Financial Sector Development & Reform *by Nasser Saidi*

The banking and financial sectors remain underdeveloped in the Middle East and North Africa (MENA) countries. The modest beginnings of financial sector liberalization and reform in the mid-1980s and 1990s did not bear fruit. In most countries, the banking sector remains protected from competition or is highly segmented and regulated, and has become non-competitive. There is limited resort to market finance by either the public or private sector. Typically, monetary policy is either subject to the requirements of maintaining a pegged or highly managed exchange rate and/or the focus of monetary policy is on credit and its allocation across sectors, with widespread attempts at controlling the cost, price and volume of credit. Given the prevalent role of the State in many of the MENA economies, the banking sector is organically linked to state owned enterprises (SOEs) and subject to government intervention in its lending and credit policies to SOEs.

Structural Issues and Financial Sector Reform: A Policy Perspective

Financial sector reform issues and the role of the State cannot be separated from an analysis of the structural problems facing the Arab and Middle East North Africa economies. These problems must be addressed as a matter of priority and must precede dealing with cyclical or macroeconomic stabilisation issues. These structural issues are "deeper" since they matter for medium and long-term economic growth prospects. We can only highlight these issues on this occasion.

Labour Market Reform. The MENA countries have demographically young populations, high population growth rates and comparatively high fertility rates. As a result MENA labour growth rates are among the highest in the world and the labour-exporting countries (Egypt, Morocco, Tunisia, Syria and Lebanon) are experiencing high unemployment rates and out-migration of their labour force. Economic policy should be oriented to improve the prospects of economic growth and job creation. However, the priority should be given to investment in human capital, with public sector investment geared towards education, on-the-job training and health. A major effort should be given to invest in the human capital of women, eventually resulting in a reduction in fertility rates, improved family health and higher female labour force participation rates.

Increase Private Sector Investment. Private sector investment and saving rates are relatively low across the MENA economies compared to economies with similar per capita incomes and resources leading to low total factor productivity growth. Clearly, many factors contribute to low domestic investment and saving rates, including macroeconomic instability, inadequate legal frameworks and protection of property rights. Economic policies should focus on mobilising domestic saving and the repatriation of capital, and on creating the institutional framework that will channel funds to the private sector. Reform of the financial sector is of critical importance in this context.

Fiscal Reform and Privatisation. The MENA tax and fiscal systems require modernisation and reform. Tax reform and new tax systems need to be instituted in the oil-exporting countries - where government revenue is highly dependent on export revenues from natural resources - and which are facing rising budget deficits as a result of a deterioration of the terms of trade while maintaining generous social support and welfare systems. In other countries, the main issue is the size of the inefficient public sector and production. Fiscal reform packages should include a substantial reduction in the size of government and the privatisation of public sector entities.

Market Pricing Systems. Government intervention in the pricing of products and services is extensive in a large number of the MENA economies, leading to distortions in production and consumption patterns as well as in international trade, as a result of high effective rates of protection despite the reduction in nominal tariff rates. In particular, the pricing of public sector goods and services requires reform to reduce or remove the implicit subsidies and to reflect the costs of production.

Trade Liberalisation. To be successful, economic reforms must lead to more open economies able to compete in an increasingly liberalised and deregulated international environment. Indeed the MENA economies must consider and implement the reforms to their trade regimes and commercial policies required by entry into the WTO and GATS and as preconditions to establishing an Arab Common Market or entering into Partnership Agreements with the European Union.

External Payments. The fundamental structural reforms noted above must include reform of the external payments regime. Attracting foreign resources, capital repatriation, trade liberalisation and financial sector reforms are tied to the implementation of open, transparent external payment regimes that end the common practices of multiple exchange rates, distortions and restrictions on payments.

Role of the State in the Financial Sector

The role of the state in the financial sector should be focused on core activities, namely enabling institutions and providing the financial system infrastructure, and the institutional framework. Government should: (a) set the framework for the organisation and infrastructure of banking, financial and capital markets to ensure competition in financial inter-mediation; (b) partner with the private sector in the establishment of modern, secure and efficient payment systems for the clearing and settlement of transactions in the money and securities markets; (c) provide an effective regulatory structure, and (d) define clear rights of establishment, licensing, entry and exit for all financial intermediaries.

What Role for Islamic Banking and Finance?

The scope and demand for Islamic banking and finance are expanding at a rapid pace in the MENA countries and extending to Asia. The challenge will be to make Islamic banking and finance an integral part of the financial inter-mediation process. This will require unifying and extending the regulatory and supervisory framework to encompass Islamic banking and financial institutions. The recent establishment of the Islamic Financial Services Board may prove important in the process of cooperating with national regulatory authorities in imposing common core principles for the supervision and regulation of bank and non-bank intermediaries, applicable to both Islamic and non-Islamic institutions. Effective regulation and investor protection require a level playing field. Similarly, Islamic financing methods and contracts will need to be developed into standardised financial products and contracts capable of being traded in financial markets.

The Purpose and Objective of Financial Reform

Policy makers may have a number of reasons and objectives for financial sector reform. These include various domestic economic policy concerns, reducing financial repression and liberalizing the saving-investment process, to external economic policy concerns. The agenda, scope and extent of financial sector reform may differ according to these diverse objectives and concerns, and include: (a) fostering the development of financial markets and instruments, and (b) opening the domestic banking and capital markets to international competition, allowing the MENA economies improved access to the international banking and capital markets.

The MENA region requires substantial funds for investment in infrastructure, to develop its natural resource base and finance economic growth and job creation. However, the region has not been able to attract funds and resources from the rest of the world. As the accompanying table shows, MENA countries have attracted less than 5% of net private capital flows to developing countries, and less than the SSA countries.

Net Private Capital Flows to Developing Countries

(Current US$ billions)

Developing Countries	1997	2001	2002	2003
Latin America & the Caribbean	114.1	58.1	25.6	47.3
Middle East & North Africa	7.8	7.7	6.1	-3.8
South Asia	8.2	4.0	8.0	10.4
East Asia & Pacific	85.8	38.0	55.2	71.0
Europe & Central Asia	52.9	32.2	55.2	62.9
Sub Saharan Africa	17.0	11.3	5.2	12.4
Total	**285.8**	**151.3**	**155.3**	**207.8**

Source: Global Development Finance, 2004.

Developing the MENA countries capital markets, available investment instruments and securities, facilitating the access of foreign investors can play a major role in attracting external resources to the region. At this stage in the economic development of the MENA countries, financial sector reform and developing well functioning capital markets is of strategic importance.

Developing efficient capital markets is a critical element in attracting back part of the estimated US$800 billion MENA funds invested outside the region. To be successful in attracting the capital and ensuring the efficient economic use of these resources, governments should actively promote the set-up and development of domestic capital markets and enhance their regional and international integration.

Financial Sector Development in MENA

A recent paper by S. Creane et al. (2004) provides evidence and an assessment of the development of the financial sector in the MENA countries. The paper develops an Index of Financial Development which is a composite of 35 indicators including: (1) development of the monetary sector and monetary policy; (2) banking sector size, structure, and efficiency (including the role of the government in the sector); (3) development of the non-bank financial sector; (4) quality of banking regulations and supervision; (5) financial openness, and (6) quality of the institutional environment

The Financial Development Index (FDI) is useful in that it can provide a benchmark for estimating the consequences of Financial Sector (FS) liberalization and reform, as well as an indicator of the development of the FS in comparison to international best practice, to international codes and standards and the extent of international integration of MENA financial markets.

The empirical results of the Creane et al. paper can be summarized as follows: the MENA financial sectors are less developed than other regions at a similar level of economic development. Within the region, there are no surprises in country rankings, with Bahrain and Lebanon leading, being regional financial centres. To quote Creane et al.: “In comparison to other countries in the region, MENA countries with higher levels of financial development tended to have (1) a greater use of indirect monetary policy instruments; (2) a smaller degree of public ownership of financial institutions; (3) smaller or no monetary financing of the fiscal deficit; (4) stronger prudential regulation and supervision; (5) higher-quality human resources, including management and financial skills; and (6) a stronger legal environment.”.

However, the indicators used may overstate the level of development and rate of growth of the financial sector in the MENA region, since it neglects (as does most of the literature), the extent of non-banked households, and the limited participation in equity markets, as well as the lack of access to organized credit markets by SMEs and by firms operating in the informal sector. Some evidence on the extent of non-participation can be surmised from the large holdings of cash on a per capita basis, or given the relatively large size of households, on a per household basis, in the MENA countries. Similarly, indicators on the incidence of poverty and inequality in the distribution of income and wealth suggest that extensive inequality is a retarding factor in the development of the financial markets in the MENA countries. However, financial sector services cannot be the privilege of the few. Financial markets can only develop and possess the desirable characteristics of ‘breadth, depth and liquidity’ if there is wide, broad-based participation by individuals, households, institutions and businesses. This enables the sharing and diversification of risk, lowers transactions costs for banking and financial services and for payments, allowing the achievement of economies of scale and the development of efficient payment networks.

The region’s relatively good performance in regulation and supervision is largely attributable to the implementation of international standards, in particular the Basel Core Principles, which laid out a clear framework for banking supervision and regulation. The contributing factor is that banking supervision appointments have tended to be non-political, being viewed as technical and professional with little prospect of political careers or otherwise lucrative callings.

An implication is that both the countries of the region and the international financial institutions should place more emphasis on the promotion, adoption and implementation of tried and tested monetary and fiscal codes and standards. These include the organizing framework of the 12 Key Standards for Sound Financial Systems issued by the Financial Stability Institute. The standards cover Macroeconomic Policy and Data Transparency (monetary and financial policy transparency, fiscal policy transparency and data dissemination), Institutional and Market Infrastructure, Financial Regulation and Supervision (insolvency, corporate governance, accounting, auditing, and payment systems); Banking Supervision and Securities Regulation, Insurance Supervision, and Market Integrity, including anti-money laundering and anti-terrorist financing. An issue in this connection is to create the incentives for voluntary compliance and effective enforcement.

Government ownership and intervention in the banking and financial sector has been a major contributor to the lack of development of MENA financial sectors. There have been negative spill-over effects and distortions, including: a high share of credit to government in total domestic credit, leading to a crowding-out of the private sector (examples include, Algeria, Egypt, Morocco and Syria), limited availability of financial instruments and secondary markets, high transactions costs, lack of transparency in government financing decisions, non-market pricing of assets and of credit and administered interest rates.

The lack of development of the financial sector in MENA is, in part, a result of pursuing an interventionist paradigm that resulted in nationalization policies in many of the countries in the region. Restoring freedom of entry and adopting principles of reciprocity - as would be required under WTO rules- would favour financial sector development, entry of foreign financial firms and the introduction of new banking and payment technologies.

Fundamentally, financial sector development is very much about the development of the capital markets and not about banking. Capital markets are the source of long-term capital investment and are a channel for long-term foreign investment, including the more stable flows of FDI. More important, they provide for more publicly available information and its disclosure, thereby leading to better governance. By contrast, banking systems and bank supervisors have a culture and incentives to avoid public information disclosure and dissemination, which could undermine confidence in individual banks and lead to a systemic banking shock.

The absence of efficient liquid equity and debt markets is a signal to the authorities and policy makers in the MENA, on the necessity for taking action. This is clearly illustrated by considering the oil producing countries. In the absence of developed debt markets and public debt management policies, energy price shocks lead to government revenue shocks, volatility in government current and investment expenditures, resulting in instability in budgets and budget deficits. In turn the process creates an oil price shock cycle which transmits itself to the private sector and overall economic activity. In turn the cycle transmits itself through trade and capital flows to the non-oil producing countries, as well as through the impact on the flow of immigrant labour and their remittances.

A major contributor to the lack of development of the FS in MENA countries is the absence of social security reform. Social Security reform, in particular the removal of restrictions on portfolio investment by SS agencies, the creation of pension funds and funded systems, can be a major tool for FS development and institutional reform. At the moment, SS systems are captive financial institutions used by governments as a source of finance. Reform is necessary to benefit from the 'demographic dividend' of young and growing populations in the MENA countries, as well as for FS development and reform.

The colonial past and its economic history are major institutional factors explaining bank dominance of FS as well as the choice of exchange rate regime in the MENA countries. The role of the banking sectors was to finance international trade between the colony and the metropolis, not to finance domestic trade, corporations, projects or infrastructure. More puzzling at first glance is the absence of development of the debt and equity markets in the MENA countries. At the turn of the 19th century, between 1880 and 1910, the Ottoman Empire turned to the international capital markets to finance major infrastructure projects, railroads in particular, issuing long-term bonds. Later, the mandatory powers in the Levant, Great Britain and France, tapped the bond markets to finance transport infrastructure including railroads, ports and utilities. Similarly, stock markets and commodity exchanges were established in Beirut, Cairo and Alexandria, Algeria, Tunisia and Morocco. They were active in the inter-war period, but their development was not sustained in the post-WW II, post-colonial period. Indeed, major determinants and building blocks of capital market development were missing. The mandatory powers faced with short mandate horizons did not invest in setting up the institutions and the rules of the game allowing for the emergence and development of the stock and debt markets. There were limited or no incentives, at the time, for developing and linking colony or mandate country capital markets. The possibly competing hypothesis is that differences in legal traditions and institutions account for and determine cross-country differences in financial market evolution. However, this does not appear to matter much in accounting for differences in financial structure across the MENA countries. The GCC countries, Egypt, Jordan and Palestine did not evolve thriving stock markets despite being steeped in the English legal tradition. This is an area for future research.

Privatization and liberalization during the 1980s and 1990s does not appear to have led to a take-off of financial markets. Perhaps part of the answer is that policy makers did not make popular, 'democratic' shareholding a priority, and did not privatize the stock markets and establish independent capital market authorities.
Recent analysis of exchange rate regimes has indicated the importance of distinguishing between de jure and de facto régimes: the policies pursued by countries are typically different from what they say they do! In particular, countries that claim to be pursuing flexible exchange rate regimes typically intervene or de facto pursue limited flexibility or fixed rates. Similarly, countries with de jure fixed rates typically run managed regimes. The counterpart in the financial sector is that conditions of entry and the 'rules of the game' are typically different from the de jure legal and regulatory regime. Interest rates and asset prices show limited flexibility in most of the MENA countries, despite official claims that interest rates and asset prices are market determined. Indeed, claims made that interest rates are flexible is inconsistent with the absence of functioning secondary financial markets.

Barriers to Market Development

Nothing kills markets and their development as much as regulatory and other non-price barriers, taxes, stamp duties, fees, commissions, inefficient trading and payment & settlement logistics and other transactions costs. While some work (R. Levine (2000), Caprio (2002) and others) have developed some measures of transactions costs, markups and margins, more research should be done in this area. Future research could usefully focus on developing measures of 'Coasian' transactions costs that are barriers to financial market development and amenable to reduction and change through the implementation of policy reforms.

Similarly, it is clear that the lack of enabling financial market legislation and regulation has been a major barrier to the evolution of the MENA financial markets. The recent theoretical and empirical literature has identified legal tradition as being a retarding factor in the emergence and development of financial markets, pointing to the difference between Common Law tradition ('Anglo-Saxon' and 'Germanic') countries, as compared to Civil Law ('French') countries, whose codes and legislation does not allow the flexibility and ease of implementation and change required by developments in the financial markets, in particular the emergence of new financial instruments such as securitization, and options and derivatives.

The MENA region is facing numerous challenges on a number of fronts. During the 'globalizing eighties' and 'roaring nineties' the MENA countries did not become more regionally or internationally integrated. The Greater Arab Free Trade Area, the Euro-Med Association Agreements and the more recent initiative, the Greater Middle East, by the US to encourage greater international integration of the MENA region have largely focused on achieving a free trade area in commodities. However, those initiatives have yet to show any payoffs for the countries of the region. Recent evidence and analysis suggest an alternative strategy . The international community and the MENA countries should give priority to: (a) regional economic integration to develop markets and create the potential for increased specialization and potential benefits from economies of scale and scope, and (b) liberalization of trade in services and (c) the development of the financial markets of the region and their international integration.

Recommendations and Financial Sector Policy Reform Agenda

The results of the timid liberalization and reform efforts of the region, the experience of emerging economies and countries in economic transition suggest a number of recommendations and items for economic policy reform in the MENA countries. There are five issues which may be considered important in the specific context of the role of the state and financial sector reform. Briefly, these are:

- The role of the state in the financial sector and financial sector reform cannot be viewed in isolation from issues relating to the size and role of government and its involvement in economic activity and social life. Economic reform must be viewed as a complex, interconnected policy package. Financial sector reform and deregulation aimed at removing financial repression is likely to fail unless accompanied by, for example, fiscal and tax reforms aimed at reducing budget deficits and the size of government, and the dependence of the SOEs on bank finance.
- The timing and sequencing of reforms is important if not critical in the success of financial sector liberalisation and deregulation. Research and the lessons of economic reform successes and failures (most recently in the former Soviet Union countries and Russia in particular) suggest the following sequence of reforms: price reform, fiscal and tax reforms, financial sector reform, trade reform, and finally, removal of capital controls and liberation of external payments. Note that domestic economic reforms should precede reform of the external sector. However, there is less theoretical and policy analysis consensus on whether reforms should be undertaken gradually or in a “big bang”. Friction-less economies, with flexible institutions and well informed agents would favour radical ‘big bang’ type policy reforms. This does not appear to be the case in the MENA region.
- The public sector should take the lead in implementing reform. Government should put its own house in order prior to imposing reform or deregulation on the private sector. Typically, it is public sector intervention in the functioning of markets and economic activity which has created the distortions. Deregulation should, as a rule, lead with public sector companies and institutions, and encompass companies involved in production, as well as financial intermediaries: various types of development banks, specialised credit and financial institutions owned or managed by government. State-owned commercial banks should be privatised. The objective should be to create a level playing field, ensuring competitive conditions in the financial sector. Policy makers implementing deregulation can expect to and will face opposition from a wide variety of special interest groups: SOEs, public sector employees and regulators running the public sector financial institutions, as well as the private sector interests and groups benefiting from the ‘cheap’ finance and other benefits.
- Financial sector reform should imply adopting international standards and regulations. The objective should be to modernise banking and financial sector structure, laws and regulations. International standards and norms include the 12 key standards for financial sector stability, which include the adoption: (a) International Accounting Standards; (b) Bank for International Settlements (BIS) and Group’s 30 recommendations for payment and settlement systems; (c) Prudential and supervisory norms and standards as recommended by the various BIS committees. There are at least three benefits from adopting international standards and criteria: (1) it leads to a harmonisation of national regulatory systems across the Arab countries, and internationally; (2) it serves to attract foreign investment in the domestic financial sector and access to the international capital markets; (3) it serves to disarm local lobbies fighting deregulation and financial sector reform, as policy makers can validly argue that the country must compete internationally and conform to international standards.

Institution Building: Market Supervision and Regulation

We need to focus on developing the role and functions and/or establishing four major institutions:

- ***Central Banks/Monetary Authorities.*** Increasingly the international trend is to define price stability or the achievement of low price inflation, with monetary and financial stability as the major objectives of the monetary authorities. This requires increasing the powers and independence of the monetary authorities to diminish interference by government. A comparative, in-depth analysis of the independence of the monetary authorities and central banks in the MENA countries is required to suggest reforms, changes to legislation and areas of competence.
- ***Capital Market Authorities.*** We need to separate the management of the securities markets from their supervision and regulation. Exchanges should be privately-owned and managed to ensure, among other, international competitiveness and the introduction of new technology and financial products. Capital market authorities should be instituted by law, run by independently appointed and mandated professionals, and endowed with independence to effectively supervise and regulate markets and participants. Notable progress in this direction has been achieved in Egypt, Jordan, Morocco and Tunisia.
- ***Banking Control Commissions*** across the region need to be strengthened to improve the regulatory framework and increase bank soundness. The commissions have an important role in introducing and implementing international norms and standards, and in harmonising regulations and supervisory procedures across the Arab world. This will require more co-operation between commissions, between monetary authorities and an increase in the exchange of information.
- Establish ***Central Securities Depositories*** that are linked to the capital markets and to the central banks to enable secure and efficient payments and clearing and settlement. Highlighting the payment systems is important for the agenda of policy-makers: sound, efficient, modern payment systems incorporating new information and communications technologies (ICT) are the technological determinants and enablers of e-banking, e-finance and more generally, of e-services. Well functioning, secure, efficient payment systems are an intrinsic component of the operation of financial markets: they are financial infrastructure ‘plumbing’!

Agenda for Action and Policy

To move forward on financial sector (FS) reform, the MENA countries should put the item as a high priority on their policy agendas given that FS development and reform can be a major tool for achieving economic reform and increased private sector participation in the economy.

In particular, they should seek to:

- Adopt and implement the twelve key Financial Standards for Financial Stability as the ‘road map’, the organizing framework for FS development.

- Establish the infrastructure for the FS: Independent capital market Authorities, enabling laws and regulations, security settlement systems, and financial market trading logistics.
- 'Leap-frog' in its reform program: focus on e-banking and e-finance as benchmarks within the medium-term
- Reform social security systems, making them the major institutional investors in the capital markets
- Develop government debt markets to enable the development of a corporate bond market, the reform of public sector finances and to break the link between the volatility of oil prices and revenues and public finances.

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***Nasser Saidi** an ERF Fellow, is a Lebanese national was former Minister of Economy & Trade & Minister of Industry and First Vice-Governor of the Central Bank of Lebanon. He was the Chairman of the Beirut Secondary Market, the Commission for the Development and the Modernization of Financial and banking Laws and the Commission for IT and the Development of Banking Technology.*

GDN Call For Proposals: Middle East, North Africa, Turkey and Iran

Impact of Rich Country Policies on Poverty: A Global View

The Global Development Network (GDN) is supporting a large multi-disciplinary global research project entitled Impact of Rich Country Policies on Poverty: A Global View. This is a call for proposals to undertake country studies in the Middle East, North Africa, Turkey and Iran on this important theme in the areas of aid, investment, migration, or trade. (Similar calls will be made in other regions.) Interested researchers are invited to submit proposals on specific issues or combinations of issues of particular importance to their countries. The proposals should include a detailed description of the methodology to be used, the availability of suitable data, and the composition of the research teams. Proposals with teams that include younger researchers or less established institutions are particularly encouraged. Studies in approximately 30 countries will be supported around the world. Selections will be made on a competitive basis with regional allocations. The deadline for submissions is on or before September 30, 2004. They should be sent to bvaughan@gdnet.org.

Selection and Eligibility

Country studies will be selected based on a competitive process. Residents of developing and transition countries are encouraged to send in proposals describing how they would meet the challenge of the project as outlined in the next section. Particular emphasis should be placed on the composition of the team, the main issues in your country, testable hypotheses, and the methodological approach(es) to be used. CVs of all researchers must be attached. The inclusion of younger researchers and institutions is encouraged. The size of the team is not fixed but should be set so as to meet the goals of the research, taking into account budgetary considerations. At least 50% of all principal researchers must be residents of a developing or transition country. Budgets should be included in the submission. Researchers will receive an honorarium and other research expenses based on local costs. These will be calculated based on involvement in a research project and not as a consultancy.

There is no fixed format for proposals. Nevertheless, each submission should contain at a minimum: (1) Composition of the research team; (2) CVs of all researchers, including countries of residence and e-mails; (3) Time period to be covered; (4) Main policies or policy interactions that are of particular interest in your country; (5) Testable hypotheses; (6) Detailed methodology; (7) Explanation of why the research team is well suited for this work; and (8) Budget.

Up to ten submissions from the Middle East, North Africa, Turkey and Iran region will be invited to present at a special one-day workshop in Beirut, Lebanon on December 13, 2004, immediately before ERF's Annual Conference. GDN will pay 50 percent of economy travel and accommodation expenses to attend the workshop and ERF conference. A five-person selection committee will choose the top four or five submissions, who will then be asked to present their work at a full project workshop in Dakar, Senegal just before GDN's Annual Conference from January 24-26, 2005. GDN will pay 100% of economy travel and accommodation expenses to the GDN Annual Conference.

Detailed information on the project can be found at: http://www.gdnet.org/activities/global_research_projects/rich_country_policies.html