Individuals and investors can purchase shares in various companies and generate high earnings. Perotti and Oijen (2001) noted that the public offering of shares in state-owned enterprises shares boosts liquidity and investment opportunities in the market. Successful privatisation can be achieved through sound strategy, strong commitment and a high standard of management.¹⁹⁹

Applying the “voucher” or “miracle” privatisation model, which requires changing the status of enterprises to public corporations and then selling their shares to individuals, accelerates the privatisation of state-owned enterprises (Hargis, 1998). Under this approach, the government issues special vouchers to individuals, who can exchange them for shares in public corporations through an agency called the ‘privatisation fund’. Usually, those vouchers are given free of charge to attract large numbers of citizens who expect to generate high earnings on their shares.

¹⁹⁸ The voucher privatisation programme, by transferring the assets of state-owned enterprises to employees, speeds up the process of privatisation. This method helped several transitional countries, such as Bulgaria, to accelerate the process of privatisation. Perotti and Oijen (2001) argued that gradual privatisation is the best way to build up investors’ confidence about the government’s course of action.

¹⁹⁹ There are three main phases to the privatisation of state-owned enterprises: (i) change in institutional framework; (ii) strategy and planning; and (iii) accomplishment and starting of new private enterprises.

Regular access to accounting information helps market participants to make quick decisions. The stock market database must show all market indicators: regulations, all categories of shares, number of listed companies, etc. Encouraging consistent and trusted security measures in the Algiers Stock Exchange also enhances market transparency. Additionally, high transparency helps investors analyse market trends adequately.

There are two types of share that are traded in the Algiers Stock Exchange: ordinary shares issued by joint-stock companies, and ordinary debentures issued by *Sonatrach*. However, the commercial code allows trading of two other groups of shares: paid-up shares and stock certificates.²⁰⁰ The first group includes five categories of share: ordinary shares²⁰¹, preference shares, share split²⁰², share certificate²⁰³ and certificate with voting rights. On the other hand, the commercial code authorises companies to issue four classes of debenture in the Algiers Stock Exchange: ordinary debentures²⁰⁴, non-voting debentures²⁰⁵, convertible loan stock²⁰⁶ and treasury bonds (SGBV, 1998). A variety of listed securities and stock-market-related savings products encourages investors to increase their share in the capital of listed companies.

Investors should be treated fairly during their trading of shares in the Algiers Stock Exchange. They should have full access to information about the changes in the

²⁰⁰ Paid-up shares include shares that have been paid entirely for listed firms by the shareholders. Stock certificates comprise shares that have been paid for partly by the shareholders.

²⁰¹ The holders of ordinary shares receive dividends and have a special voting right. Each share has a *par value* and the issue price is always above the *par value*.

²⁰² Shareholders have the right to purchase paid-up shares and share certificates simultaneously.

²⁰³ Shareholders receive dividends and have no special voting rights.

²⁰⁴ Ordinary debentures are issued for the long term and are secured by the assets of the company.

²⁰⁵ Debentures are secured by the assets of the company, but holders of debentures do not have voting rights.

price of listed companies' shares. Another way to boost public trust in the market is to open the stock exchange to foreign investors. Hargis (1998) noted that foreign investors have long-term experience in trading shares and other types of security. Therefore, their presence in the Algiers Stock Exchange is essential to accelerate equity trading.

The size of the stock market and its liquidity are directly correlated (Hargis, 2000). Shares usually have a market value when they are traded continuously.²⁰⁷ In markets with a few listed companies such as the Algiers Stock Exchange, the share price is highly sensitive to the demand for shares in both the short- and long-term (senior manager, Algiers Stock Exchange, 2001), whereas in markets with many quoted firms, the demand for shares is high and this has positive effects on trading volume and market liquidity (Hargis, 2000).

The value of shares offered to the public had reached AD4,200,000 by the end of 1999. The amount subscribed by the clients of BEA exceeded the quota subscribed by its shareholders: 68 per cent and 32 per cent, respectively (Boucenna, 1999). About 96 per cent of clients subscribed are shareholders of *Saïdal* and *El-Aurassi*.

Table 6.11: Subscription of shares by BEA in each capital security

		<i>Eriad Sétif</i> ' Shares	<i>Saïdal</i> ' Shares	<i>Hotel El-Auras</i> ' Shares
OPV' Global Volume		1,000,000	2,000,000	1,200,000
BEA' Quota		200,000	-	-
Amount Subscribed	Shareholders	163,524	-	-
	Clients	14,748	210,844	120,721
BEA' Quota in Percentage		17.83	10.54	10.06

Source: Boucenna, 1999

Sonatrach's debentures declined have minimally in value since their issuance at an offer price of AD109.02. This is because the company has high earnings (senior

²⁰⁶ It includes debentures, which can be converted into ordinary shares at a specific date.

manager, Algiers Stock Exchange, 2001). The company enjoys a monopoly over the oil industry, which accounted for 41.20 per cent of Algeria's GDP (IMF, 2001). The government has protected the company from both domestic and foreign competitors ever since. The public also has confidence in *Sonatrach* because of its good reputation. It has raised funds equivalent to AD12 billion from the Algiers Stock Exchange.²⁰⁸ The interest rate on debentures is 13 per cent plus 2.5 per cent as a merit bonus (COSOB Online, 2001). This is a good indicator for other large companies to issue long-term debts in the Algiers Stock Exchange.

Table 6.12: Eriad Sétif, Saïdal and El-Aurassi' financial indicators in Algerian Dinar

	<i>Eriad Sétif</i>	<i>Saïdal</i>	<i>El-Aurassi</i>
Turnover	888,725,934	20,233,740,828	4,201,749,206
Value Added	667,610,655	4,864,083,091	2,300,818,867
Cash Flow	325,663,923	2,592,199,086	623,838,348
Net Profit	174,032,289	1,598,466,612	271,109,220
Dividends per share	230	20	20
Financial profitability	12.5%	9.65%	5%
Net Profit per Share	320	29	27
Share Price / Profit	7	13.41	29

Source: COSOB Online, 2001

The volume of transactions in the Algiers Stock Exchange depends on the share price of each listed company. In fact, the demand for shares in *Saïdal* exceeds those of *El-Aurassi* and *Eriad Sétif*. The sensitivity of share price to number of transactions can be reduced if the offer for sale of each share has been fixed at an appropriate level. *Saïdal* offers higher share price/profit than the two other companies: 29 in 2001 (see Table 6.12). Another explanation is that *Saïdal* has high liquidity and value

²⁰⁷ See Hargis (2000)

²⁰⁸ It is worth noting that there is no issue of securities in foreign currencies within the Algiers Stock Exchange.

added. This makes shareholders very confident about the company's ability to pay dividends on their shares.²⁰⁹

It has also been found that the subscription to each listed company's shares differs across Algeria from one region to another. Most subscribers are from the east and the capital, Algiers (see Table 6.13). This is because the three quoted companies have most their branches based in those regions. As a result, the listing of new companies with a significant presence in the west and south of Algeria would encourage individuals in those areas to take a part in the trading of shares on the Algiers Stock Exchange.

Table 6.13: Classification of each listed company' number of shares by region

<i>Eriad</i> OPV	<i>Sétif</i>	Branch	<i>El Eulma</i> (East)	<i>Palais des Expositions</i> (Capital)	<i>Ben M'Hidi</i> (Capital)	<i>Skikda</i> (East)	<i>Msila</i> (South East)
		Number of Shares	2,150	1,806	1,689	1,601	1,127
<i>Saïdal'</i>	OPV	Branch	<i>Guelma</i> (East)	<i>Constantine</i> (East)	<i>Blida</i> (Centre)	<i>Amirouche</i> (Capital)	<i>Sétif</i> (East)
		Number of Shares	11,558	10,681	9,209	8,355	7,310
The <i>El-Aurassi'</i>	OPV	Branch	<i>Tiaret</i> (West)	<i>Amirouche</i> (Capital)	<i>Batna</i> (East)	<i>Skikda</i> (East)	<i>Blida</i> (Centre)
		Number of Shares	9,478	8,776	6,802	5,341	5,247

Source: Nourredine, 1999

In this section we have shown that the Algiers Stock Exchange is still in its infancy because of low market capitalisation, an unsound regulatory framework and delays in the privatisation of state-owned enterprises. It has been stressed that the opening of the market to private and foreign investors will result in an increased trading volume and a boost in market liquidity. On the other hand, the reduction in the price of tradeable shares will encourage individuals with medium incomes to

²⁰⁹ *Eriad Setif*, offers better dividends per share because of its high reported earnings.

invest a fraction of their savings in the Algiers Stock Exchange and thus foster market capitalisation.

5.8. Conclusion

This chapter has shown that the national banking industry has grown steadily after financial liberalisation, as reflected by the increased number of local and foreign market participants. The new players motivate state-owned banks to be conscientious in their lending to both public and private sectors. Besides, foreign banks have attracted many investors into the market, particularly European and American investors.

To face the increasing banking competition, state-owned banks have focused on developing their information technology. They have also introduced new financial products similar to those of foreign banks. On the other hand, the approach of new players to boost their market share is to expand their network, to provide first-class financial services, and to offer innovative products (see: Appendix V, Q.3). Barriers confronting state-owned banks and newly emerged banks in performing their tactics are cultural and regulatory (interview notes). Many individuals and investors have no previous knowledge of business. Poor administration and inadequate assessment of the financial situation of state-owned banks are caused by regulatory constraints.

Bank managers agree that discrimination among financial institutions has to be abandoned to boost public confidence in services offered by state-owned banks, Algerian private banks, foreign banks or non-interest banks. This suggests applying the same rules for all market participants. The financing of government projects is

subject to competition between private, state and foreign banks rather than giving the advantage to state-owned banks.

State-owned enterprises continue to accumulate large losses because of low productivity and increased competition from foreign companies after the liberalisation of foreign trade. The unit cost of state-owned enterprises is also high because of overstaffing, undeveloped equipment, poor transportation and weak internal management (interview notes). Managers stated that the rise in state-owned banks' non-performing loans cannot be stopped without changing the ownership of state-owned enterprises. The earnings of state-owned enterprises' earnings will increase after privatisation because of good internal and external management. The implementation of competitive salary schemes and discretionary payment bonuses has encouraged managers to improve their performance under private ownership.

Scarcity of capital and high lending costs have prevented entrepreneurs from engaging in large businesses. Instead, they have concentrated their activities on trade, construction and the creation of small-size enterprises. The elimination of regulatory obstacles on foreign and private banks will encourage them to fund local investors and to meet the financial needs of large enterprises.

The soaring inflation rate resulted in a sharp increase in nominal interest rates and a decline in banks' assets. However, the improvement in macroeconomic conditions has contributed to a decline in inflation rate. The result is positive real interest rates and an increase in saving rates. But this did not contribute to a rise in non-government savings because of the sizeable public sector and because of the delay in the privatisation of state-owned banks.

The interviews show that state-owned banks need commercial autonomy from the state to function effectively. To achieve this, it is indispensable to sell state-owned banks' assets to private or foreign investors. It has been also noted that step-by-step banking privatisation will contribute to better results than quick privatisation in Algeria. Usually, private ownership makes state-owned banks highly concerned about their profitability and daily expenses (bank's senior managers, 2001).

Senior managers believe that online banking is playing a minor role in the developments of the Algerian banking industry. This impression is justified by the low demand for e-banking services, the small number of Web servers, and the absence of Internet safety measures. Bankers agree that the increase in the number of Internet specialists and gradual alterations of customers' behaviour towards those instruments are the means of improving online banking in Algeria.

Financial authorities have introduced rules that allow the Algiers Stock Exchange to operate according to market mechanisms (senior manager, Algiers Stock Exchange, 2001). But the study shows that individuals are unable to engage in equity market activities because of the scarcity of capital (senior managers, the Union Bank, 2001). Banks also place a small amount of funds in the trading of shares on the Algiers Stock Exchange. Other barriers include a limited number of listed companies, underdeveloped telecommunication systems, and high country risk.

Foreign participation in the Algiers Stock Exchange is still absent. Political uncertainty and low transparency have prevented foreign investors from taking part in the trading of shares on the Algiers Stock Exchange. This has caused low confidence in the market. Consequently, senior managers in banks suggest full information

disclosure and progress toward political stability to boost market certainty and encourage foreign players to enter the market.

We have seen that the process of financial liberalisation has not yet been completed because of the absence of a clear banking privatisation plan and the small presence of foreign and private banks. Policy makers are advised to remove remaining regulatory obstacles towards emerging banks and to create a good environment for investments to avoid the negative consequences of globalisation.

In the next chapter, we present the study's conclusions and policy recommendations. These research recommendations are aimed at helping the Algerian government better restructure the banking sector and stock market, and to fully benefit from the outcomes of globalisation. The method used in understanding the needs of the modern Algerian financial market is based on this study's analyses and the experience of other countries, which have successfully implemented the programme of financial liberalisation.

Chapter 7:

CONCLUSIONS

7.1. The applications of the study

The study presented is an analysis of the changes incurred in the Algerian banking industry and stock market because of the globalisation of financial services. It is argued that this phenomenon of globalisation is being mainly caused by financial liberalisation, financial innovations and the Internet. The analyses show the impact of these three factors on banking competition, profitability and efficiency. It also examines the response of different banking categories to the removal of regulatory and technological constraints on their activities.

Building on Shaw and McKinnon (1973) and Jbili *et al* (1997), this study used quantitative and qualitative research methods to assess the Algerian experience of financial sector reforms. The Algerian government's financial liberalisation plan included four major measures. First, the government has gradually withdrawn from the financial sector. Second, many restrictions on state-owned banks have been removed since the introduction of financial liberalisation. Third, private investors were given the right to own financial institutions. Finally, the national financial market has been opened to foreign banks. The aim of the financial liberalisation was to establish a market-oriented financial system that serves the needs of the Algerian economy and to develop the role of stock market in the mobilisation of financial resources.

Moving from a centrally planned to a market-oriented economy meant fewer regulatory barriers towards local and foreign banks. Before the financial reforms, the government was the main investor in the national economy. Priority sectors also received generous subsidisation from the state. The excessive control on trade and foreign exchange made the public sector grow faster than the private sector. Regulatory constraints, which were used to protect the national banking sector from foreign interests, took the form of high reserve requirements, capital movement restrictions and administratively set interest rates. The role of the entire financial sector was to receive public savings and to use the collected funds to finance state-owned enterprises and government expenditures.

Financial sector reform is a process, which starts with the liberalisation of interest rates, the launch of market-based monetary policy instruments and the creation of a sound banking supervision. Policies to develop equity markets and non-banking institutions are also part of the financial reforms. The speed of reforms depends on the strength of the domestic financial system as well as the effectiveness of banking supervision.

The study unambiguously confirms the argument expressed by Jbili *et al* (1997) that the launch of market-based monetary policy instruments was not supported by further measures to enhance the role of the money market (see Chapter 2 and 6). The introduction of clearing and settlement systems and other means that facilitate the trading within the money market is still not completed and needs to be reinforced. Setting up rules that regulate risk concentration, identifying provisions for bad debts

and loan classifications and increasing market transparency would also enable individuals and investors to assess the financial position of market participants.

Authorities introduced market-based financial instruments to finance the state budget and maintain fiscal sustainability. They have also created market-based mechanisms of monetary policy to manage liquidity more effectively. However, as shown in this study, a stable macroeconomic environment in Algeria is influenced by the growth in oil exports rather than by the sequence of financial reforms. Jbili *et al* (1997) also found that almost all macroeconomic financial variables had no impact on non-government savings after the reforms.

Macroeconomic data show that a high inflation rate and fiscal imbalances make economic growth less sensitive to financial sector reforms. In this study we found that sustainable fiscal balances and a low inflation rate are tools to avoid negative real interest rates, to make financial variables more informative and to reduce the risk involved in holding financial assets (see Chapter 6). Jbili *et al* (1997) said that financial sector reform needs to be implemented even in bad macroeconomic conditions as this may improve economic stability within the long term.

7.2. What is learned and policy recommendations

7.2.1. The determinants of the globalisation of financial services

The results show that financial liberalisation, financial innovations and the Internet are the main driving forces of the globalisation of financial services in Algeria. The three factors facilitate Algerian integration with global financial markets, although not exactly with the same scope. Financial liberalisation is the main force that drives the

phenomenon of globalisation of financial services followed by financial innovations and the Internet. By incorporating this fact into the research model, the study finds that financial liberalisation removed many constraints imposed on capital movements and opened the market to foreign banks. The capital account was also liberalised by the closing stages of the reforms to ensure the stability of the market. Moreover, the treasury gradually withdrew from directly financing the national economy and the central bank was given the full authority to manage the banking sector (see Chapter 3). The auction system was instituted to facilitate repurchase contracts in the interbank and money markets. Nevertheless, the underdeveloped secondary market for trading government papers has hindered the efforts to improve market liquidity.

Financial innovations are attributed to the increase in banking competition and to the decline in transactions costs. Financial institutions have responded to the increase in the demand for financial services by introducing new financial instruments. Those products are used for different purposes, including hedging against market risks, attracting new customers, cutting costs and escaping domestic regulations. The increase in the range of financial products has encouraged investors to purchase more banking services. This study suggests that the characteristics of emerged financial instruments are to be acceptable to the recipient financial markets. Foreign banks offer basic and sophisticated financial products to attract private and foreign investors. But exceptions are made for individuals with low and middle incomes because of uncertainty that is associated with their activities.

The Internet has played only a minimal part in the globalisation of financial services in Algeria. There are few Internet providers in Algeria and individuals have

no interest in purchasing online banking products because of lack of knowledge about e-banking and uncertainty about the safety of the system itself. However, the Internet gives various advantages to its providers. It allows banks to penetrate and link all markets without a need for a physical presence in the host country. It also enables banks to reduce the costs of delivering their financial products. To the extent that individuals are not well notified about the use of new technological tools, banks are advised to set up informative services within their branches, send full information back to their customers or publicise their new products through mass media channels. Investing in the telecommunication sector would result in an increase in the number of Internet providers. Setting up personal access codes and placing pictures of each user in his Web site could also improve the security of online banking.

7.2.2. State-owned banks

The results indicate that the gradual withdrawal of the government from the banking sector would improve the lending decisions of state-owned banks and reduce their losses. This can be achieved by selling the assets of state-owned banks to foreign and private investors. However, as Abarbanell and Bonin (1997) suggested, bidders have to state clearly their short- and long-term investment plans, the number of shares they are willing to purchase, and the time period for which they intend to hold those shares.

As far as banking recapitalisation is concerned, the study supports the argument of using government bonds to eliminate the non-performing loans. Bonds are to be repaid by adopting external debt rearrangement or by issuing a loan-bond swap. The accumulation of bad debts, however, cannot be stopped without ending the relationship between the government and state-owned banks as well as between state-

owned banks and state-owned enterprises. Moreover, the study recommends eliminating short-term debts before the medium- and long-term ones. This implies allocating banking credit and asset pricing in accordance with market mechanisms when the process of banking recapitalisation is completed.

Respondents stressed that state-owned banks' funds are largely used in financing the projects of state-owned enterprises. The fear of social conflict made authorities reluctant to privatise state-owned banks. Senior managers also believe that the economic performance of state-owned enterprises has deteriorated since the initiation of financial liberalisation, because of mismanagement and bureaucracy inherited from the former economic regime. The financed projects yield low earnings due to lack of investment strategy and inadequate business plans.

The obligatory holding of government papers and the underdeveloped equity market resulted in scarcity of capital. This has prevented state-owned banks from granting long-term loans. The annual reports of banks show that short- and medium-term loans still account for the largest proportion of their credit, to either public or private sectors. Interviewees emphasised that the state does not guarantee the loans extended to state-owned enterprises, except those included under the category of priority sectors, such as the food industry.

The return from financial projects is low because of lack of investment strategy by entrepreneurs. Adopting a good approach to borrowing would allow state-owned banks to reduce the volume of non-performing loans, which are often incurred because banks are not well informed about borrowers' ability to repay their debts. Banks are required to examine and understand the exposures that confront them in

each sector they finance. Moreover, a developed information system would facilitate the flow of financial information between state-owned banks and their borrowers, enabling them to make good investment decisions.

The state is planning to withdraw from the banking sector when the process of recapitalisation is completed. Under the new scheme of credit allocations, it is suggested that banks create advisory departments to help entrepreneurs invest in less risky projects and increase the number of business opportunities that are available for them. This will reduce the amount of public funds kept outside the national financial market because of the increase in the saving rate.

State-owned banks are urged to develop their payment system to enhance trust among individuals and investors in using the banking system for channelling their funds. Depositors should be allowed to withdraw their funds 24 hours a day, 7 days a week, as in developed countries. This is to be achieved by increasing the number of automated teller machines and making large stores accept credit cards as a means of payment.

It has been found that the delivery system used by state-owned banks is poor. The structure of the banking network shows that there are few branches in large cities and municipalities. The consequence is many inhabitants per branch. Therefore, we suggest increasing the banking network in regions where banks are less of a presence. The increase in the banking network would stimulate individuals to have their savings placed in the banking sector. It is also essential to increase the range of financial products that are available for savers in the branch. Additionally, using a

computerised payment system in the branch would quicken the financial transactions and thus boost public savings.

State-owned enterprises, which receive the largest portion of banks' loans, are experiencing the problem of poor productivity. This has contributed to an increase in the credit risk bore on loans granted to those enterprises. The private sector still receives a small amount of credit from the state-owned banks. This cannot be eliminated without giving more autonomy to state-owned banks in their financing of private and public enterprises.

The removal of non-performing loans from the state-owned banks' balance sheet has not been completed because the amount injected into those banks is far below the total bad debts. Many new borrowers are unable to service their debts regularly. Therefore, we recommend being cautious in lending to less experienced investors. The debt recovery services need to be in place through a strong legal system in case borrowers fail to meet their debt obligations, as stated in the agreement between investors and state-owned banks.

It has been found that the credit assessment used by state-owned banks is poor. Respondents stressed that banks are not frequently informed about the financial position of their borrowers leading to high risk of default. Accordingly, we recommend strengthening the relationship between state-owned banks and their clients. Managers also need to develop their investment evaluation skills, through training, to be in a position to examine the financial information provided by borrowers thoroughly.

The actual social cost of state-owned privatisation is high because of overstaffing. There is overwhelming support for the fact that privatisation makes many bankers lose their jobs and therefore forces banks to pay a large amount of redundancy. State-owned banks also need large investment in new technologies and instant removal of existing bad debts to be attractive to private and foreign investors. The elimination of non-performing loans would require the issuance of additional long-term bonds and the repayment of those bonds through external debt rearrangement.

Senior managers believe that banking privatisation would develop the current payment system leading to an increase in public savings and private investments. New owners have the expertise to improve the lending and borrowing policies of privatised banks, by introducing new financial products and by investing heavily in sophisticated technologies such as those of electronic banking. State-owned banks would consider the creditworthiness of the project financed, when they become privatised, rather than granting credit to priority sectors of the national economy without particular assessment of their productivity.

It has been stressed that selling the assets of state-owned banks at a low price using the shock-therapy privatisation programme would facilitate the process of finding private or foreign bidders. The experience of Hungary shows that the new owners assist the privatised banks to improve the quality of their portfolios, to strengthen their financial position and to boost their cost-effectiveness (Bonin and Wachtel, 1999). This has accelerated the output level of banks over recent years. Foreign investors showed their capabilities in developing the information technology of privatised banks and also in alleviating the bad debts from their balance sheet.

However, the survey shows that a ‘big bang’ banking privatisation would not be the appropriate option of selling the assets of state-owned banks to private investors in Algeria, for two main reasons. First, the process of banking recapitalisation has not been completed, as state-owned banks continue to accumulate large amounts of bad debts. Second, the political climate is not in favour of such mass privatisation because of fear of large job losses. Therefore, technical assistance from the IMF and the World Bank is required to help the Algerian government accomplish a successful programme of banking privatisation. Such assistance should include finalising the banking recapitalisation and selecting a suitable privatisation plan.

The existing scheme of state-owned enterprise privatisation provides various facilities to investors willing to buy their assets. The incentives are in the form of tax exemptions and the setting up of investment agencies that offer technical support to the new owners of state-owned enterprises. In addition, new legislations governing their equity management is in place, and the government ended all forms of subsidisation to enterprises sold to private investors or employees. However, the debt burden of the remaining state-owned enterprises constitutes an obstacle towards selling their assets to foreign and private investors. Therefore, we recommend cleaning the balance sheet of state-owned enterprises of bad debts as this would facilitate the finding of private bidders.

There is a positive correlation between the activities of state-owned banks and their market share in Algeria. The high specialisation within the banking industry needs to be tackled by removing the inhibitory obstacles on lending and borrowings. State-owned banks would boost their earnings if they are given more autonomy in financing

different sectors of the national economy. On the other hand, the relationship between the collected financial resources and banks' market share is negative. Individuals' annual income and their consumption are the two factors that directly influence public savings in Algeria. This study suggests a new scheme for small savings in the form of current accounts, but with payment of a small rate of interest, similar to those in the UK or Sweden. The scheme allows small savers to have permanent access to their funds and to benefit from an overdraft facility. It is also recommended to strengthen the link between banking networks through the use of computer systems to enable savers to have access to their funds without the need to travel long distances. Likewise, banks need to be aware of the current developments within the national economy and to take into account the social characteristics of Algeria to succeed in attracting large amounts of savings.

As we noted in chapter 6, problems associated with the mortgage market include unclear property possession, limited mortgage products, high inflation rate and absence of guarantees by home seekers. The mortgage market needs to be opened to foreign and private banks to raise additional capital for dwellings and to launch new mortgage solutions. Another way to raise funds is by listing companies that specialise in constructions on the Algiers Stock Exchange. Clear rules managing the property market also need to be in place to strengthen the relationship between households and mortgage providers.

State-owned banks have realised the threat they are facing because of the entry of reputable foreign banks. Interviewees noted that new financial products are developed to meet the needs of market economy. Additionally, advanced risk assessment

methods are in place to improve the quality of their portfolios. Many of funds are also invested in the modernisation of the payment system. Despite all of these efforts, the quality of their services remains poor compared with those of foreign banks, because of a problem of misgoverning, which resulted in misallocation of financial resources.

In general, alleviating regulatory barriers has enabled state-owned banks to increase their outputs and to select trustworthy borrowers. Banks have also used the advances in information technologies to reduce their operating expenses. However, the amount invested by state-owned banks in new technologies is still small compared with those of foreign banks.

7.2.3. Algerian private banks

The second category of banks included in this study is the Algerian private banks. Their senior managers pointed out that the amount of funds available to the newly established banks is limited. They are mainly relying on shareholders' funds to meet the financial needs of their clients, which are in most cases small businesses and international trade. The result is restrictions in their lending to large and long-term investments.

Private banks need to take a long-term view to establish themselves as major financial institutions capable of meeting the demand of different groups of customers. They are advised to offer a vast range of financial services and to strengthen their relationship with their existing clients. It is also proposed to notify individuals and investors about the characteristics of the newly created financial products. This would accelerate the demand for private banks' services and the yield on their investments.

The *Sofinance* business plan can be used as an example by other private banks in selecting their projects (see Chapter 6). Sharing information between private banks would result in high transparency, and thus a decline in the credit risk facing them in investing in industrial sectors. It has also been suggested that an internal audit department be at every bank to assure the best use of shareholders' and savers' funds.

Merger and acquisition is required between private banks to boost their credit potential. Consolidation is another method that allows banks to fund large projects and take high risk in their financing of different sectors of the national economy. The increased asset size of consolidated banks and diversification of personal risks would improve the operating performance of private banks, allowing them to be competitive in the market.

Respondents stressed that the Algerian financial market benefited enormously from the activities of the newly established private banks. The survey shows that private banks are involved in setting up small private business and in strengthening Algeria's relations with its foreign partners. They offer various advisory services and participate in the privatisation programme of state-owned enterprises. It is believed that co-operation between private and foreign banks would attract foreign investments into Algeria.

The increase in the efficiency of private banks was attributed to recent developments in information technology and staff training. It has been emphasised that computer systems have allowed banks to cut their costs and to increase their output levels. Staff training has also resulted in an increase in managers' awareness

and skills of modern banking. This made managers participate effectively in the short- and long-term strategic plans of the Algerian private banks.

7.2.4. Foreign banks

In this study we have also focused on the role of foreign banks in the process of reforms. It has been noted that the business plan of the foreign banks in Algeria is to finance large foreign companies, especially those operating in the oil fields. However, a small amount of their funds is used to meet the financial needs of medium-size private enterprises. The method followed by foreign banks to increase their market share is to offer a vast range of innovative financial products. Senior managers agree that the advisory services provided by foreign banks outperform those of local banks. The survey also shows that the response of foreign investors to those products is high.

Foreign banks offer basic financial products in their early years of entry to Algeria. But, because of the steady increase in the demand for their services, foreign banks have broadened the scale of their businesses in the national market. It has been noted that initiating clear rules for managing financial transactions would stimulate existing foreign banks to strengthen their presence in the national financial market. Domestic investors are also to be informed on how to use the newly created financial products, such as those related to commercial finance and electronic banking.

The political and economic assessments are conducted by foreign banks before their entry into the national market. Foreign banks also examine the financial rules and the behaviour of domestic investors as part of their assessment plan. Besides, foreign banks take into account the market potential of Algeria by using the A–E

system. This system shows that unemployment and high political risk are the two major problems encountered by Algeria in the past two decades.

At micro-level, foreign banks offer competitive lending and borrowings rates.²¹⁰ They have also increased the number of their branches in the main cities and near oil fields. Local investors are asked to give full guarantees on the extended loans and to provide comprehensive reports on how the funds are to be used. Loans are only granted to reputable local companies, those with strong financial positions. The currency and liquidity risks are considered by foreign banks until the loan is fully repaid by the investor. Domestic banks are advised to take this example of foreign banks into their future business plans to improve the quality of their portfolios.

Senior managers of foreign banks noted that the demand for their services is high by both foreign and local investors. This has been reflected by the steady increase in their market share during the past five years.²¹¹ Their clients have access to sophisticated financial products and also benefit from the large facilities offered at foreign banks' branches, including cash dispensers and telephone banking.

The human resources management plan of foreign banks includes employing local staff as they have the advantage of speaking the local languages. This is adopted to strengthen the relationship with their clients. However, it has been noted that the cost of employing local staff is high when they first start their job at foreign banks, as most of them need training on the use of new technologies, and to be familiar with various modern financial products.

²¹⁰ The wide interest rate margin during the early years of financial liberalisation helped foreign and domestic banks generate high earnings. Nevertheless, the sharp decrease in inflation rate and macroeconomic stabilisation led to decline in the spread between lending and borrowing rates starting from 1997.

²¹¹ Refer to the Appendix V

Interviewees stressed that foreign banks have encouraged domestic banks to improve the quality of their services. For instance, state-owned banks have increased the number of financial products offered to their customers as a precaution to protect their market share. Foreign banks also participate indirectly in promoting the image of Algeria abroad and thus attract foreign direct investments into the domestic market.

As we noted in Chapter 6, efficiency of foreign banks increased because of two main factors: (i) low level of inputs; and (ii) high return on their borrowings. Their high standard lending strategy has enabled them to avoid financing low-performing projects. The underdeveloped telecommunication system, however, undermined their efforts to cut their costs to minimum levels with advanced technological tools. Foreign banks are also not allowed to receive public savings, making them reliant on their own funds in financing private and foreign projects.

Statistical data have shown that foreign banks have low overhead expenses in Algeria because of their small number of branches and working staff. This has allowed them to reduce their operating expenses and boost their profit margin. These findings, however, do not endorse the argument of Demirgüç-Kunt and Huizinga (1998) that foreign banks have high overhead costs when they invest abroad. The assets of foreign banks are also negatively correlated with the national income as foreign companies constitute most of their customers in Algeria. Respondents pointed out that the increase in capital productivity has enabled foreign banks to boost the return on their assets. It has been emphasised that low overhead costs and tax payments combined with a high interest margin have accelerated foreign banks profit. These factors also made other foreign banks willing to invest in Algeria.

7.2.5. The non-interest bank

The sole non-interest bank, *El-Baraka* Bank, offers a limited number of financial products, and most of them are used in short-term financing. Trade remains the favourite sector financed by the non-interest bank with 87 per cent of the total loans. The bank keeps large amounts of provision for loans granted under the *murabaha* contract. This implies diversifying the portfolio of *El-Baraka* Bank into other sectors of the national economy, such as agriculture and small industries, to reduce the level of credit risk and boost its earning outside *murabaha* and leasing contracts.

Unlike interest banks, the profit earned by *El-Baraka* Bank is shared with entrepreneurs and the savers, in accordance to the duration and the amount of deposits allocated to the project. If the project yields negative returns, depositors will lose part of their saved funds. Therefore, the bank is asked to choose low-risk projects to satisfy its clients. The survey clearly shows that the main concern of the non-interest bank is to improve personal contact with its customers. The bank's business plan also includes offering new products, opening of new branches and expanding its business in foreign markets. Senior managers stressed that the bank has to offer services that comply with Islamic financial principles only to boost customers' confidence in its products. Senior managers are confident that the public is interested in buying Islamic financial products. This has been reflected by the rise in the number of *El-Baraka* Bank clients over the past decade.

The bank has implemented various organisation reforms to improve the quality of its services. Financially, the bank offers full guarantees to deposits held in current and

investment accounts. Entrepreneurs are also obliged to produce interim reports to maintain high transparency within the bank. We have endorsed the argument of using international accounting standards in banks' information disclosures. By doing so, the bank would attract more investors and meet depositors' demands of ensuring the best use of their funds.

For better distribution of profit *El-Baraka* Bank is advised to move from the traditional accounting system to the use of international accounting standards.²¹² The bank would also benefit if it were to consider the current developments in Islamic banking about the acceptance of newly created financial products. There is evidence that some conventional financial products may fulfil the needs of Islamic investors without infringing the *sharia* rules. This is to be obtained by removing the interest rate and replacing it with a profit and loss sharing mode of financing. A regulatory framework for an Islamic banking model needs to be in place to ensure the best use of *El-Baraka* Bank financial resources. The bank must also work on developing financial products geared towards long-term financing. In our opinion, it is essential to learn from the experience of other Islamic banks who are already well established in other markets such as those in Egypt and Bahrain.

This study found that there are limited Islamic financial products available to individuals and investors. Moreover, most of the existing financial instruments are used in financing short-term investments and commerce. Islamic investors cannot trade most securities because of the religious prohibitions against speculation and the high volatility of stock market prices. It is essential to have comprehensive financial

²¹² Similar changes in procedures have been undertaken by large Islamic banks, such as *Faisal* Islamic Bank of Egypt and Dubai Islamic Bank.

guidelines from the *sharia* board to determine if the product is *halal* (permitted) or *haram* (forbidden) under Islamic rules. The harmonisation of rules that govern Islamic banking helps non-interest banks effectively manage their assets and liabilities. Implementing single supervisory guidelines and setting explicit accounting standards would improve market transparency and enhance the presence of non-interest banks in foreign markets.

7.2.6. Banking competition

As we have stressed throughout the thesis, the main aim of financial liberalisation is to boost banking competition. The study has shown that the competition of state-owned banks with other banking categories is restrained. They still have the monopoly in financing state-owned enterprises and government projects even after the financial liberalisation. Private and foreign banks are only competing in funding non-state enterprises. Therefore, we suggest opening the public sector to foreign and private participations. This would result in a decline in the cost of borrowing as foreign banks have access to international financial markets.

The study confirms some earlier findings in the literature on the liberalisation of interest rates. The nominal interest rates rose sharply during the early years of financial liberalisation, because of a high inflation rate and deterioration in macroeconomic indicators. In this vein, the negative real interest rate has contributed to a decline in the profit margin of state-owned banks. The study stresses that the improvement in macroeconomic indicators and the decline in the rediscount rate are behind the increase in real deposit and lending rates.

It has been found that the interest rate is positively correlated with macroeconomic indicators such as inflation rather than microeconomic variables. The sharp increase in the inflation rate has contributed to negative real interest rates, especially in the early years of financial liberalisation. Nevertheless, the rate of inflation has declined since 1997 to reach its lowest level in 2001, 1.2 per cent. As a result, the real interest rate becomes positive on both lending and borrowings.

The number of banks operating in Algeria has increased by threefold since the initiation of financial liberalisation. This has been attributed to the delay in the privatisation of state-owned banks and the increase in the newly established private banks. State-owned banks have responded to the increase in the number of private and foreign banks by improving their personal contact with their customers and by developing their payment system. But the statistical data still show a steady decline in the market share of the state-owned bank.

One of the benefits of increased banking competition is the emergence of sophisticated financial products, which have been introduced by private and foreign banks. State-owned banks also moved into other methods of financing such as micro-credit. In addition, an Islamic mode of financing has been launched for the first time in Algeria by the non-interest bank. It is believed among senior managers that opening the market for other non-interest banks would boost competition for Islamic financial products.

Private banks are restricted by the present financial rules from receiving public funds and involvement in various banking activities. Interviewees agree that by relaxing financial rules private banks become more effective in their lending and

borrowings. Financial authorities are advised to become involved indirectly in providing the technical assistance and in helping private banks reinforce their relationship with foreign financial institutions.

The number of depositors and borrowers leaving state-owned banks to join private and foreign banks has accelerated in the past five years. There is evidence that the quality of services offered by new players is surpassing those of state-owned banks, both in the speed of transactions and the risks associated with investments. In addition, depositors receive higher return with emerged banks than with state-owned banks.

Banks face various obstacles during their operations in Algeria: market uncertainty, high country risk and investors lack of business experience. To tackle these problems the banks need to consolidate and exchange information among them. The non-interest bank also finds various problems in raising funds from the money market because the same rules are applied for conventional and Islamic banks. Financial authorities must introduce a parallel scheme of dealing in the money market that does not violate Islamic financial principles.

Financial authorities focused on removing lending restrictions, bringing banking specialisation to an end and opening the capital of local banks to foreign investors. The domiciliation imposed on certain banks was eliminated and banks are now allowed to engage in various financial activities. Jbili *et al* (1997) noted that the low level of banking competition in Algeria is attributed to high banking specialisation and the small number of banks. This study further states that state-owned banks still have more facilities than other banking groups in terms of receiving public savings and lending to state-owned enterprises. Algerian private banks have insufficient funds

to finance large projects. Policy makers can find another method to boost competition for deposits. This is by allowing newly established banks to receive public savings. Without this prerequisite, the scarcity of capital would continue and thus reduce the volume of investments in the national economy.

7.2.7. Banking profitability

The decline in the claims on public and private enterprises has caused a decrease in the value of state-owned banks' assets. The increase in the inflation rate is another reason for the drop in the value of state-owned banks' assets. It is also found that reserves and foreign assets account for a small portion of state-owned banks' assets. Liabilities of state-owned banks are dominated by time and savings deposits, demand deposits and credit from the central bank.

The decline in the profitability of some of the state-owned banks is attributed to interest rate liberalisation, non-performing loans, elimination of subsidisation and disappearance of many state-owned enterprises. The saving rates rose sharply in the early years of financial liberalisation and the cost of refinancing becomes higher than the return earned from their assets. The increase in refinancing rates followed a rise in the use of overdraft facilities. The acceleration in the inflation rate has also led to a decline in the value of state-owned banks' assets from 1990 to 1998 (see Chapter 6).

The survey shows that the lending policy and the type of operations are the two determinants of banking profitability in Algeria. Banks dealing with private and foreign companies achieved high profit margins compared with those that finance state-owned enterprises. A good auditing system is a means to control the use of funds

by local banks and thus reduce their losses from non-performing loans. Another method to boost banking earnings is by expanding the network and improving the quality of the current services.

In this study we found that the net profit of state-owned banks declined in the early years of interest rate liberalisation, as the real lending rate soared, leaving state-owned enterprises unable to service their debts. However, the sudden decline in the inflation rate has made real lending rates positive, and in the meantime has enabled borrowers to meet their financial obligations. The consequence is an increase in the return on banks' assets as well as net profit.

Another factor that drives banks' profitability is the amount of deposits held in their accounts. There is evidence that state-owned banks have more depositors than private or foreign banks. But new market participants have achieved higher net profits than those of state-owned banks, which are burdened by sizeable non-performing loans and bureaucracy.

As we have seen, many highly positioned managers left state-owned banks to join private or foreign banks, because of the differences in the amount of salaries paid by each banking group. Therefore, we recommend that state-owned banks increase their salary scale and improve the working conditions within their branches to avoid the flow of more highly skilled staff into the new market participants.

7.2.8. Electronic banking in Algeria

In this study we have considered the role of the Internet in the ongoing modernisation of the Algerian banking industry. Senior managers pointed out that administration

charges for online banking are negligible, except for development costs such as Web design. This implies developing banks' Web sites to ensure the safety of banking users from errors in data input and hackers. The Kuwaiti experience shows that the firewall system is an effective tool to protect users of online banking. However, customers of online banking services should be asked to pay an annual rate for insurance against Internet-related banking problems.

The analysis of electronic banking in Algeria indicates that almost all existing banks have their own Web site on the Internet. But, we pointed out that the Web sites are used primarily for publicity purposes. Citibank is the only provider offering a full package of electronic financial services in Algeria. The survey shows that the response to its online services is high by both local and foreign investors. But, some of the users of online banking take time to make their orders through the Internet. A more simplified structure of online banking would result in an increase in the demand for financial products offered through Internet channels.

Interviews with senior managers have shown that the Internet helps banks cut their costs and enhance their competitiveness in the market. Operating expenses are reduced to minimum levels when banks use the Internet as the delivery channel. However, the Internet is less secure than other delivery channels such as the branch, where an instant check of financial records is available. Domestic investors also have little experience in conducting financial transactions by the Internet. Moreover, Algeria has few Internet servers, and banks' Web sites are not designed in a way that allows depositors access to their own accounts. All these led to low demand for Internet banking services in the Algerian financial market. In our view, foreign

companies should be invited to improve the Internet infrastructure and its safety measures. Joint ventures can also be established between local and foreign telecommunication companies in re-engineering electronic banking. Collaboration between those firms and banks would facilitate the process of modernising electronic banking in Algeria. In addition to this, clear rules managing online banking need to be in place to boost transparency and confidence in the market. Policy makers are asked to set up a platform for reforming e-commerce and invite foreign computer experts to develop electronic banking. Incentives from banks' senior managers are necessary to convince the government to invest in Internet technologies.

7.2.9. The Algiers Stock Exchange

In this study we have also examined the performance of the Algiers Stock Exchange and its role in the mobilisation of financial resources. We have found that lack of transparency has prevented stock market dealers from evaluating the change in the shares prices. Shareholders need data on the earnings and dividend policies of quoted companies to make their decisions on buying or selling of shares. The stock market should provide price formation mechanisms and publication of trade data to boost public confidence in equity trading. It is also suggested to use international accounting standards in preparing financial statements to enable comparison between listed companies.

Regulatory bodies are advised to set up clear rules on how the market is governed to limit concentration of equity trading. Large and small investors should be treated equally to improve market certainty. The database on equity trading must provide

information on types of share, volume of trading by listed companies and settlement of transactions. These would help investors decide on holding additional shares or selling existing ones. The continuous trading of shares would result in an increase in the market liquidity as shares are given a market value.

Opening the Algiers Stock Exchange to foreign investors is a means to develop sophisticated financial products as competition intensifies between quoted companies. The increase in the number of securities available within the stock market would encourage investors to increase their stake in the capital of quoted companies. Other outcomes of foreign companies listing are: (i) strengthening the market's legal framework; (ii) bringing first-class managerial tools; and (iii) increasing the market capitalisation and growth.

The survey shows that the quoted companies' share price, earnings and reputation are the main drivers of equity trading in the Algiers Stock Exchange. We argued that the high-priced shares caused negative effects on the trading volume. Individuals cannot afford trading in shares because of their minimum wage, USD100. The price of housing and similar assets soared during the 1990s because of a high inflation rate meaning that individuals with low incomes cannot even meet their daily expenses. The listing of new companies would attract capital investments and promote equity trading among individuals with low incomes.

Another obstacle facing stock market developments is the delay in the privatisation of large state-owned enterprises and banks. We argued that the stock market could be used as a means to accelerate the privatisation of state-owned enterprises. This would attract more investors into the market and thus boost the trading volume of shares.

Moreover, the rise in market liquidity, as a result of high demand for shares, would encourage other companies to go public. We also emphasised that particular attention should be paid to management and planning of state-owned enterprises before transferring them into public corporations.

7.3. Summary and future research

This study showed that globalisation of financial services has more advantages than disadvantages to the Algerian banking industry and stock market. Many barriers were removed on domestic and foreign banks under the process of financial liberalisation. Foreign banks entering Algeria have provided various benefits to the modernisation of the national banking sector. This is particularly shown by innovative financial products being launched by foreign banks in the past five years. Globalisation of financial services has enabled state-owned banks to benefit from the transition from the centrally planned economy to a market-oriented one. Forms of control including credit ceiling and administratively set interest rates have all been removed. This has allowed state-owned banks to diversify their portfolios and improve the quality of their services.

This study points to other areas of possible research. First, an analysis of the effects of globalisation of financial services on Algerian non-banking institutions, particularly insurance companies and pension funds. Second, an examination of how globalisation is changing the structure of the central bank in Algeria and other transitional economies. Third, an analysis of the changes in the pricing of Islamic financial products. This study will provide an inspiration for other scholars to explore these topics with in-depth analyses.

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APPENDIX I

List of banks operation in Algeria

Commercial Banks "Banque Commerciale"	Al Ryan Bank
	Arab Bank
	Arab Banking Corporation
	<i>Banque Al Baraka Algérie</i>
	<i>Banque Commerciale et Industrielle d'Algérie</i>
	<i>Banque de Developpement Local</i>
	<i>Banque de l'Agriculture se du Developpement Rural</i>
	<i>Banque Extérieure d'Algérie</i>
	<i>Banque Generale Mediterranéen</i>
	BNP / Paribas
	<i>Caisse Nationale d'Algérie</i>
	<i>Caisse Nationale d'Epargne et de Prévoyance</i>
	<i>Caisse Nationale de Mutualité Agricole</i>
	Citibank of Algeria
	<i>Companie Algérienne de Banques</i>
	<i>Crédit Populaire d'Algérie</i>
<i>Khalifa Bank</i>	
<i>Natexis Amana Banque</i>	
<i>Société Générale d'Algérie</i>	
Financial Institutions with a General Vocation " Etablissement Financiers a Vocation Generale"	Algerian International Bank
	<i>El Mouna Bank</i>
	<i>Sofinance</i>
	Algerian International Bank
Financial Institutions with a Specific Vocation " Etablissement Financiers a Vocation Specific"	ALEM
	<i>Banque Algérienne de Développement</i>
	<i>Finalep</i>
	<i>Société de Refinancement Hypotecaire</i>
Representatives "Bureaux de liaison"	<i>El Mouna Bank</i>
	<i>Credit Lyonnais</i>
	<i>Société Générale</i>

Source: Bank of Algeria (2003)

APPENDIX II

El-Baraka Bank' selected financial ratios

	1997	1998	1999	2000	2001	2002	2003
<u>Cash</u> Total Assets	1.10%	0.54%	1.59%	1.39%	na	22.19%	17.03%
<u>Net Profit Before Tax</u> Total Assets	1.74%	1.66%	2.11%	1.08%	na	1.25%	1.21%
<u>Total Revenue</u> Total Assets	9.62%	8.12%	8.29%	7.06%	na	6.06%	7.05%
<u>Total Deposits</u> Total Assets	61.07%	49.25%	45.60%	46.11%	na	53.11%	55.91%
<u>Net Profit After Tax</u> Equity Capital	27.91%	33.00%	40.69%	24.45%	na	16.43%	14.19%
<u>Cash and Net Banks' Due</u> Total Deposits	7.64%	12.44%	14.95%	25.12%	na	22.53%	30.38%
<u>Cash and Net Bank' Due</u> Current Deposits	26.09%	34.98%	42.16%	68.07%	na	32.07%	39.68%

Source: El-Baraka Bank Annual Reports

APPENDIX III

Algeria: Expansion of Banks' Network, 1996-2002

	1996	1997	1998	1999	2000	2001	2002
Bank of Algeria	49	49	49	49	49	49	49
Bank <i>El Baraka</i>	5	5	5	5	5	8	8
<i>Banque de l'Agriculture et du Développement Rural</i>	303	305	307	305	305	315	317
<i>Banque de Développement Local</i>	168	168	164	170	152	170	170
<i>Banque Extérieure d'Algérie</i>	73	74	74	74	74	76	76
<i>Banque Nationale d'Algérie</i>	162	183	187	181	182	189	190
<i>Crédit Populaire d'Algérie</i>	121	133	134	135	119	135	135
<i>Caisse Nationale d'Épargne et de Prévoyance</i>	174	174	180	185	185	185	187
Union Bank	1	1	1	1	1	1	1
<i>El-khalifa Bank</i>	0	0	5	5	24	24	60
<i>Mouna Bank</i>	0	0	1	1	1	1	1
<i>Société de Refinancement Hypothécaire</i>	0	0	1	1	1	1	1
<i>Banque Commercial et Industrielle d'Algérie</i>	0	0	1	1	12	12	24
Citibank	0	0	1	1	1	1	4
<i>Companie Algérienne de Banque</i>	0	0	0	1	4	4	9
Arab Banking Corporation	0	0	0	1	1	1	4
<i>Société Générale</i>	0	0	0	1	1	2	4
<i>Natexis El Amana Bank</i>	0	0	0	0	1	1	1
Algerian International Bank	0	0	0	0	1	1	1
<i>Al Rayan Algerian Bank</i>	0	0	0	0	1	1	1
Arab Bank	0	0	0	0	0	1	1
BNP Paribas El-Djazair	0	0	0	0	0	1	1
<i>Banque Générale Méditerranéenne</i>	0	0	0	0	0	1	1
Total	1,056	1,092	1,110	1,117	1,120	1,180	1,246

Sources: Bank of Algeria.

APPENDIX IV

Personal computers, per 1,000 people in selected countries

	1990	1995	1999	2002
Albania	na	na	5.19	9.05
Algeria	1.00	2.97	5.84	7.43
Argentina	7.23	24.43	49.18	56.05
Australia	149.71	275.14	469.20	522.24
Burkina Faso	0.11	0.26	1.03	1.23
Cameroon	1.30	1.50	2.72	2.95
Canada	107.01	217.69	360.80	354.88
China	0.43	2.28	12.21	11.12
Egypt	na	4.26	12.00	16.20
France	70.55	134.25	221.80	240.75
Ghana	0.05	1.17	2.54	2.26
Greece	17.16	33.33	60.20	65.12
India	0.32	1.29	3.31	3.50
Malaysia	8.43	37.31	68.70	79.70
Morocco	na	3.20	10.75	12.64
Poland	7.87	28.50	62.02	65.66
South Africa	6.58	26.70	54.70	65.36
Tunisia	2.60	6.70	15.33	17.94
United Kingdom	107.64	201.71	302.40	334.05
United States	216.80	328.14	510.50	529.43

Source: <http://www.wttc.org/compMon/xls/socialdev/pc.xls>

APPENDIX V

Questionnaires Appraisal

Q1. Do you believe that the liberalisation of the financial market is enhancing the competition in the banking sector?

	No	Yes		
		Minimal	Small	Dramatic
State-Owned Banks	CNEP		✓	
	BAD	✓		
	BNA		✓	
	BEA		✓	
	CPA		✓	
	BADR	✓		
Algerian Private Banks	BCIA			✓
	EBK		✓	
	UB			✓
	Sofinance		✓	
Foreign Banks	ABC			✓
	SGA		✓	
	Citibank		✓	
Non-Interest Bank	EBB			✓

Q2. In which of the following banks your bank is facing competition with?

	State-Owned Banks	Algerian Private Banks	Foreign Banks	Non-Interest Bank
State-Owned Banks	25%	25%	31%	19%
Algerian Private Banks	25%	50%	25%	0%
Foreign Banks	29%	29%	29%	13%
Non-Interest Banks	20%	40%	40%	0%
Overall	25%	36%	31%	7%

Q3. How does the bank deal with the new competitors?

	State-Owned Banks	Algerian Private Banks	Foreign Banks	Non-Interest Banks
Introduces new financial products	4 th	5 th	4 th	5 th
Promote its technology	1 st	3 rd	5 th	2 nd
Improves a personal contact with customers	2 nd	1 st	2 nd	3 rd
Offers attractive interest rates	5 th	6 th	na	na
Penetrates new markets	6 th	8 th	3 rd	6 th
Improves the quality of its current services	3 rd	2 nd	1 st	1 st
Expands the network	7 th	4 th	6 th	4 th
Consolidation	8 th	7 th	7 th	na
Merger and acquisition	9 th	na	na	na

Q4: What are the factors that change bank performance in Algeria?

	State-Owned Banks	Algerian Private Banks	Foreign Banks	Non-Interest Bank
New competitors	1 st	1 st	2 nd	1 st
Change in financial regulations	3 rd	2 nd	1 st	2 nd
Technology (especially Internet)	2 nd	3 rd	3 rd	4 th
Financial innovations	4 th	4 th	4 th	3 rd

Q5: Do you consider that the removal of financial restrictions is helping banks to make good lending decision?

	Yes	No
State-Owned Banks	70%	30%
Algerian Private Banks	86%	14%
Foreign Banks	100%	0%
Non-Interest Bank	100%	0%
Overall	89%	11%

Q6: How do banks utilise their financial funds?

	State-owned banks	Algerian private banks	Foreign banks	Non-interest bank
Government expenditures	3 rd	4 th	-	5 th
State-owned enterprises	1 st	3 rd	-	3 rd
Private sector	2 nd	1 st	3 rd	2 nd
Trade	4 th	2 nd	2 nd	1 st
Foreign Companies	5 th	5 th	1 st	4 th

Q7: In which of the following credit categories we can classify the bank loans?

		Short-term loans			Medium term loans			Long –term loans		
		Small	Medium -sized	Large	Small	Medium -sized	Large	Small	Medium -sized	Large
State-owned banks	CNEP	✓			✓			✓		
	BAD	✓					✓		✓	
	BNA	✓					✓		✓	
	BEA			✓	✓			✓		
	CPA			✓	✓			✓		
	BADR			✓	✓			✓		
Algerian Private Banks	UB			✓	✓					
	BCIA			✓	✓					
	Sofinance						✓			
	EBK			✓		✓				
Foreign Banks	ABC			✓						
	SGA			✓		✓		✓		
	Citibank		✓		✓			✓		
Non-interest bank	EBB			✓	✓			✓		

Q8: How does the market share of the bank changes?

		Increase			Decrease			Stagnant
		Minimal	Small	Dramatic	Minimal	Small	Dramatic	
State-owned banks	CNEP		✓					
	BAD					✓		
	BNA						✓	
	BEA				✓			
	CPA		✓					
	BADR		✓					
Algerian private banks	BCIA			✓				
	EBK			✓				
	UB		✓					
	SF		✓					
Foreign banks	ABC			✓				
	SGA			✓				
	CB		✓					
Non-interest bank	EBB		✓					

Q9: How do banks involve in the trading of shares in the Algiers Stock Exchange?

	State-owned banks	Algerian private banks	Foreign banks	Non-interest bank
Yes	BEA, CPA, CNEP	UB	ABC	
No	BNA, BADR, BAD	BCIA, EKB, SF	Citibank, SGA	EBB

Q10: How do you consider the growth prospects for the Algerian financial market?

		Very good	Good	Average	Poor	Really poor
State-owned bank	CNEP				✓	
	BAD			✓		
	BNA				✓	
	BEA			✓		
	CPA				✓	
	BADR			✓		
	BCIA		✓			
Algerian private banks	EBK			✓		
	UB				✓	
	SF			✓		
Foreign banks	ABC			✓		
	SGA			✓		
	CB		✓			
Non-interest bank	EBB			✓		

Q11: What are practical constraints that face the bank activities in Algeria?

	State-owned banks						Algerian private banks					Foreign banks			Non-interest bank
	CNEP	BAD	BNA	BEA	CPA	BADR	BCIA	EBK	UB	SOF	ABC	CGA	CB	EBB	
Financial regulations	✓	✓			✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	
Market size	✓	✓	✓		✓	✓					✓			✓	
Economic weakness	✓	✓		✓	✓			✓	✓	✓	✓	✓		✓	
Cultural barriers	✓	✓	✓	✓	✓		✓	✓	✓	✓	✓	✓		✓	
Certainty					✓		✓			✓				✓	
Security	✓			✓			✓							✓	
Accounting standards														✓	
The range of financial products		✓			✓	✓		✓	✓	✓	✓			✓	

Q12: Does the bank provide its services through the Internet channels?

		No	Yes			Response		
			Some	Many	Most	High	Medium	Low
State-owned banks	CNEP	✓						
	BAD	✓ (cite for publicity)						
	BNA	✓ (cite for publicity)						
	BEA	✓ (cite for publicity)						
	CPA	✓ (in progress)						
	BADR	✓						
Algerian private banks	BCIA	✓ (cite for publicity)						
	EBK			✓		✓		
	UB	✓ (cite for publicity)						
	SOF	✓ (cite for publicity)						
Foreign banks	ABC	✓ (cite for publicity)						
	CGA	✓ (cite for publicity)						
	CB		✓			✓		
Non-interest bank	EBB	✓ (cite for publicity)						

Q13. Do you consider that the Internet is helping the bank in strengthening the link with its customers?

		Internally			Externally		
		No	Yes	I do not know	No	Yes	I do not know
State-owned banks	CNEP						
	BAD		✓			✓	
	BNA		✓				✓
	BEA			✓			✓
	CPA			✓			✓
	BADR			✓			✓
Algerian private banks	BCIA			✓			✓
	EBK		✓			✓	
	UB			✓			✓
	SOF	✓			✓		
Foreign banks	ABC	✓			✓		
	SGA	✓				✓	
	CB		✓			✓	
Non-interest bank	EBB	✓				✓	

Q14. Do you think that e-banking help the bank to achieve the following targets?

		State-owned banks					Algerian private banks					Foreign banks			Non-interest bank
		CNEP	BAD	BNA	BEA	CPA	BADR	BCIA	EBK	UB	SOF	ABC	SGA	CB	EBB
Penetrate financial markets	Yes					✓		✓	✓		✓	✓			
	No											✓		✓	
	I do not know	✓	✓	✓	✓	✓		✓		✓					
Low costs	Yes	✓	✓		✓		✓	✓			✓	✓	✓	✓	
	No														
	I do not know			✓	✓		✓		✓	✓					
High speed	Yes	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	
	No														
	I do not Know														
Low risk	Yes							✓	✓		✓	✓		✓	
	No					✓							✓		
	I do not Know	✓	✓	✓	✓	✓		✓		✓					
Large package of services	Yes		✓					✓	✓		✓	✓	✓	✓	
	No														
	I do not know	✓		✓	✓	✓	✓	✓		✓					

Q15. Do you think that opening the market to both private and foreign banks contributes to the emergence of new products?

		No	Yes		
			Some	Many	Most
State-owned banks	CNEP		✓		
	BAD		✓		
	BNA		✓		
	BEA		✓		
	CPA		✓		
	BADR		✓		
Algerian private banks	BCIA		✓		
	EBK		✓		
	SOF			✓	
	UB		✓		
Foreign banks	ABC			✓	
	SGA			✓	
	CB			✓	
Non-interest bank	EBB		✓		

Q16. Do you believe that 'going global' has changed the financial environment in Algeria?

		No	Yes		
			Minimal	Small	Dramatic
State-owned banks	CNEP		✓		
	BAD				✓
	BNA			✓	
	BEA			✓	
	CPA	✓			
	BADR			✓	
Algerian private banks	BCIA	✓			
	EBK				✓
	SOF			✓	
	UB				✓
Foreign banks	ABC				✓
	SGA		✓		
	CB		✓		
Non-interest bank	EBB			✓	

Q17. Do you consider that the bank efficiency has been increased in the last years?

		No	Yes			I do not know
			Minimal	Small	Dramatic	
State-owned banks	CNEP			✓		
	BAD				✓	
	BNA			✓		
	BEA		✓			
	CPA			✓		
	BADR					✓
Algerian private banks	BCIA	✓				
	EBK			✓		
	SOF			✓		
	UB			✓		
Foreign banks	ABC				✓	
	SGA		✓			
	CB	✓				
Non-interest bank	EBB				✓	

Q18. Do you think that the bank profitability has been increased in the last three years?

		No	Yes			I do not know
			Minimal	Small	Dramatic	
State-owned banks	CNEP			✓		
	BAD					✓
	BNA			✓		
	BEA	✓				
	CPA			✓		
	BADR			✓		
Algerian private banks	BCIA			✓		
	EBK				✓	
	SOF			✓		
	UB			✓		
Foreign banks	ABC				✓	
	SGA			✓		
	CB					✓
Non-interest bank	EBB				✓	

Q19. How many clients, approximately, does the bank have?

		From 1 to 100	From 101 to 500	From 501 to 1,000	From 1,001 to 10,000	More than 10,001
State-owned banks	CNEP					✓
	BAD				✓	
	BNA					✓
	BEA					✓
	CPA					✓
	BADR					✓
Algerian private banks	BCIA					✓
	EBK					✓
	SF	✓				
	UB		✓			
Foreign banks	ABC				✓	
	SGA				✓	
	CB		✓			
Non-interest bank	EBB				✓	

Q20. In which category we can classify those clients (1 to 6)?

	Large enterprises	Medium enterprises	Small enterprises	Wealthy individuals	Average income individuals	Small income individuals
State-owned banks	CNEP	na	2 nd	3 rd	5 th	4 th
	BAD	1 st	2 nd	3 rd	na	5 th
	BNA	1 st	2 nd	4 th	3 rd	5 th
	BEA	2 nd	3 rd	4 th	6 th	5 th
	CPA	6 th	5 th	4 th	3 rd	2 nd
	BADR	3 rd	1 st	2 nd	na	4 th
Algerian private banks	BCIA	na	1 st	2 nd	3 rd	na
	EBK	3 rd	2 nd	4 th	5 th	1 st
	SOF	3 rd	1 st	2 nd	na	na
	UB	2 nd	3 rd	4 th	1 st	na
Foreign banks	ABC	1 st	3 rd	4 th	2 nd	5 th
	SGA	2 nd	1 st	na	3 rd	na
	CB	2 nd	1 st	na	na	na
Non-interest bank	EBB	3 rd	2 nd	1 st	4 th	5 th

Q21. How many employees, approximately, does the bank have?

		Number of employees
State-owned banks	CNEP	5,000
	BAD	420
	BNA	5,400
	BEA	4,000
	CPA	4,000
	BADR	7,000
Algerian private banks	BCIA	200
	EBK	3,000
	SOF	15
	UB	44
Foreign banks	ABC	168
	SGA	55
	CB	77
Non-interest bank	EBB	278

Q22. How many employees are entering and leaving the bank very year?

		Number of employees entering the bank every year	Number of employees leaving the bank every year
State-owned banks	CNEP	100	100
	BAD	20-22	32
	BNA	400	400
	BEA	na	na
	CPA	80	60-70
	BADR	na	na
Algerian private banks	BCIA	80	30
	EBK	150-200	10-20
	SOF	na	na
	UB	2-5	2
Foreign banks	ABC	35-50	5-7
	SGA	na	na
	CB	na	na
Non-interest bank	EBB	na	na

Questions 23 to 30 are designed only for state-owned banks.

Q23. Do you consider that the role of the government in the banking sector has been declining after the financial liberalisation?

	No	Yes		
		Minimal	Small	Dramatic
CNEP			✓	
BAD			✓	
BNA	✓			
BEA			✓	
CPA	✓			
BADR				✓

Q24. Do you believe that the financial liberalisation has improved state-owned banks internal and external management?

	No	Yes		
		Minimally	Little	Dramatically
CNEP			✓	
BAD			✓	
BNA			✓	
BEA			✓	
CPA		✓		
BADR			✓	

Q25. Do you think that the foreign banks entry has encouraged state-owned banks to promote their services?

	CNEP	BAD	BNA	BEA	CPA	BADR
No						
Yes	✓	✓	✓	✓	✓	✓

Q26. What is the current financial position of your bank?

	CNEP	BAD	BNA	BEA	CPA	BADR
Strong	✓					
Moderate		✓	✓	✓	✓	✓
Weak						

Q27. What are the factors that weaken state-owned banks financial position?

	CNEP	BAD	BNA	BEA	CPA	BADR
Government interventions	✓	✓			✓	✓
Mismanagement	✓	✓			✓	
Poor lending policy	✓			✓		
Interest rate margin		✓	✓			
The range of financial products	✓	✓		✓	✓	✓
Underdeveloped payment system	✓	✓	✓	✓	✓	✓
Untrained staff	✓	✓		✓		

Q28. What are the practical reasons that make state-owned banks not ready for privatisation?

	CNEP	BAD	BNA	BEA	CPA	BADR
Large amount of debts	✓	✓		✓	✓	✓
Non-developed information system	✓	✓	✓		✓	✓
Management complexity of current activities	✓	✓		✓	✓	

Q29. Do you think that privatisation of state-owned banks will improve the following factors?

	CNEP	BAD	BNA	BEA	CPA	BADR
Improve financial resources allocations	✓	✓		✓	✓	✓
Develop the information system	✓	✓	✓	✓	✓	✓
Boost market certainty	✓	✓	✓		✓	✓
Ameliorate their financial services	✓	✓		✓	✓	✓
Strengthen their financial position	✓	✓		✓	✓	✓

Q30. Do you think that liberalisation of interest rate has an impact on the bank earnings?

		CNEP	BAD	BNA	BEA	CPA	BADR
No							
Yes	Minimal		✓	✓			
	Small	✓				✓	
	Dramatic				✓		✓

These questions are for foreign banks only

Q31. What are the criteria followed by the bank in deciding to enter the Algerian financial market?

	ABC	SGA	CB
Market size	✓	✓	✓
The presence of many foreign companies	✓	✓	✓
Suitable financial regulations	✓	✓	✓
Low taxes	✓		
Enhance the link with customers	✓	✓	✓

Q32. What are the bank activities in Algeria?

	ABC	SGA	CB
Financing large companies	✓	✓	✓
Financing medium enterprises	✓	✓	✓
Financing small enterprises	✓		
Financing trade	✓	✓	✓
Trading of shares in the Algiers Stock Exchange			
Receiving funds from the public	✓ (wealthy individuals)	✓ (wealthy individuals)	

Q33. What is the response of your customers to the services provided?

	ABC	SGA	CB
Satisfactory	✓	✓	✓
Indifferent			
Poor			

These questions are for non-interest bank only:

Q34. What is the response of your customers to the services provided?

	Depositors	Lenders
Satisfactory	✓	
Indifferent		✓
Poor		

Q35. What are the practical problems that face *El-Baraka* Bank in Algeria?

	Yes	No
Asset evaluation	✓	
Risk assessment		✓
Taxation		✓
Liquidity		✓
Absence of uniform accounting standards	✓	
Limited financial products	✓	
Public trust	✓	

Q36. How does the bank distribute the profit generated from its operations?

Money owner	50%	
The entrepreneur		50%
The bank	50%	50%

Q37. Do you believe that globalisation of financial services has changed the shape of the Algerian financial market positively or negatively?

		Positive	Negative
State-owned banks	CNEP	✓	
	BAD	✓	
	BNA	✓	
	BEA	✓	
	CPA	✓	
	BADR	✓	
Algerian private banks	BCIA	✓	
	EBK	✓	
	SOF	✓	
	UB	✓	
Foreign banks	ABC	✓	
	SGA	✓	
	CB	✓	
Non-interest bank	EBB	✓	