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POLITICAL RISK & THE BANKING SECTOR IN THE MENA REGION

by

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Political Risk & The Banking Sector in the MENA Region

ABSTRACT

by

CLAUDE EL-MAALOUF

The MENA region is attracting the attention of foreign investors. However, since violence and instability are the chief characteristics of this region, there are hurdles that prevent economic prosperity. In recent years, terrorism has further dampened the prospects of the MENA countries.

This thesis discusses the existence of political risk in the MENA region. How important is the influence of political risk on the development of banking sectors in the MENA countries? What is the current and future status of the MENA region and its integration in the global economy?

The study focuses on the banking sector and the way it copes with political risk. Thus, the question which constitutes the basis of this thesis is: What are the consequences of the prevailing political risk factors on the operations of the banking sector in the MENA region? It would be prudent to make extensive use of political and governance indicators to manage political risk and to find out where vulnerabilities are, as political risk could have negative consequences on foreign investments, especially in the MENA region. Included are case studies on the banking sectors of Saudi Arabia and Sudan to illustrate the political risk factors in the region. These two MENA countries have similar ethnic, religious, and social backgrounds; and both are rich in oil resources. Yet, they are different when it comes to the effect political risk has had on their banking sectors. Saudi Arabia is strong in promoting foreign investments, while Sudan has not experienced an improvement in its financial and banking sectors.

The references consulted range from books to selected articles, as well as internet sources and publications by international organizations. However, the limited availability and at times questionable accuracy of relevant information present serious challenges to any approach to political risk analysis. In addition, the capacity and willingness of governments and concerned organizations to collect and disseminate information varies among countries.

TABLE OF CONTENTS

1. **Introduction** ____ **1**

2. **Historical Background & Literature Review** ____ **5**

    2.1 Sources of Political 5

    2.2 Changes in the Nature of Political Risk 9

    2.3 Political Risk Techniques 11

    2.4 Variables Cited in the Literature on Political Risk 13

    2.5 The Political Risk Phenomenon & Specialized Survey Institutions 15

    2.6 Political Risk & the Banking Sector 18

3. **Economic Development** ____ **20**

    3.1 Economic Background 21

    3.2 Current Economic Situation 24

4. **Financial Development** ____ **34**

5. **Political Risk & the Banking Sector** ____ **41**

    5.1 Political Risk & the Banking Sector in General 41

    5.1.1 Identification, Assessment & Analysis 43

    5.2 Political Risk in the MENA Region 46

    5.3 Political Risk & the Banking Sector in the MENA Region 50

6. **Saudi Arabia – The Banking Sector** ____ **55**

    6.1 Overview 55

    6.2 The Banking Sector 56

    6.3 Overall Assessment 66

7. **Sudan – The Banking Sector** ____ **68**

    7.1 Overview 68

    7.2 The Banking Sector 70

    7.3 Overall Assessment 77

8. **Conclusion** ____ **80**

Bibliography

List of Abbreviations

Business Environment Risk Intelligence (BERI)

Control Risks Information Services (CRIS)

Economist Intelligence Unit (EIU)

Gulf Cooperation Council (GCC)

International Country Risk Guide (ICRG)

Multilateral Investment Guarantee Agency (MIGA)

Non-Governmental Organizations (NGOs)

Organization for Economic Cooperation and Development (OECD)

Overseas Private Investment Corporation (OPIC)

Standard & Poor's Rating (S&P)

United Nations Development Programme (UNDP)

Chapter 1: Introduction

In today's unstable world, there is growing concern about the repercussions of political risk on the investment climate in general, and on the performance of the banking sector in particular. However, nowhere else is the issue more alarming than in the troubled region of the Middle East and North Africa – MENA.[1] Conflicts still persist within the countries of this region. Hard-liners want to maintain the semblance of normality, a certain status quo, while reformists and moderates strive to restore democracy. Some extracts from the International Herald Tribune newspaper, indicating increasing tension and predicting further violence, are proof for this – a few examples, randomly selected from the IHT of March 26 and 27, 2005:

> "US agrees to sell F-16 Jet fighters to Pakistan. India has lobbied in Washington against Pakistan's acquisition of the planes because it fears Pakistan would use them if war between India and Pakistan, both nuclear powers, breaks out again, as it has several times in the past half century" (Stout, p.1).
>
> "A bomb in Christian area of Beirut hurts 5... the bombings have taken place against a backdrop of political turmoil set off by the assassination of Rafic Hariri" (Filkins, p.8).
>
> "Iran's decision to refine enriched uranium is highly dangerous. It can be used in the future for nuclear weapons" (Bokhari, Khalaf, p.5).

The chaos reigning in Iraq certainly cannot be forgotten. The American invasion was aimed at bringing peace and security. The end of Saddam's rule of terror was meant to provide a great opportunity for American investors to benefit more than ever from rich oil reserves and

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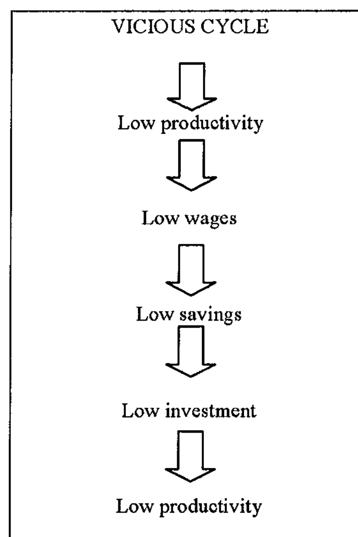
[1] According to the International Monetary Fund (IMF), the MENA region is composed of the following countries: Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Syria, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Tunisia, the United Arab Emirates, Yemen, Afghanistan, Iran, Pakistan, and the West Bank and Gaza

lucrative deals. Countries that sided with the USA in Iraq also had high hopes. However, the situation has grown worse. Insurgents not only target Americans, or Westerners, but also Iraqis working for them. Here is only one incident of what is happening there:

> "Since September 2004, the pace of suicide car bombs has picked up dramatically. Newsweek was able to count 108 attacks cited in news reports and military press releases – about 1.5 a week over the span of the occupation" (Hosenbell, p.28).

Financial institutions and multinational organizations need to pay particular attention to the political risk issue in their host countries. Confiscation, creeping expropriation, and nationalization are examples of negative actions that can be instigated by host governments (Monti-Belkaoui, Riahi-Belkaoui, p.XI). Why then are investors interested in countries ravaged by trouble and heading towards uncertainty, thus putting themselves and their companies in danger? Foreign direct investment plays a great role in the development prospects of host countries. Underdeveloped countries are often caught in a vicious cycle, as illustrated below:

UNDERDEVELOPMENT



Source: Moran, p.3.

Foreign direct investment can turn this vicious cycle of underdevelopment into a virtuous cycle of growth by offering new capital and new avenues for earning hard currencies to complement local savings and supplying techniques of management, marketing, and technology. Accordingly, foreign direct investment improves efficiency in production and enhances the prospects for growth (Moran, p.3).

Political risk directly affects the operations of multinational firms. It differs from political instability, which indicates a feature of unexpected change in government leadership. Such instability may not involve political risk for international business (Jeocho, p.1). To be more specific, political risk refers to the host government's policies on decisions that constrain the business operations of a given foreign investment. Furthermore, it takes into account the security of private rights more than does political instability, because this risk measures government credibility and private property rights protection (Jeocho, p.1). Certain elements can be attributed to political risk, including:

- interpretation and prediction of the behavior of the political system of a country;
- linkage between the political system analysis, economic policy environment, and national performance; and
- emphasis on social issues and developments, as political and economic issues do not exist in isolation (McRorie, p.41).

Hence, political risk can be seen as one of the leading impediments to the flow of capital, goods, and services, and to investment activities of all forms. Many MENA countries are attracting attention from foreign investors; but since violence and instability are the main characteristics of the region, there are numerous obstacles that prevent economic development. In addition, terrorism has in recent years further dampened the prospects.

The objective of this thesis is to look into the political risk factors in the MENA countries, their impact on the development of the banking sector there, and the potential of this sector to integrate into the global economy. Chapter 2 surveys the historical background and literature review of political risk and the major approaches used in political risk assessment. Chapter 3 tackles the economic development and includes a brief overview and history of the area. Chapter 4 deals with the financial development of the region, while Chapter 5 discusses the impact of political risk on the banking sector. In addition, there are two case studies: the banking sector in Saudi Arabia; and the banking sector in Sudan. The reasons these two countries were chosen are a) the availability of data, and b) the difference in experience they represent.

The conservative nature of political risk, the key unit of analysis in this thesis, made it difficult to obtain data. The restricted availability and at times questionable accuracy of relevant data presented challenges to the validity and reliability of the analysis. The capacity and willingness of governments and concerned organizations to collect and disseminate information varied among countries.

Chapter 2: Historical Background & Literature Review

The emergence of political risk may be due to local and global threats. Firms and corporations which are willing to expand their activities or investments to foreign markets are likely to have setbacks related to the internal situation of their targeted country.

2.1 Sources of Political Risk

The sources of political risk have changed over time. To understand what currently occupy international investment analysts, the key features of today's political risks and their sources need to be put in a historical perspective.

Traditional sources of political risk – war, civil disturbances, and the emergence of independence movements – have not disappeared. The end of the Cold War and the collapse of the Soviet Union have given increasing prominence to ethnic religious tensions. First, republics under the rule of the former Soviet Union broke away and proclaimed their independence, such as Georgia, Armenia, Azerbaijan, and Ukraine which today are sovereign nations. Then, the ex-Communist countries of Central and Eastern Europe demanded secession from Soviet influence and became democratic. The world was entering a new era where Capitalism had triumphed over Communism. The Communist regimes had proven inefficient, bringing hardship and poverty to millions of people. However, while the Soviet empire was trying to encompass the damage of its disintegration, ethnic wars unexpectedly started to flare up. First, the war between Armenia and Azerbaijan over the region of Nagorna Karabakh; then the civil war in the ex-Republics of Yugoslavia, Croatia, Bosnia Herzegovina, and Serbia.

Today, the political risks investors face in developing countries are principally the result of forces external to the industrial sector and which involve some sort of government action – or often inaction (Wells, p.15). This is the case in the Caspian region, which includes the newly-independent countries of Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan. Many confirmed reports say this region holds an important percentage of world oil and gas reserves. However, these countries are bordered by Russia and Iran, two nations with much influence across a wide range of issues. Iran has never hesitated to export its Islamic revolution; on the other hand, the Russian government has never tolerated the Islamic threats coming from Chechnya, a predominantly Islamic province of Russia. The complexities of financing new oil pipelines in this region would require considerable investment, local involvement, and multinational financing and participation. Consequently, this would entail the presence of bankers and financial institutions in the fields of project finance, treasury, and trade finance (McRorie, p. 42).

Investment insurance is available for firms investing in areas marred by political risk. The Overseas Private Investment Corporation - OPIC, for example, sells insurance to US firms operating in a large number of host countries. Moreover, investment insurance can be obtained from the Multilateral Investment Guarantee Agency - MIGA, which is part of the World Bank Group. MIGA offers coverage against the following types of political risk:

- *Transfer Restriction*: against cases arising from an investor's inability to convert local currency, for example capital, interest, principal, and profits, etc., into foreign exchange for transfer outside the host country. The coverage insures against excessive delays in acquiring foreign exchange caused by host government action or failure to act by deterioration in conditions governing the conversion and transfer of local currency (www.miga.org/screens/ p.1).

- *Expropriation*: against the risk of property loss due to host government actions directed against foreign investors or due to a series of actions that produce cumulative outcomes (Moran, p.142). Coverage is available on a limited basis for partial expropriation. For total expropriation of equity investments, MIGA pays the net book value of the insured investment. The threat of expropriation, prevalent during the past decades, has declined. In the mid-70s, there were many expropriation cases; but during the 80s and into the 90s, only a few cases were recorded.
- *War and Civil Disturbance*: against loss from damage to, or the destruction or disappearance of tangible assets caused by politically-motivated acts of war or civil disturbance in the host country, including revolution, insurrection, *coups d'etat*, sabotage, and terrorism (www.miga.org/screens.p.2). Coverage also extends to events that, for a period of one year, result in an interruption of project operations essential to overall financial viability.
- *Breach of Contract*: against losses arising from an investor being unable to obtain and/or enforce a decision, or award a host country that has repudiated or breached an investment contract (Monti-Belkaoui, Riahi-Belkaoui, p.142).

Nowadays, many multinational companies continue to produce in high-cost, developed countries because, among other factors, these countries are considered to be politically stable. By contrast, investments in many 'low-cost' countries are exposed to large political risk. Investment analysts argue that while a stable political environment is desirable, it is certainly not a sufficient condition for attracting foreign investment. Companies often wish to extend their activities beyond their borders. However, by accomplishing such goals, they become subject to different regulatory regimes and there is a likelihood that a new set of risks will emerge in the near future.

A survey conducted by the Kearny International Consultancy House indicates some of the critical risks investors perceive as a threat to their operations. The 2003 survey used primary data from a proprietary survey administered to senior executives of the world's 1,000 largest corporations (Chan, Gemayel, p.8). Findings showed that 62% of senior executives believed political and social disturbances were the most critical risks that bear on their investment decisions; 63% worried about currency risk; 67% thought that a country's financial risk constituted an obstacle; and 69% regarded government regulations to pose a high critical risk. Other factors were: absence of rule of law, 34%; disruption of supply chain, 33%; corporate governance issues, 25%; security threats to employees and assets, 22%; terrorist attacks, 21%; theft and intellectual property, 17%; employee fraud or sabotage, 8%; natural disasters, 8%; and activist attacks on global brands, 5%.

Since 2003, terrorist activities have increased around the world. Westerners are often the target of these attacks, whether in Asia, Europe, or the Middle East. Some of the deadliest attacks in the last couple of years include:

- the Madrid train station bombing;
- the Hong Kong and Shanghai Banking Corporation - HSBC bombing in Turkey;
- the bombing of the compound for foreign workers in Saudi Arabia; and
- the hotel bombings in Amman, Jordan.

Such political risks rank very high when compared to factors like theft of intellectual property, IT disruptions, or product quality and safety programs. Also in Lebanon there have been, and still are, threats against foreign interests, especially American. For example, the fast-food chain McDonald's has 24-hour protection by the Lebanese armed forces at all outlets in the country.

These threats are not negligible. Political risk factors, together with business conditions and macro-economic variables, tend to influence foreign direct investment to developing countries.

Analytical models stress political risk and business-operating conditions as being important determinants for investors in countries that have historically attracted high foreign direct investment. However, for countries with relatively low foreign direct investment, a major determinant is the degree of socio-political instability. Current studies are investigating the degree of instability associated with investment risk on foreign direct investment inflows to MENA countries (Chan, Gemayel, p.7).

2.2 Changes in the Nature of Political Risk

Political risk was subject to numerous changes since the early 20th century. A historical perspective shows how the nature of dangers and risks has changed as the geopolitical course of the world moved rapidly in different directions. Following World War I, political risk became a major issue for a company or organization when deciding to invest in a foreign country. The colonial system was crumbling and newly-emerged independent nations were seeking a major role in controlling their own national resources. The end of the colonial period coincided with United Nations Resolution 16 in 1963 on Permanent Sovereignty over National Resources, recognizing the right of all states to freely dispose of their national wealth and resources in accordance with their national interest and in respect for their economic independence (Boulos, p.5). Today, nationalization is no longer a major issue. There are a number of reasons for this change, the main being globalization of international finance and the influence international financial organizations have on the world economy.

However, starting from the mid-1950s, the environment was more complex and ideologies were then shaping the political orientation of emerging countries. Armed conflicts were erupting here and there, mainly on the Asian continent, in Africa, and in the Middle East. Perhaps the key

event that had a rippling effect in many places was the Islamic Revolution in Iran in 1979, championed by the exiled spiritual leader Ayatollah Khomeini. Iran, once a strong ally and bastion of US interests under the rule of the Shah, became the scene of a spiral of violence, street protests against the USA - the 'Great Satan', and socio-political upheaval. The American embassy in Tehran was under siege for several weeks and staff kept hostage. The pseudo-democratic regime of the Shah reverted to theocracy; the country was under the rule of Imams, with Islam the guiding manual. The revolution brought about a massive wave of property confiscations and expropriations, especially in the oil industry, and American investors faced several setbacks. As a result, in the years that followed, international investors became ever more conscious of the threat political risk could impose on their investments (Marcwick, p.53).

The convergence of trends required the private sector to take appropriate measures to understand and manage its interests in a new and highly complex environment. Multinational companies are increasingly perceived as having wider reach, as well as greater power, influence, and visibility than the governments in host countries; take for example Procter and Gamble, Nestle, or Coca Cola. The presence of international business companies can lead to an increase in political risk in unstable regions (www.eforum.org.p.1). Ever greater volumes of capital are today at risk in the complex international political environment, according to the opinion of many company leaders at a workshop on security and political risk held shortly after the 9/11 attacks. The gathering was under the auspices of the World Economic Forum, which holds annual events at Davos in Switzerland.

There is no doubt that after 9/11, conditions for foreign investment were further aggravated as political risks increased. At the World Economic Forum held on October 24-25, 2001, one private-sector representative noted that threats resulting from terrorism had immediate ramifications for businesses in terms of protection of physical and informational business assets and

infrastructure, as well as on personal security issues in high-risk areas (www.weforum.org.p.1). These issues complicate the maintenance of client-, supplier-, and distribution-network relations. The increasing awareness of political risk triggered by 9/11 will likely result in the following trends in political risk insurance:

- Reinsurance capacity will be greatly reduced and terms and conditions circumscribed to exclude terrorism.
- Greater clarity will emerge in the definition of political risk, as mentioned earlier; and in the distinction between commercial and political risk, especially in cases of devaluation and inconvertibility.
- More and more countries, as well as multinational development bankers, will enter the political risk insurance market (www.viewswire.com/index/merisk p.1).

2.3 Political Risk Techniques

Political risk techniques first emerged in the USA as businesses there tended to lack the international perspective European businesses had acquired, and therefore felt more in need of systematic analysis. With political instability being prevalent in the Third World and a significant factor in world markets in general, the importance of political problems was acknowledged. For example, Nicaragua and other hotspots understood the need for such acknowledgment as they tried to ensure foreign firms would not again be affected by major political events (Overholt, p.5).

However, there is a need to manage political risk and a risk management plan should include a description of the probability of occurrence relative to the impact on a project, as well as present relative mitigation strategies. One way to mitigate political risk is to use negotiation strategies that align with the length of time a company intends to stay in a country and its desired international

reputation. However, organizations which make deals where the benefits are largely in their favor, face a higher probability of undesirable government interference in their activities. Companies with excessive, aggressive negotiation strategies may hamper their future ability to do business in other countries (Irwin, p.68). Thus, the best solution is to strive for relations that are mutually beneficial.

In the past, banks were uncertain about how to integrate political variables into macro-economic analysis. These variables tended to be considered only as marginal to the analysis. Later, in the wake of the Iranian revolution and other political events, political factors became more centrally and systematically integrated into macro-economics. One executive at the US Chemical Bank said: "Iran was a watershed, making us appreciate that our approach to political analysis had to change" (Kennedy Jr., p.17). There are various conceptual approaches to political risk, each offering a different explanation. One prevalent view identifies six approaches in explaining political risk:

1. *Actor/Source*: in terms of different groups and actors causing political risk.
2. *Relative Deprivation*: in terms of national frustration leading to expropriation.
3. *Product/Venture*: in terms of the varying degrees of sensitivity or vulnerability presented by different products/industries.
4. *Structural*: in terms of the vulnerability of an industry and structural characteristics of that industry.
5. *Bargaining Power*: in terms of the sources of bargaining power for the foreign firm.
6. *Government Type*: in terms of the risk of radical political changes resulting from different types of governmental forms (Monti-Belkaoui, Riahi-Belkaoui, p.84).

Daniel Wagner, an expert in political risk, believes that political power to some extent may cause political risks in international business, and that this power can affect the value of a company. Indeed, the nature of a local regime has direct influence on the homogenous growth of the business

climate. A company which is oriented towards international exposure cannot prosper under harsh authoritarian and repressive rule where openness is banished and transparency is not rigorous (www.irimi.com.p.1). Wagner adds that the policies adopted by the host government can either have negative or positive impact. Thus, a student-led protest for political change may not alter the investment climate, while a change in local tax law can very quickly erode a firm's profits. Therefore, a distinction must be made between firm-specific and country-specific risks. Firm-specific risks are directed at a particular company. An example is when a government arbitrarily and without specific reason nullifies its contract with a given firm; or when a terrorist group targets the physical operations of an organization. Country-specific risks are, as the term implies, specific to a certain country. They may affect a firm's performance and goals in the host country, as well as hamper its business pace. Examples are a government's decision to forbid currency transfers or the outbreak of civil war (www.irimi.com.p.2).

According to Wagner, the main types of political risks are government risks and instability risks. Government risks are on a country-level and include mass nationalization, regulatory changes, and currency inconvertibility. Instability risks concern internal developments and include mass labor strikes, urban rioting, and civil wars (www.irimi.com.p.3). While the first category is directly associated with the nature of the current regime and the government's way of handling affairs, the second category indicates the disenchantment and the growing disaffection of the population.

2.4 Variables Cited in the Literature on Political Risk

Through a project-based political risk analysis, it is possible to come up with the most effective strategies to manage risks. Political risk analysis should be undertaken early on as an integrated part of the feasibility study. A company needs to understand the political uncertainties

and the dynamics within a host country that drive politics at national, regional, and local levels (Marcwick, p.55). However, effective political risk analysis is not just a question of evaluating country risk – an assessment must identify the implication of social, political, and economic conditions for the project in question. The attitude of the host government towards an investment will also be influenced by the relationship between investor and government. The foreign investor may well be the first to manufacture a certain product in the host country. However, if the technology required for the project does not evolve or change significantly over time, it is likely that local businesses soon will follow suit. On the other hand, if the technology requirement is dynamic, a foreign investor may stay one step ahead of local competition and will be more likely to maintain a strong position toward a host government (Marcwick, p.55).

Howell Llewellyn, another expert in political risk, emphasizes the following socio-political circumstances that predict trouble:

- Nature of political regime: To what extent is it efficient for the procurement of a healthy business environment? Does it encourage foreign investors?
- Degree of legitimacy of the government: Is it elected through legal or competent elections? Does it have general consensus? Does it have full sovereignty over the nation?
- The extent of corruption (Llewellyn, p.14).

Though not new to businesses operating around the world, the implication of corruption must not be underestimated – it is one of the most negative factors of poorly functioning or undeveloped institutions. Demands for bribes from senior officials and politicians to win contracts are inherent in many countries of the MENA, while officials at all levels also resort to such practices to facilitate bureaucratic processes. Therefore, corruption constitutes an obstacle to business and a

genuine risk to investors. In many cases, companies may lose commercial opportunities unless they pay large-scale bribes to public officials. Thus, companies find themselves confronting a dilemma; if a firm does resort to paying a bribe to secure a project, the possible revelation of that payment may subsequently undermine the firm's position (Moran, p.12).

2.5 The Political Risk Phenomenon & Specialized Survey Institutions

To many, political risk may be regarded as a phenomenon that characterizes an unfriendly climate in developing countries. However, risks may be found anywhere, without exception; and the term 'political' does not necessarily imply 'terrorist'. Political risk has a wide range of interpretations and can include different aspects that cause trouble in a country. A high crime rate or an upsurge in violent unrest, even in highly-developed countries, qualifies as political risk. As political risk refers to potential economic losses arising from governmental measures or special situations, all foreign organizations can be affected. Thus, developments may either limit or prohibit the multinational activities of a company. If political risk is on a general scale, it is termed macro-political; if it affects only selected firms or industries, it is referred to as micro-political. In both cases the risk is related to:

> "...that uncertainty stemming from unanticipated and unexpected acts of governments or other organizations which may cause a loss to the business firm. It is obvious in a climate of uncertainty dominated by a probable loss to the business enterprise. It may arise from different sources. A wide spectrum of political risks may be generated by the attitudes, policies and overt behavior of those governments and other local powers-such as rival political parties, labor unions and nationalistic groups" (Llewellyn, p.37).

Because of the wide repercussions of political risk and the prevalence of local and international threats, special monitoring groups and organizations are conducting country-risk surveys, rating a country according to the aspect of its institutions and grading governance performance. Bank of America World Information Services, Business Environment Risk Intelligence - BERI S.A., Control Risks Information Services - CRIS, the Economist Intelligence Unit - EIU, Standard & Poor's Rating - S&P, International Country Risk Guide - ICRG, and Moody's Investors Service are among the most prominent. Each institution has its own methodology or index for evaluation, hence ratings are different. One of the most used is ICRG as its composite index contains considerable information in terms of forecasting risk-adjusted returns on the portfolios they construct. S&P and Moody's ratings are based on a limited number of criteria which are weighed similarly with ICRC and therefore closely correspond to its financial rating with a rank correlation of 90% (sba.luc.edu/orgs/meea/volume4/cinar.htm.p.2). In general, identifying the relationship between the criteria and the actual ratings of the various rating agencies is difficult, partly because some criteria are not quantifiable. Furthermore, the agencies provide little guidance to the relative weights they assign for each factor. In addition, availability and accuracy of the needed information and data, especially from developing countries, may hamper an agency's evaluation. Although substantial progress has been made over the last decade to improve transparency and timely flow of information, further efforts are essential to support and strengthen political risk analysis and thus bolstering confidence of foreign investors.

Is there a solution for countries with higher risks and poor grading? Riad Safadi, head of Trade Policy Dialogue Division and lead economist at the Organization for Economic Cooperation and Development - OECD, believes that implementation of reform calls for pragmatism when

addressing the political strains. It requires realistic planning and effective treatment of unforeseen sources of opposition, often by accommodation rather than by confrontation, which may lead to bloody events and general paralysis. However, time is the main element; in the long term, a reform program must survive several governments. This will only be possible if it commands legitimacy among at least a significant majority of the population and economic actors (Safadi, p.3). The democratic and legitimate institutions of the government should therefore invite the contesting party for a dialogue, so that the latter does not feel a loser and tries to undermine the reform process. There is a delicate balance the government should try to maintain and stabilization must prevail. Safadi argues that legitimizing reform will be easier if the local institutions are reasonably balanced and equitable in their power structures and the outcomes they engender, as parties will be more willing to accept short-term hardship in the expectation of longer-term gain (Safadi, p.3).

2.6 Political Risk & the Banking Sector

The banking sector can be significantly affected by political risk due to losses incurred when borrowing fails. Expanded political risk coverage provides a certain stability and balance. Today, many bank lenders who underwrite a substantial portion of project debts have an ongoing need for political risk insurance. If a UK bank wishes to participate in oil-well exploration in Sudan via a US$20 million 12-year loan, the Bank of England, in examining that bank's exposure in various classes of assets, might insist it set aside funds to cover possible defaults, thus lowering the prospective returns. The easiest way to avoid such provisioning is to purchase political risk insurance (Moran, p.143). Political risk insurance is often available – and for good reasons – for countries whose risk profile would not support large amounts of capital. The presence of such insurance supports longer maturities and may be provided at rates subsidized either by the host or by

various developed countries for strategic reasons (Moran, p.143).

Globalization and technological advances in telecommunications have allowed markets to transact large values on a 24-hour basis. In addition to financial liberalization, new horizons and new challenges have opened up competition and forced not just the financial sector, but also the real economy to adjust. The reason why banking systems play such an important role is that they form the heart of the global financial markets by being custodians of the liquid savings of the public; and lenders of these resources to facilitate economic activity, such as investment or risk management (Cheng, p.157).

The financial sector is supposed to help the real economy allocate resources and manage risks. However, this sector itself can be a major source of additional risks. Given that large risks in open financial markets can induce shock in many economic sectors, central banks must focus on national risk management. Some factors can be deduced by looking at earlier incidents:

- Bank failure is due to poor risk management and losses.
- Fraud is a vice that could bring major harm.
- Stopping the flow of future losses is critical.
- Inadequate supervision creates further losses (Cheng, p.164).

Throughout the social, political, and military events that have shaped today's world, there were many factors of political risk. In the early 70s, the dominating theory stated that the sources of political risk were competing political philosophies, social unrest or disorder, recently-acquired political independence, and armed conflict or rebellion for political power and nationalism. Later, high levels of national frustration were seen as the key determinant of expropriation, i.e. the relative deprivation approach. In the 80s, the emphasis was on the structural approach, affirming that the vulnerability of a firm to political risk was mainly dependent on structural characteristics, like ownership structure and

the host country's dependence on the international system (Monti-Belkaoui; Riahi-Belkaoui, p. 89). Today, in the age of globalization, new factors related to socio-political issues are emerging. Massive protests in Latin American countries over political scandals of any kind may augur political risks. A war of influence between Islamists and Moderates in Turkey may also create a sense of insecurity.

To what extent is the banking sector in the MENA region able to resist the social and political events in order to maintain stability? To study political risk in the banking and economic sectors in this region, the worldwide environment in which it is operating also must be taken into account. Although most countries in the MENA region follow rigid economic systems that are directly affected by an unstable political climate, many are adapting to the changes imposed by globalization.

Chapter 3: Economic Development

The Middle East and North Africa region has long been a center of attraction, but became especially so during the last century when the oil crisis led the superpowers to reorient their focus onto this fertile, but troubled area. As stated in the Chapter 1: Introduction, according to the IMF, the MENA countries are: Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Syria, Libya, Mauritania, Morocco, Oman, Qatar, Saudi Arabia, Somalia, Sudan, Tunisia, the United Arab Emirates, Yemen, and Gaza and the West Bank; as well as Iran, Afghanistan, and Pakistan. The region is economically diverse and the various countries are at different stages of economic development. However, a significant number benefit from rich, natural resources and share a common heritage.

According to a 2003 IMF survey, the region's 24 countries and territories hold about 7.7% of the world population, and about 75% of the world's proven reserves of crude oil. Thirteen MENA countries are oil exporters: Algeria, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Sudan, Syria, the United Arab Emirates, and Yemen (www.imf.org/imf survey.p.4).

Though the dominant religion is Islam, there are other religious minorities in several countries; notably Iraq and Syria, where various ethnic communities participate in socio-political life. Arabic is the most spoken language throughout the region, with the exception of Iran, Afghanistan, and Pakistan. Together, these three countries make up almost half of the region's population (www.imf.org.p.2). France is historically and culturally linked to several MENA countries. Ties with Lebanon culminated with the Mandate and French is still used in government and judiciary. French is also widely spoken in the Maghreb countries of Algeria, Mauritania, Tunisia, and Morocco.

In the early 1980s, the six countries of the Persian Gulf – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates – formed the Gulf Cooperation Council - GCC. By January 2010, a monetary union with a single currency is expected to be in place (Abed. p.2). Several other countries have concluded bilateral commercial treaties covering a wide array of business activities.

3.1 Economic Background

During the 19th century and into the first decades of the 20th century, the Western World was driven by industrial innovations, to some extent also affecting the MENA region. However, the two World Wars resulted in a prolonged depression, and it was not until the 1950s that a series of key transformations started to be felt in the MENA region (Ed. Safadi, p.18).

From 1950 to 1975, there was a strong oil-resource boom which helped realize high initial export to GDP ratios and high GDP growth rates. Consequently, the region benefited greatly from the sharp increase in oil prices. The explosion of investment and growth in the oil-exporting countries also resonated in neighboring countries through a steep rise in worker remittance, trade, and capital flows (Abed, Daroodi, p.1). There was a significant improvement in living standards, and the oil boom allowed financial assets to be accumulated abroad as national savings exceeded investment. In subsequent years, oil exports continued to be a substantial source for foreign exchange earnings for the oil-producing countries. However, the large gains in terms of trade during this period only accelerated the already declining trend in export to GDP ratios as cutbacks in oil exports were required to sustain higher prices (Ed. Safadi, p.19).

During 1985 to 2000, the MENA region suffered from the poor economic policies that many countries had adopted. They were characterized by:

- extensive government interventions;
- large public sectors;
- restrictive trade policies;
- inefficient mass subsidies; and
- badly managed fiscal policies (Salehi, Esfahani, p.6).

Economic growth was low and volatile. Data from developing countries on economic experience during the last 50 years indicate it is easier to initiate growth than to sustain it. However, what is evident concerning countries in the MENA region is the extent to which growth rates since the 1970s have been volatile and low compared to other developing countries (Abed, Daroodi, p.3). Table 1 shows the differential growth experience of the regions of the world (Salehi Esfahani, p.9).

Table 1: Differential Growth Experience of World Regions (real per capita GDP growth rates - %)

Growth	**60s**	**70s**	**80s**	**90s**
East Asia and Pacific	2.42	5.02	5.71	5.88
South Asia		0.33	3.55	3.4
Latin America and Caribbean	2.51	3.35	-0.11	1.45
Middle East and North Africa		3.4	-1.19	1.25
Sub-Saharan Africa	2.66	1.09	-0.7	-0.75
High-Income OECD	4.48	2.8	2.17	1.5
World	3.51	2.06	1.2	0.89

Source: *Salehi Esfahani, 2003.*

For example, East Asia and the Pacific region had a GDP growth rate of 2.42% in the 60s; by the 90s that had more than doubled, reaching 5.88%. South Asia registered a meager growth of 0.33% in the 70s, while in the 90s it had jumped to 3.40%. Comparing these figures to those of the MENA region shows a major disparity. After a promising start in the 1970s with 3.40% growth rate, there was a sharp drop in the 1980s to -1.19%, with a slight recovery during the 1990s to 1.25%.

Another setback was MENA's weak trade integration with fast-growing segments of world trade. A study examining the region's trade characteristics until the mid-1990s, noted two key factors affecting MENA trade:

- high dependency on European markets for exports in a narrow range of goods, e.g. fuels, agricultural products, textiles, and chemicals; and
- small base for intra-industry trade and only partial engagement in international production sharing (Ed. Safadi. p.22).

Such factors have affected the potential of the region and, while there is an urgent need of integration and diversification, the MENA countries have been unable to seize these opportunities and follow the trend. Subsequently, they have lost ground in terms of integration into the world economy. In the period from the mid-1980s to the mid-1990s, the median country in the MENA had a pace of integration that was about the same as in Sub-Saharan Africa, or Latin America and the Caribbean (Van Gelder, p.46). While East Asian countries in the last two decades have liberalized their economies and, at the same time, adopted more outward-oriented policies, this process has clearly been absent in the MENA region. Although most MENA countries have undertaken tariff and tax reforms since the 1980s, the process has been slow (Van Gelder. p 46).

In addition, there is an accumulation of other persistent problems which need to be resolved. High unemployment has been reinforced by years of high growth rates of population and labor force, leaving the region unable to adequately cope with these demographic developments. In recent years, unemployment in the MENA countries has grown faster than in other developing countries. Rapid population growth has become a serious problem. It has inflated the ranks of the young and flooded the labor market with a rising tide of job seekers, exceeding the absorption capacity of many economies (Abed, Daroudi, p.3).

3.2 Current Economic Situation

In evaluating a country's economic infrastructure, certain factors should be taken into consideration. Standard and Poor's, in Governance and Risk of 2004, pose the following questions:

1. Are there significant ownerships?
   a. state ownership
   b. financial / industrial groups
2. Is there a country code of governance that is generally adhered to?
3. Is there a universal banking system against separation between commercial and investment banking?
4. What is the degree of transparency? (Dallas, p.156).

Today, global markets are increasingly involved in competition among production systems, which have substantially improved in countries like China, Hungary, and Ireland. Multinational corporations are on the lookout for:

- access to key markets;
- adequate skills at competitive costs;
- high quality infrastructure and logistics;
- competitive domestic enterprises, i.e. cost, quality, and delivery; and
- efficient bureaucracy (Devlin, Yee, p.79).

The MENA region should benefit from available human, natural, and financial resources, and has often been challenged to manage these assets to create wealth and gain for its citizens. The MENA economies can rely on three major advantages: indigenous entrepreneurship, significant raw materials, and unique geographic locations (Devlin, Yee, p.79). However, not always have these assets been converted to tangible benefits for the region. Not only has growth faltered compared to

the rest of the developing world, but the share of world exports has been declining. Economic indicators suggest that the MENA region is under-performing in four major areas:

1. decline in economic growth compared to international benchmarks;
2. low level of share in international trade, with concentration on resource-based exports;
3. failure to generate job opportunities in the labor market; and
4. increased poverty and vulnerability (www.erf.org.rg.p.3).

A country's economic performance relies on its human capital. However, the MENA region suffers from a significant increase in unemployment, it is among the highest in the world. This is one of the factors that has resulted in economic malaise. There is also a slowdown in economic reforms. Countries like Chile or Malaysia know how to operate globally and in a short period of time have doubled their per capita income. They accumulated national wealth and improved living standards by adopting and/or encouraging open and competitive markets; a strong investment climate; and the mobility of people, ideas, firms, products, and services (Devlin. Yee, p.77). Nevertheless, since the late 1980s, many MENA countries have moved ahead, updating macro-economic structures and introducing reforms. Countries like Egypt, Jordan, Mauritania, Morocco, and Tunisia were pioneers, endorsing reforms such as: fiscal reforms, i.e. implementation of value-added tax and expenditure-management reform, and phasing-out of subsidies; introduction of indirect monetary policy instruments; liberalization of the trade; and introduction of some flexibility in exchange rates (Abed, p.5).

However, for most other countries, the investment climate remains difficult. Liberalization of services can create further investment opportunities for the domestic private sector and help attract non-debt-creating foreign financing, such as portfolio investment (Dasgupta, Nabil et al. p.144). The

MENA countries are poorly integrated in the world economy and the region receives only a small part of the foreign direct investment. Therefore, trade performance is below that of other regions. Moreover, while oil exports continue to be a significant source of foreign exchange earnings, the relative importance of such exports has declined since 1985 (Abed, p.4).

Various studies confirm there is an inadequate regulatory framework restricting competition and inhibiting private-sector participation infrastructure (Abed, p.4). Because of poor and high-cost infrastructures, such as transportation, telecommunications, storage, and distribution, the competitiveness of MENA firms is reduced. One example is the public monopolies of ports and port services, where poor and inefficient infrastructure for the loading and storing of goods results in high costs for importers, exporters, and traders. Monopoly shipping and domestic policies favoring national carriers tend to result in low-quality, low-frequency, and high-cost services. Policies restricting trade in land transport services impose high costs on intra-MENA trade (Dasgupta, p.145). Consequently, reforming the service sector may affect the economy as a whole, not just the external sector.

The region would also benefit from the liberalization of key services, such as telecommunications. In the document The Challenge of Trade and Competitiveness in the MENA Countries, the role played by information technology is emphasized and IT is decisively associated with a country's economy. The current rapid changes in information, telecommunications, and electronic trading technologies present another challenge. However, implementing a national information and telecommunications infrastructure is not problematic in terms of technology transfer of equipment and operations installations (www.erf.org.eg/html/economic.p.7). Nevertheless, there is a necessity to identify requirements of government, industrialists, and researchers as the main users of industrial data. The issue of quality and reliability is critical as there

are serious delays in data publishing.

Among developing countries, India and Malaysia have focused on developing their IT sectors. Malaysia has become an international hub for business to business, B2B, trade in information and communications technology products, especially semi-conductors. By 2008, the Indian IT sector is expected to provide about 2.2 million jobs, account for 35% of India's exports, and attract US$5 billion of foreign direct investment a year (Dasgubta, p.146). Though the MENA region is not a center for export-oriented IT services, a number of countries have the human resources and capabilities to compete internationally. The World Bank has conducted a comparative study of telecommunication and transport in Morocco and China. The findings were revelatory, clearly showing how low-quality and costly infrastructure services can imperil economic prospects of a country. The number of telephone lines per thousand people in the largest city in China is roughly three times higher than in Morocco; shipping a container of textiles from Morocco to the USA costs twice as much as from China; and Moroccan firms pay about twice as much for energy as do firms in China (Devlin,Yee, p.82).

The current economic assessment of the region was debated at a recent economic forum, Fulfilling a Promise: Reform Prospects in the MENA Region, held under the auspices of the IMF. Extensive discussions were held on what factors had negatively contributed to the economic malaise and what improvements had been endorsed by some countries. The region has avoided major economic or financial crises, but has done so through macroeconomic stabilization and defensive measures – thus restraining the potential for much higher rates of growth. The MENA region may be characterized as being in a state of low-growth equilibrium, or a low-growth path (www.imf.org external.p.2). There are indications the region's potential for reaping the benefits of globalization is great; but today, it is less integrated into the world economy than it was thirty years ago. Despite

earlier heavy investment in physical infrastructure and education, both quantitative and qualitative shortfalls are substantial and many countries are still in the process of ridding themselves of the legacy of a past 'statist' model of development that gave undue prominence to public investment and state-owned enterprises at the expense of private-sector initiative (www.marabe.org/temp/p.3).

One key area that has seen improvement is the import/export sector. Total manufactured exports from the MENA region increased by 49% during the second half of the 90s, while imports increased by 21% during the same period. (www.erf.org.eg/html/economic.p.1). In parallel with liberalization efforts on the trade front, many Arab countries have implemented structural adjustment programs. However, institutional and administrative reforms are still needed. For example, the process of importing and exporting is often characterized by excessive red tape; this increases costs and reduces competitiveness of MENA exports (www.erf.org.eg/html/economic.p.3).

Presently, the MENA region stands at the crossroads. There are important global trends towards new flexibility in production systems, financial networks, and international trade. These stress on the fact that location or resource endowments no longer need to determine economic destiny. For this reason, the MENA countries now find themselves before a crucial decision; whether to change or not.

One rewarding alternative is that they can pursue an agenda for prosperity, based on securing growth that is rapid, widely shared, and environmentally sustainable (www.marabe.org/temp/p.3). Prosperity will allow a quantity and quality of investment flow. Three broad and interrelated components shape these expectations and are determinants of competitiveness and profitability:

- There are a set of country-level issues; e.g. economic and political stability, and valid national strategies with regard to foreign trade and investment.

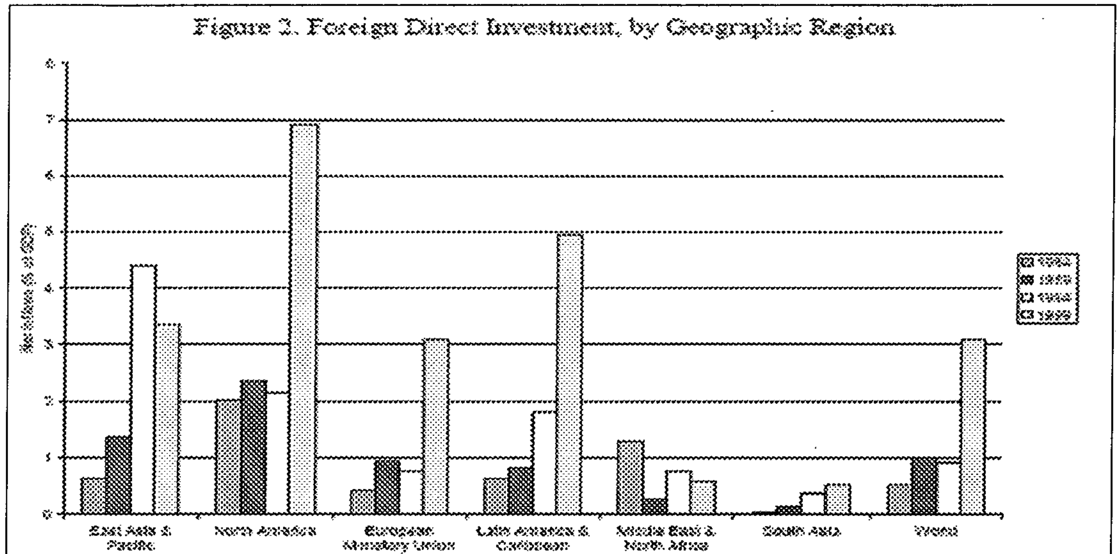
- Through the effectiveness of a country's regulatory framework, companies and firms should implement labor relations, efficiency, and transparency of financing and taxation, as well as reconsider other legitimate public interests.
- Identification of infrastructure capacity such as power reliability, access, and efficiency of finance (Devlin, Yee, p. 81).

The magnitude of net gains from trade will depend to a great extent on the degree of competitiveness of MENA industry. Rapid growth is not impossible, but it requires the will to cooperate on many levels and will depend on three critical factors:

- maintaining macroeconomic stability to promote business confidence and encourage private investment;
- deepening trade liberalization to promote integration into the global economy; and
- reforming domestic economic policy across a wide front to give priority to private-sector development (www.marabe.org/temp/p.3).

The remarkable increase of foreign direct investment in developing countries during the past decade is attributed to the improvement in local investment environments, based on the adoption of solid macroeconomic and structural reform measures. Table 2 presents a comparative picture which clearly indicates that foreign direct investment in the MENA region was low as compared with other regions (World Bank Group, Sector Brief, p.4).

Table 2: Foreign Direct Investment – Geographic Region



Source: World Bank Group - Sector Brief 2002, p.4.

Historically, the MENA countries have a higher level of instability linked with investment risk relative to developed countries. Stability allows investors to fairly accurately incorporate risk when evaluating the rate of return. The desire for this stability increases as the investment risk escalates. Given such circumstances, the question is whether the MENA region can integrate with global economy. It seems that even though there has been a movement towards macroeconomic-related structural reforms, they have not been well applied. There has been a failure to address deep-rooted structural and governance issues. In the long term, the region cannot afford to stay on the sidelines because of a lack of progress in this critical area. Broad action is needed, including a reassessment of the role of the state in the economy; the creation of a rules-based regulatory environment, governance, and quality of state institutions (www.imf.org/external/p.8). Standard and Poor's worldwide study based on broad measures of governance, presented the following conclusions:

- Governance does matter, because investors show that this is an important concern. Furthermore, some empirical studies show positive linkages with governance-related variables and performance measures.
- Governance is not a 'one-size-fits-all' concept. There are few insights from empirical research about transparency standards and broad structures (Dallas, p.13).

Research indicates that effective governance has long been viewed as essential for healthy markets. However, there has to be an assessment of countrywide governance risks, including a closer inspection of effectiveness especially of legal systems. Hence, a reliable legal environment is essential to good governance. Legal institutions remain ineffectual in some MENA countries (Dallas, p.15).

East and Central Europe made outstanding economic efforts after the collapse of Communism. These countries emerged from an archaic economic system and made the transition to market economy within a relatively short period of time. The MENA countries, although they cannot be directly compared, should nonetheless appraise that brief transitional period that witnessed an old system succeeded by a better one. There was a drastic change towards a private, free-market economy and parliamentary democracy. Later, free elections were followed by more differentiated political policies, as well as freedom of the press and human rights reverence. In addition, new legal and institutional frameworks, following the Western pattern, were in the making. This proved not easy, especially for countries like Hungary, Poland, and the then Czechoslovakia. However, macroeconomic stabilization – a prerequisite of successful transition – provided important results. Soon, the availability of goods and services improved dramatically and economic ties with the West progressed impressively (Ed. Good, p.90). Today, these countries have joined the

European Union thanks to their encouraging performance which proved beneficial to their economies and citizens at large.

Despite the inherent weaknesses that still prevent some countries from enjoying economic prosperity, there are many opportunities that could benefit the MENA region, especially in the context of liberalization. One often-mentioned factor is that the process of privatization is still absent in some countries, due to the fact that governments will not concede to readapt themselves according to new measures. Each of the 24 economies in the MENA region has its own, in some ways unique experience. The differences arise between oil producers and non-oil producers, and between countries that undertook restructuring and those that were less vigorous in pursuing reforms – in other words, some countries grew at higher rates, while others stagnated. Viewing the MENA region as a whole, weak economic performance can be attributed to:

- high population growth and low productivity;
- lagging political and institutional reforms;
- large and costly public sectors;
- inefficient and inequitable educational systems; and
- underdeveloped financial markets (www.imf.org/external/p.6).

These factors are interrelated and characterize each country to a varying degree. In the case of low productivity, most of the output growth has occurred as a result of increases in capital and labor, rather than in Total Factor Productivity - TFP, particularly in non-oil economies. A sustained rise in living standards is difficult if higher rates of accumulation of physical capital and labor are not accompanied by positive TFP growth (www.imf.org/external.p.7). The countries that achieved positive TFP growth rates, like Tunisia and Pakistan, have also achieved relatively high growth rates; while those with negative TFP growth rates have often witnessed poor growth performance.

Because the region has one of the much-prized natural resources on which many other countries depend, conflict of influence, strife, and archaic system of governance prevail in certain countries where state systems are authoritarian and tribal in character. Two negative elements are prevalent: political fragmentation and recurring conflict. Such factors often hamper the development of democratic institutions and remain a major obstacle to economic reform. The region performs poorly when it comes to civil and political freedoms, and gender equality, and offers few opportunities for the full development of human capacities and knowledge, according to The Arab Human Development Report by the United Nations Development Programme - UNDP (Abed, p.6). There are many obstacles that prevent the centralization of reforms and while institutions are urged by Non-Governmental Organizations - NGOs to safeguard civil and human rights, they clearly lack the means. There are neither freely-elected legislatures, nor competent or independent judiciaries.

Although the MENA region is a troubled area, it is rich in many natural resources, making it economically diverse and placing it at the center of attraction. The two World Wars during the 20th century had strong effects on the region and led to a series of transformations. After World War II, the area witnessed the first phase of development in the economic sphere. However, its subsequent slow and limited integration into the world economy negatively affected the region's potential. The MENA region later began to make some developments by moving towards new flexibility in production systems, financial networks, and international trade. A large number of Arab countries implemented structural adjustment programs and achieved some liberalization in trade. Yet, privatization is still not taking place in countries unable to adapt to new measures. This may be due to a lack of harmony among these countries in cooperating together. Thus, there is an inevitable need for economic and financial reforms in the MENA region.

Chapter 4: Financial Development

The banking sector in the MENA region has long been hampered by factors like political fragmentation and recurring conflicts that have caused setbacks and negatively affected growth and prosperity. Financial reforms that can help bolster the region to challenge such critical issues have long been needed. In some MENA countries, gradual reforms of the financial sectors have been proposed and implemented as decision-makers are becoming more aware of the urgency of the situation. While progress has been made, their efforts are just a footnote compared with reform and growth in other parts of the world. However, certain governments have brought in research analysts from international institutions to develop reform strategies and offer constructive advice on issues concerning the monetary sector or monetary policy, the banking sector size and efficiency, and the roles adopted by the government in the sector and others.

Both the IMF and the World Bank Group have undertaken studies on the financial development of the region to identify areas where progress has already been made and where reforms are still needed. The IMF study was based over 100 quantitative and qualitative statistics for twenty MENA countries. The data was organized under various themes to reflect aspects of financial-sector development: development of the monetary sector and monetary policy; quality of banking regulations and supervision; and banking sector size, structure, and efficiency, including the role of the government in the sector (Creane, Goyal, p.1). The findings do not differ from those gathered by the World Bank Group in its Sector Brief - Financial Sector in MENA. Despite gradual economic liberalization, the state in several countries retains a dominant role and the sector remains largely shielded from the pressures of competition. Even in countries where most banks are privately owned, competition remains low (Sector Brief-MENA, p.3). Though the banking systems may be

stable, performance tends to be poor or inefficient and services out of reach for large segments of the population. Another survey by the Global Development Finance Project states that the MENA was the only region where private capital flows did not increase in 2003; in fact, there was a significant decline. Gross bank lending declined from US$12 billion in 2002, to US$7 billion in 2003; while bond issuance declined from US$3 billion to US$1 billion; and foreign direct investment from US$3 billion to an estimated US$2 billion in 2003 (GDP 2004 Summary, p.3).

Public-sector dominance tends to hinders development. For example, in countries where the banking sector is privately owned and operated, as is the case in some Gulf states, the sector is well developed, profitable, and efficient. In contrast, public-sector banks are characterized by government intervention in credit allocations, losses and liquidity problems, and wide interest rate spreads (Creane, Goyal, et al. p.2). The IMF cites the heavy dominance of public sectors as an obstacle. For example, in the face of rising unemployment, the public sector increasingly serves as the employer of last resort, inflating public payrolls and wage bills. Governments in the region are relatively large and have been, for the last generation, net dissevers (Abed. p.6).

Most MENA banks tend to lag behind in product innovation and provision of new services to both savers and borrowers. A key prerequisite is to establish an efficient banking system that can perform basic, immediate functions. This requires improved strategic and financial management and greater intermediation. Such strategies could include opening markets to new domestic and foreign entrants and further deregulation of interest rates and products, combined with strengthened prudential supervision (Sector Brief-MENA, p.1). Furthermore, the regulatory environment is often week and rules are either non-existent or not adhered to. It is of utmost necessity that a regulatory and legal framework is set up and policies tailor-made for the economy of each respective country. For example, oil-exporting countries need to conduct fiscal policies based on a longer view of their

resource endowments and the impact they have on the country's welfare in order to enable diversification of the economy and develop non-oil sectors (Abed, Daroodi, p.18). On the other hand, non-oil economies rely on capital flows and worker remittances from oil-producing MENA countries. These economies are now striving to make necessary adjustments.

Jordan has already taken the initiative to make adjustments and has embarked on a program to encourage the private sector and attract foreign investment. The late King Hussein had made a personal plea to the Cabinet to stimulate and invigorate the economy. He particularly asked for reform of the investment law to reduce the government's rigid price-fixing policy, and advocated increased communication and coordination between government and the business community. Subsequently, a program on public-private sector relations was approved, introducing privatization on a commercial basis into some public sectors and encouraging the private sector to share in the ownership and management of public enterprises (Brent, p.173). Since then, the private sector has received increased support for research to enhance efficiency, and incentives to attract private investment have been made available. Moreover, new laws on property rights and commerce have been ratified. An economic consultative council has been established, composed of leading representatives from the public and private sectors. The aim is to coordinate and diffuse tension between the two sectors. (Brent, p.173).

When it comes to governance, some progress have been achieved. In most MENA countries, elections for representative legislations are becoming more open and meaningful, and the political leadership is becoming more aware of the need for political reform. Expanded access to diverse sources of information, as well as internal and external pressures, has brought about these positive developments (Kauffman, Gray, p.9). Still, a deepening of political reforms is viewed as a priority for the application of badly-needed reforms. However, there is currently a tug-of-war in the MENA

region. On one side, there are well-organized public-sector workers and established business interests with a stake in maintaining the status quo; on the other, diverse consumers and taxpayers who favor reform. Furthermore, relatively high public-sector wages combined with high unemployment rates undermine political support for privatization – equated with pay-offs (Bennett, p.9). For this and other reasons, the global investment community has neglected the MNEA region. Low growth rates are chronic and slow economic growth, together with rapid labor force growth, exacerbate the region's unemployment problem.

Today, while all countries in the region need to maintain macroeconomic stability and pursue structural reforms, it is the reform of public- and private-sector institutions that will make the difference. According to the 2003 IMF report, strengthening the quality of institutions in the MENA to that of the advanced economies could bring about good reform (www.imf.org/external/p.18). Inappropriate exchange-rate regimes could be regarded as a major problem, as they are thought to be a significant factor to slow growth of non-oil exports. They may also have delayed the development of monetary policy frameworks that are judged to be more suitable to emerging economies in the region seeking to integrate with the world economy (Abed, p.7). Moreover, emerging advanced technologies of telecommunications and the internet have a considerable influence on the banking sector, as many countries are trying to come to terms with these new trends.

Banking regulations in MENA countries are not adequate to efficiently accompany new developments. To do so, several steps are required, such as:

- ensuring the safety and soundness of banks and financial instruments; the purpose being to maintain domestic and international confidence;
- providing monetary stability and competitive financial system; and
- maintaining the integrity of the nation's payment systems (Chan, Gemayel, p.60).

In order to make the region more competitive, serious efforts have been undertaken not only by leading international organizations and institutions, but also by country officials. They all want to change the business climate through appointing new politicians to high positions in government and paying more attention to privatization, liberalization, and transparency (www.meforum.org/p.1). Algeria, Egypt, and Oman have embarked on monetary and financial policy transparency, while Jordan and Tunisia have focused on data transparency and integrity. Listed are a few developments that could further strengthen the prospects:

- The IMF, in conjunction with the World Bank's Financial Sector Assessment Programs, has helped to ameliorate banking supervision in many countries.
- The IMF is supporting steps by MENA countries toward trade liberalization and multinational trade initiatives.
- The IMF is contributing to significantly modernize customs administration and streamlining tariff policies by providing technical assistance (www.imf.org/external.np.p.2).

These efforts indicate that the MENA region is undergoing transition in three key areas: demographic, institutional, and global integration. The IMF World Economic Outlook shows a strong correlation between per capita income and the quality of institutions. Institutions are defined by regulatory frameworks, such as the independence of the central bank. They also include the quality of governance, such as political rights, public-sector efficiency, degree of corruption, protection of property rights, and enforcement of law (Jbili, Karamarenko, p.3).

Regarding transparency, the IMF, in consultation with the Bank for International Settlements and other financial experts, developed the Code of Good Practices on Transparency in Monetary and Financial Policies. The main aim was to make policies of central banks and financial agencies

transparent to the public. The four categories of transparency are:

- Clarity of responsibilities and objectives
- Open process for formulating and reporting decisions
- Timely availability of information to the public
- Assurance of integrity (Vanhoose, Kasperson, p.121).

Some MENA countries do not provide financial markets with sufficient information; conversely, they are susceptible to hasten their economies to the brink of a crisis. In reality, the word 'transparency' carries a powerful array of moral and political associations: honesty, guilelessness, and openness. Moreover, transparency has a democratic ring to it; and the pursuit of transparency is a project that is very difficult to challenge (Vanhoose, Kasperson, p.126). In order to make information available in a transparent and timely manner, the IMF recommends that central banks follow a set of standards for data dissemination and establish and maintain information departments.

The advent of globalization and its significant impact has urged the region to cope with liberalized markets while focusing on internal reforms. The issue of privatization increases as the improvement in productivity becomes important to overall prosperity and growth. The MENA region is realizing that the state's ability to play a useful development role should gradually decline as the economy become more complex. In reality, the shift to free markets does reduce the extent to which social goals can be pursued through market interventions or corporate objectives. Debates continue in most MENA countries over the need, modalities, and pace of such enterprise. However, privatization is a long-term process, especially in the Middle East, and the state will continue to play an important role in economic activity, if only by way of regulating, overseeing, and participating in the process of privatization. The reason privatization has been so long in coming is that when the modern states were formed after the return of sovereignty and independence from foreign mandates,

the economic system in place was hegemonic. The state then stepped in to fill a gap in the industrial sector which was very small, undercapitalized, and oriented toward production of consumer goods. Thus, the state has had a dominant role in the economy (Frost & Sullivan, p.3). Today, advocates of privatization need reflect on the appropriate role of the state after privatization has been implemented, as well as if it is not, and especially if it should fail (Frost & Sullivan, p.7).

Many financial reform initiatives remain stagnant due to several contributing factors, including political opposition, the unique nature of Arab kingship and tribal relationship, and the diffidence of the private sector (Mehanna, p.38). As a whole, the MENA region trails behind other emerging economies. The IMF and the World Bank agree that the region's industry is still shielded from pressures of globalization and competition, while banks have to a large extent failed to come up with product innovation and new services. However, improvements can be seen in countries like Syria and Lebanon, where the banking sectors are making every effort to reposition themselves, accepting gradual changes, and acquiring advanced technologies. The assistance of international organizations is significant, but more crucial is the adoption and implementation of programs for transparency and campaigns against institutional corruption. Finally, the political risk issue may also impede the positive performance of the banking sector in the MENA region.

Chapter 5: Political Risk & The Banking Sector

5.1 Political Risk & the Banking Sector in General

In today's unpredictable climate of world politics dominated by violent conflict, upheaval, forced intervention, army intimidation, and assassinations, the management of political risk is a highly specialized task. For multinational organizations, political risk does not necessarily result from the type of political system in place in the host country. For example, Western companies have successfully operated under many types of political systems, be they Marxist, capitalist, nationalist, socialist, monarchic, or democratic. However, political risk is affected by changes in political and socio-economic conditions, as when a new government takes over and adopts an anti-foreign investment attitude contradicting with that of the previous government (Monti-Belkaoui, Riahi-Belkaoui, p.1).

With the success of overseas operations influenced by the actions of host governments and competing political factors, political risk assessment has become an essential component of any profitable foreign investment strategy. An accurate assessment demands a detailed study of the environment for international business in general, and the economic environment in particular, including the evaluation of the fiscal system. The degree of political risk is related to the current activity in the host country that is affecting – or likely to affect – the stability of the government, i.e. insurrection, rebellion, or criminal activity; prospect of change of national or local government; past history of nationalization or expropriations; experience of other financial institutions and banks in the country; political activity and trends in the region; as well as punitive taxation, burdensome labor and environmental regulations, and price and monetary controls (www.s2a.com.p.1).

The relationship between the business world, where banking institutions play an important

role, and the political world, in which institutions operate, has changed dramatically. After the radical transitions from colonial governance and control to independent and innovative systems of governance in the 1960s and 1970s, the world has become increasingly governed by the principles of nationalist economy, which poses a threat to foreign investors through nationalization and expropriation (Howell, p.3).

On micro- and macro-economic levels, political risk assessment is dependent on type of investment, business activity, and the way it performs. For instance, a bank with debt exposure in a developing country will be concerned when there are changes in macroeconomic policies, since such changes may directly affect debt value. On the other hand, a bank with no physical presence is obviously less concerned about risks such as political violence. An oil company with exploration and production projects in that country will emphasize on security issues and its relationship with the host government; while for a company selling to other markets, the host country's macroeconomic policies will have much less impact on its business operations (Minor, p.4). The impact of politics on business operations can well have negative results, including expropriation, damage from civil strife, and breach of contract for political reasons. Such consequences of political interference are what agencies like the United States Overseas Private Investment Corporation - OPIC and the World Bank's Multilateral Investment Guarantee Agency - MIGA insure against. Political impact that demands the presence of a stable and structured legal system, provides a set of expectations that foreign corporations find familiar and protective (Howell, p.4).

Recent political crises in Southeast Asia, Russia, Latin America, and the Middle East underline the risks of globalization. International financial institutions are taking a global view of their strategies, whereas host countries are beginning to recognize the importance of the global dimension in their economic development planning and the necessity to strengthen economic

stability (www.aon.com, p.1) Moreover, foreign banks are expanding financing options, including long-term loans, to large clients. These are often companies that are big employers and provide key goods and services. Retail banking is also seeing radical change, with banking deposits and loans growing rapidly. Hence, the government of host countries not only have to develop policies that make it attractive for foreign banks to invest in their markets but, more importantly, reduce their risk perceptions through regulations that permit repatriation of profits, majority ownership and control, patent protection, and enforcement of contracts. From the government's perspective, regardless of the stage of economic development of the country, introducing policy variables that reduce risk will have positive impact on inward foreign banks or financial institutions. Recent trends indicate a move by developing countries to do just this, whereby conditions are being created for a more favorable investment climate through relaxation of investment controls and provision of investment incentives, including better protection of property rights and enforcement of contracts. Under these circumstances, firms with strong ownership structure are willing to enter these countries and enjoy the benefits and advantages as first mover (www.aon.com, p.2).

5.1.1 Identification, Assessment & Analysis

In order to identify and assess political risk, a systematic and comprehensive approach is required. The analysis can be conducted in-house or by specialists brought in, using methods like qualitative briefings by experts or quantitative computer-based assessments by a numerical ranking of different variables (Erol, p.77). Generic approaches are not viewed as accurate determinants in assessing political risk in relation to foreign investment. Though they take into consideration a variety of data from different countries and industries, they fail to determine an accurate assessment of the political risk dimension and its relationship with investments from outside the host country.

Both the peculiar characteristics of the host country and the attributes of the investment project are required. Projects can be differently affected by the political events of a host country. How and to what degree the effect on various projects may have been in the past is then taken into account when determining future potential risks (Erol, p.79).

A rational, accurate approach to making a foreign investment decision requires the financial institution to carefully examine numerous factors related to both the general environment of a proposed investment and the specific operating function in that environment. Presently, major banks with substantial participation in international lending are driven, both by law and by competitive pressures, to accord greater importance to country-risk analysis. This is now a top priority in most major international banks, and many have instituted and strengthened the process by setting up elaborate risk-assessment systems. The fact they have institutionalized risk-assessment systems is a sign of better adaptability to world events that may affect them.

The spectrum of analytical approaches and formulations in political and country-risk assessment systems vary from quantitative approaches to those based mainly on structured qualitative judgments (Ting, p.154). Through analysis, a bank is provided with a clear identification and assessment of the risks facing the proposed investment, for example government nepotism or social unrest. Risk factors are then plotted on a special matrix to demonstrate the likelihood of their occurrence and potential impact on the investment. This process enables the institution to implement measures and adjustments so the risks are acceptable (Control Risk Group, p.2). Sociopolitical risks involving political instability and disruptions affect a country's willingness to meet its external obligations. Both inability and unwillingness to permit outflows lead to inconvertible risks for international lenders; thus, policy risks come from a country's ability as well as its willingness to meet its external obligations (Ting, p. 154).

Many studies have outlined how country-risk assessment can be organizationally integrated into bank lending and operating decisions. A multi-stage process would include:

- a review of the development in the field of political risk assessment;
- a survey of in-house expertise regarding the setting up of the assessment methodologies and information-collection methods;
- the selection of an in-house panel comprising country accounts officers and foreign account personnel, as well as their supervisory management;
- the development of an in-house questionnaire survey and measuring instrument; and
- the synthesis and integration of the results of the various qualitative and quantitative assessments (Ting, p.157).

The assessment of political risk reveals existing problems and vulnerabilities. The degree of willingness to accept political risk varies from one financial institution to another. What one institution finds acceptable, may be too risky for another. In addition, there is usually a direct correlation between the degree of political risk a company is prepared to accept, and the degree of potential of the proposed contract area (Ting, p.158). However, there are several ways to mitigate the impact of political risk, including the following techniques:

- *Contractual undertakings with the host government*: Though contracts cannot prevent a government from changing laws and policies, they can establish a right to compensation if changes negatively affect foreign institutions.
- *Joint venture with local company and/or strategic investor*: Local joint-venture partners can help navigate the local political scene and may be in a position to exercise more influence over government policy-making. Moreover, governments may be disinclined to damage or harm significant local interests. However, joint

ventures with governments are less desirable; historical analysis suggests that public/private joint ventures are more – not less – likely to be subject to expropriation. They may also perform less efficiently than government wholly-owned enterprises as the roles of the government as owner, operator, and regulator are easily blurred.

- *Community relations*: Measures include educating the public on the benefits of foreign investment on the role of the private sector, and providing previously public services. Moreover, foreign investors should keep a low profile, maintain close relationship with the host government, anticipate change and work with it, avoid geographical concentration, be a good corporate citizen, and utilize local suppliers and personnel to the greatest extent possible so as to create an economic link with the host country that establishes a national constituency with a stake in its continued political survival (Minor, p.8).

5.2 Political Risk in the MENA Region

Numerous terrorist incidents, such as the attacks of September 11 and the war on terrorism that followed, have added a new dimension to future political risk concerns in the MENA region (Dillman, p.4). This sequence of events affects the Arab and Muslim sensibilities and could increase cynicism on the part of the Arabs against the USA. It could intensify the upsurge in terrorist strikes against US interests. Thus, the attacks of September 11 constitute a new twist to political risk. The ongoing US occupation of Iraq, where stability has not yet been achieved, could trigger increased anti-Western sentiment and intensify the upsurge in terrorist strikes, not only in Iraqi territories, but throughout the MENA region. Since Westerners believe that the MENA region is mired in Islamic

fundamentalism and growing hostility toward foreigners, there is a growing hesitancy to fully invest there. In addition, political uncertainty still characterizes the region; the current political situation of Iraq's immediate neighbors may illustrate this. In Saudi Arabia, there is fierce confrontation with the Islamic groups led by partisans of al-Qaida. There has been a series of suicide attacks on foreign compounds and *jihadists* swear that they will continue to target foreign infidels and force them to leave (www.yahoo.new.saudiarabia.pl). Oil-rich Kuwait was much relieved when the Baathist regime of Saddam Hussein was toppled. Kuwait is one of the leading MENA countries in terms of economic integration, reformed financial institutions, and advanced infrastructure. Yet, there have been repeated armed confrontations against local authorities and news reports have indicated a terrorist group affiliated with the al-Qaida base of Osama Bin Ladin. Though the government has to a certain extent been able to stop these attacks, the threat still persists as the group has vowed to retaliate.

For the MENA region, current projections are for a modest pick-up in economic growth. However, there are three significant factors that could halt the growth of manufactured exports and hinder foreign direct investment:

- the possibility that the pace of domestic reforms may slow down with the aftermath of regional conflicts as governments find it difficult to address the more controversial structural amendments critical for raising productivity and promoting diversification;
- the persistence of a negative investor outlook toward the region, thus causing great difficulties in attracting foreign direct investment and other forms of capital flows; and
- the expectation that the Iraqi war could last longer than envisaged (Haddad, Hakimian, p.7).

This intense environment, combined with worldwide economic crises, will certainly bring political risk management back. Thus, many financial institutions are taking out political risk insurance as an effective means of managing political risk exposures. Today, large and mid-size institutions alike operate in areas of the world where foreign businesses did not venture only some years ago. According to Maura Garyeh of Marstis Political Risk Practice: "The current economic and political climate [is] less certain and more volatile than it was even two years ago… [This] has made corporations profoundly aware of their responsibility in protecting their shareholders' interest, while taking into consideration the increased risk of manufacturing and selling in developing markets of the MENA" (www.marsh.com.p.1).

There is a widely-held belief that the map of political risk has taken on a changing form in the past few years, especially in the Middle East. The political risk issue has been given a higher priority in the last five years because of the emerging new risks resulting from escalating violence in the Middle East. It would be a mistake to overlook the insidious political risks that may gradually chip away an organization's international operations (Minor, p.3). During the past decade, reforms have fundamentally changed the political elite and affected state-society relations. Amnesty International and other watch groups affirm that in the 1990s, a reinvigorated authoritarianism has emerged in Egypt, Algeria, and Tunisia (Dillman, The Middle East Journal, Volume 55, No.2, p.4). In these countries, military and other officials have remained key political actors as various riots were sparked by structural reform programs.

AON Corporation places insurance for investments with commercial insurers worldwide; as well as with the Overseas Private Investment Corporation for US investors, and the World Bank - MIGA. Insurable risks include:

- Confiscation, expropriation, or nationalization of fixed/current assets

- Cancellation, suspension, or withdrawal of concession permits, exploration or operating licenses
- Deprivation of rights to own and use an asset
- Forced abandonment or forced divestiture
- War, terrorism, sabotage, and other forms of political violence
- Foreign exchange restrictions
- Breach of government undertakings on which the investment was predicted (www.aon.com/us/busi/risk-management, p.1).

A set of political indicators, such as civil and regional wars, unconstitutional and violent attempts at change of governments, and riots, is systematically associated with investment and growth. The MENA region has historically been one of the most violence-prone areas of the world. In addition to the Arab-Israeli conflict of wars and instability, the region has been negatively affected by three major regional wars in the 1980s, 1990s, and 2003 (El Badawi, Liman, p.106). Moreover, since the 1970s, numerous leaders have been assassinated during political struggles between moderates and hardliners in Saudi Arabia, Egypt, Algeria, and Lebanon. Thus, war is seen as one complicating factor of special relevance to the MENA region and continues to be so as minor and major conflicts erupt every now and then. Some conflicts have had both regional and international implications. Unlike the rest of the world, MENA continues to suffer from lack of democracy, while wars and military incursions, as well as economic sanctions and blockades are commonplace (Hakimian, Nugent, p.3). Conflicts include the territorial claims by the Palestinian Authorities; the tension between Lebanon and Syria, unresolved since the civil war; the situation of Iraq, the temporary compromise between Egypt and the Islamic Brotherhood; and the bloody warfare against Front Islamique du Salut in Algeria. Presently, with major national and regional

resources tied up in these unresolved conflicts, the prospects for economic and political integration appear as distant as ever. In addition, these conflicts show to what extent political factors affect the aggregation of the region on both local and trans-national levels – the occupation of Iraq, for example – can well have serious repercussions in other MENA countries.

The political experience of the MENA region is one of unrelieved autocracy, in which obedience to the sovereign is a religious, as well as political obligation; and in which disobedience is a sin, as well as a crime (World Bank: MENA Development Report, p.204). There are contradictory arguments about authoritarian regimes and the rise of Islamic fundamental groups, and it is debatable whether their presence helps explain the authoritarianism of political regimes by providing governments with an iron fist (www.sba.luc.edu/orgs/meea/volume4/cinar).

Two distinct trends have emerged:

- Integration at the sub-regional level: organizations like the GCC and the Arab Maghreb Union were founded in the 1980s.
- Gradual trade liberalization: the Euro-Med Initiative, between the European Union and the southern Mediterranean MENA countries, aims to define a common area of peace and stability through the reinforcement of political and security dialogue; gradually establish free trade areas; and build rapprochement between peoples on the social, cultural, and human levels for building understanding and exchange between civil societies (Hakimian, Nugent, p.3).

5.3 Political Risk & the Banking Sector in the MENA Region

In the MENA region, the banking and financial services sectors play an especially pivotal role in the implementation and enforcement of procedures by corporate governance. However, since

the region on occasion faces political uncertainties, domestic disturbances, unresolved crises, and persistent antagonism against Western influence, these factors hinder development. An example is 9/11 and its rippling effects. In its wake, support of the war on terrorism fueled internal political tensions in several Muslim states, particularly Egypt, Pakistan, and Saudi Arabia, where most people seemed hostile to American hegemony (Longueville, p.28). With repercussions still affecting the region, there are possibilities of near-term, top-level changes that could add to political risk in some countries such as Saudi Arabia, Iraq, Pakistan, Syria, and Jordan. For example, Saudi Arabia has had to cope with the risks emerging from the repeated threats posed by the claim that some of its institutions have political and financial links to terrorism. The US government has a list of Saudi institutions which have been financing al-Qaida and other banned groups. In spite of reinforced bi-lateral support in case of difficulty, destabilization of some states is unavoidable in the medium term (Longueville, p.28).

To what extent can the MENA banking sector absorb these threats? Is it well equipped to counter these negative developments? In some countries, like those in the GCC, the banking sector is well developed, profitable, and efficient; however, for about half the region the situation is different (Creane, Goyal, et al, p.3).

Nasser Saidi, in his book on improving transparency and disclosure, insists that MENA banks must improve their own governance, transparency, and adherence to international standards for financial institution stability. They must transmit those practices to their clients by using corporate governance tools to better assess risk factors and investment decision (Saidi, p.19). Most banks operate without accommodating current tools for risk management. Such a climate could hamper the objectives of financial institutions to maintain their vital interests. In a journal article entitled Political Risk, Securing Competitive Advantage, the Arab Bank Review proposed a

practical solution to current needs with regard to risk management: offer training – bankers with an understanding of political risk have considerable competitive edge over fellow bankers who lack such understanding (www.ab.arabbank.com/review, p.1).

The principle of a political risk analysis is being fully conversant with the dynamics of a particular country so that a business plan can be adapted according to that country's needs. By providing a good risk analysis and following up on the needs of a country, macroeconomic growth and development of domestic markets can be achieved.

On the other hand, bankers may be asked to provide insights that require political risk expertise. The main benefit of political risk analysis is that it studies the bank's adherence to the country's risk management climate.

A suitable approach is to build an internal team- and reporting-process, as well as develop a management process and appropriate methodology. Thus, a bank can formulate its own pro forma and populate it with the data it deems relevant (www.ab.arabbank.com/review, p.7).

Today, MENA banks need to function on a daily basis with the issues that are fundamental to profitability. They must, through a network of general managers, country managers, and risk department managers, have a sophisticated understanding of individual countries and their business there. Countries adopt different approaches when it comes to the integrity and efficiency of their fiscal regimes (McRorie, p.42).

The Arab Bank Review points to four key areas for examining the extent a bank responds to a country's needs with regard to political risk management:

Structure ⇨ 20% of the Analysis	This investigates the power structure and balance with the country	This area relates to the current situation
Efficiency ⇨ 30% of the Analysis	This seeks to look at how well the country evolved, problem solving	This looks at managerial past performance
Resilience ⇨ 40% of the Analysis	Capacity to manage challenges, demonstrate strength	This seeks to forecast how adaptable and rational the country will behave
Values ⇨ 10% of the Analysis	It is necessary to to understand adherence to and the development of human and commercial values	Over the long-term, this seeks to assess pressure points

Source: McRorie, p.44.

The end result of these four areas, showing linkages between political, economic, and social dynamics, can offer a means for generating a level of commercial confidence. There is ample evidence suggesting that the degree of political instability in the MENA region is relatively high and the status of institutions weak. The outlook is pessimistic, as two negative elements undermine real progress: political instability and low institutional quality, due to inefficiency and corruption. They both affect policy credibility and lead to unstable incentive. Political violence and civil wars, chiefly in Sudan with genocide in Darfur, and Iraq where Sunnis, Shias, and minorities are engaged in a bloody, destabilizing conflict, are still very much present in the region. Even though there are hopes on the Israeli-Palestinian front following the new leadership of Mahmoud Abbas, peace remains absent. Moreover, as long as there is no comprehensive and just resolution of the Arab-Israeli conflict, not only with the Palestinian Authority, but also with Syria and Lebanon, the region will continue to be one of the most volatile and violent-prone in the world (El Badawi, Liman, p.123).

The MENA countries should take further steps in order to overcome political instability and

low institutional quality. This can be done through implementing reforms in the financial and banking sectors that address economic deregulation, enhance prudential regulations, and improve structural financial regulations (Ed. 2 Iman, Uttam, p.45). The MENA countries seem to be determined to overcome the decade-long setbacks that have prevented them from emulating recently-flourishing Asian countries, especially in the banking sector. Currently paralyzed by numerous factors, MENA banks need to adapt, become flexible, and embrace world standards.

Chapter 6: Saudi Arabia – The Banking Sector

Over the last few years, there have been significant changes in the financial and banking sectors in Saudi Arabia. The modernization of the sector and the introduction of new products and services through advanced technological mechanisms have translated into expanded customer service, better understanding of customer needs, and a more targeted approach. More banks are offering Islamic banking services and authorization has been given to open up the banking sector to foreign investors. New mechanisms are also permitting Saudi banks to better absorb difficulties related to political risk.

6.1 Overview

The Kingdom of Saudi Arabia was founded in the early 1930s by King Abdul al-Aziz al-Saud. The cornerstone of the al-Saud family's legitimacy is *Wahhabism*, a conservative interpretation of Sunni Islam. Today, Saudi Arabia is the world's largest oil exporter with by far the greatest proven reserves of crude oil. Based on current output, this is sufficient for almost 90 years' extradition (www.viewswire/index.asp,p.1). With such overwhelming natural resources, oil wealth has transformed the country's economy and transferred the Kingdom to a glitzy metropolis amid a desert of dunes. Wealthy Saudi businessmen go on spending sprees buying important assets in foreign markets, especially Europe and North America. But conservatism is rigorous, and the country's policies and society remain stuck in rigid conservative tradition. Any transgression, internal disturbance, or criminal activity is subject to harsh physical penalties, including capital punishment by beheading.

King Abdullah bin Abdel Aziz al-Saud is head of state and prime minister; his deputy, and

also minister of defense and aviation, is Crown Prince Sultan bin Abdel-Aziz al-Saud. About three years ago, a consultative council, *Majlis al-Shawra*, was appointed. Though having a purely advisory function, the Consultative Council has been encouraged to become more assertive. For example, it rejected a government proposal to levy income tax on expatriates. Since October 2003, the Council is able to propose and debate legislation on which the government may disagree. However, the monarchy has absolute legislative and executive power and the king appoints the Council of Ministers, which he also leads as prime minister. Since Saudi Arabia is the location of Islam's revered shrines and the pilgrimage destination of millions of Muslims from all over the world, the political and judicial apparatus remain bound to Islamic principles, with the *sharia* Islamic law the basis of all legislations (www.viewswire.com/index.asp,p.1).

The changing political situation in the region poses challenges for the economies of the Middle East. Yet, the fundamentals of the Saudi economy are relatively robust. Modernism is focused on social issues, but also covers key industries and urban affairs. The petroleum industry is very advanced compared to other oil-exporting countries. The financial system functions well and, despite government debts, there is currency stability and inflation is low (Wilson, p.50). Saudi Arabia can surely compete with most foreign countries on many issues, and in different sectors.

6.2 The Banking Sector

The banking sector is subject to state controls, with the authorities determining the basic structural elements, leaving banks and other financial institutions for the most part free to compete and expand within these boundaries. There is a marked difference compared to the approach of the neighboring countries Iraq and Syria, where the banking system has been nationalized. Saudi Arabia does not share this ideology and is highly unlikely to follow such a path (Wilson, p.56).

Two years ago, the Saudi Arabian Monetary Agency – SAMA, in a move that surprised many, granted a license for the Deutsche Bank to begin independent operations and open a branch in the country. From the Saudi perspective, the presence of the Deutsche Bank, Europe's second largest by assets, was an important note of confidence in the economy, especially at a time when international press headlines were focusing on political pressures within the country (www.ameinfo.com/news/detailed,p.1). It also indicated the willingness of Saudi Arabia to strengthen economic ties with Europe. Subsequently, other foreign banks have followed suit, including BNP-Paribas, JP Morgan, the National Bank of Kuwait, the National Bank of Bahrain, Emirates Bank, Gulf International Bank, and the National Bank of Pakistan. In October 2005, BNP-Paribas opened in Riyadh as the first European bank to enter the Saudi market as a fully foreign-owned and operated bank.

Globalization has played a crucial role. Despite the repressive and entrenched system in many sociopolitical facets of the country, the authorities are realizing that the currents of globalization are unavoidable. Hence, since 2000, they have initiated long-awaited reforms in the economic and financial sectors, and in some cases implemented, a series of structural reform measures to:

- give more responsibility to the private sector;
- liberalize trade and investment regimes;
- improve banking services; and
- diversify the overall economy (Engaging with the World, World Bank, p.100).

Several steps have been taken to strengthen the financial infrastructure as Saudi Arabia wanted to establish a sound financial system based on international standards that rival those of major industrial countries. This has resulted in a strong banking sector that benefits from

international expertise and sophisticated technologies. Some recent developments particularly show how seriously economic commitments are taken:

- The banking system is well integrated with that of international banking. At present, there are five joint-venture banks with significant shareholdings and technical agreements with their foreign partners, all highly respected international banks.
- Recently three GCC banks have been granted licenses to operate, while other applications are being assessed. This is part of the GCC economic integration development.
- For the last decade, there has been an organic growth in domestic bank balance sheets. At the end of 2002, the risk weighted capital to assets ratio of banks stood at 20.3%, compared to the Basel Standard of 8% (Al-Sayari, p.7).

There are at present ten commercial banks, two foreign banks, five specialized public banks, one supranational development bank, numerous money-changing institutions which operate under SAMA supervision in a slightly different capacity from that of commercial banks, and several specially-constituted financial organizations. Most of the commercial banks are privately owned. However, three have stakes held by government agencies; of the remaining seven banks, one is fully Saudi-owned, one has majority Saudi stakeholder, and five are joint-ventures.

The government's main reform efforts give a clear indication where the country is headed in the near future. As the political environment is slowly turning towards democratization and the influence of the international media is increasingly felt in society, the following initiatives, despite some delays from the authorities, have been timely:

- Decision to join the World Trade Organization - WTO; accepted as member.

- Moves to privatize parts of the dominant state sector.
- Efforts to improve the foreign direct investment climate, including the crucially important hydrocarbon sector.
- Attempts to diversify tax revenues away from over-reliance on volatile oil prices (Engaging with the World – World Bank. MENA).

These reforms had been carefully planned and implementation followed with utmost care, resulting in success beyond expectation. In the September 28, 2004 wire report by the Economist Intelligence Unit, Saudi Arabia's score in the EIU's business environment rankings jumped from 5.50 for the historical period 2000-2004, to 6.23 for the forecast of 2005-2009. This reflected a robust and improved score for the tax regime, a strong score for market opportunities, and an improved score for policies towards private enterprises and foreign investment (www.viewswire.com/index, p.1). In the regional rankings of 2000 to 2004, Saudi Arabia was third out of seven countries: Algeria, Egypt, Iran, Israel, Nigeria, Saudi Arabia, and South Africa.

According to rating agency Capital Intelligence, Saudi Arabia has one of the best-managed banking systems in emerging markets, with good regulations, disclosure, and transparency. In 2004, the agency upgraded seven major banks to A-, above the country's sovereign ceiling of BBB+. Similarly, Moody's Investors Service praised the performance of Saudi banks as they emerged after the 1980-1991 oil-price downturn stronger and leaner, following cost-cutting and extra provisioning (Al Sayari, p.12). According to Standard and Poor's, financial transparency represents the backbone of a banking sector. For Saudi Arabia, such factors would open the way for capital markets to invest in the country. According to a S&P's credit risk analyst: "As far as accounting practices and financial disclosures are concerned, GCC banks including Saudi Arabia represent some of the most advanced financial institutions in emerging markets in general, and in the Arab world in particular.

Most of them have adopted international accounting standards over a period of several years and reached an adequate level of financial disclosure" (Hassoune, Volland, p.1).

However, there are areas related to economic liberalization which are not expected to be reformed over the short to medium term. Bureaucracy is slow and regulations not transparent, while good connections a distinct advantage when doing business. Although less so today, corruption is acknowledged by the government to be substantial. Moreover, the government favors domestic interests over foreign concerns (EIU-Saudi Arabia, p.3).

Nevertheless, Saudi Arabia is still considered number one in the region in terms of attracting foreign direct investment. New regulations are eagerly anticipated as legal and regulatory frameworks will open up the capital market, support privatization, and increase public participation in financial markets through greater efficiency and transparency. One key decision is the setting-up of the Securities and Exchange Commission, whose objective is to protect investor interests; ensure orderly and equitable dealings in securities business; and promote and develop the capital market (www.strategic.gc/epic/internal.p.1).

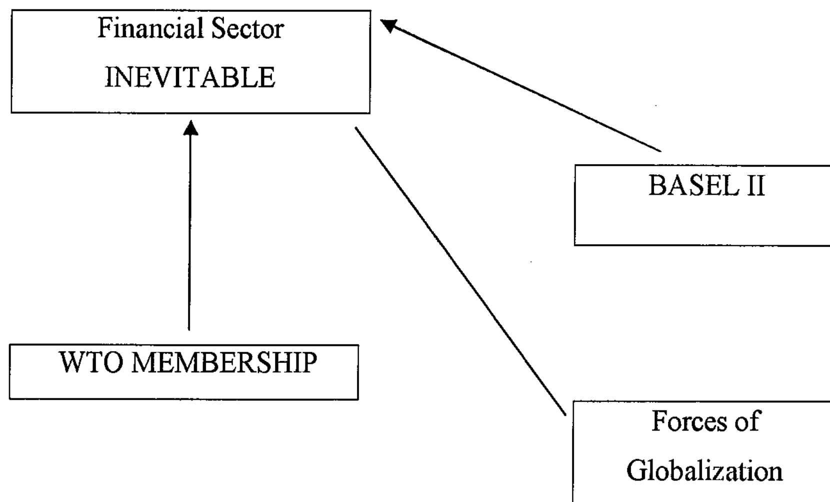
Saudi banks have a big advantage over many others in the developing world – profitability. Despite lack of growth in net loans, both improvement in interest differentials and a downward trend in the system's cost ratio have been major factors in bringing returns on average assets to a strong 2.23% in 2003. Most banks are showing improvement at some level of the income statement which will ultimately produce higher profitability. The average return on equity for the largest nine banks in 2003 was over 23%. Capitalization is very strong and every Saudi bank exceeds, some significantly, minimum capital adequacy ratio - CAR standards; the average being 19.98% in 2003, considered high by international standards. Thus, moving to the Basel II Accord, which stipulates a new set of standards for establishing minimum capital requirements for banking organizations, is

unlikely to cause Saudi banks any difficulties from a capital adequacy ratio (www.globalriskregulator.com/archive.p.2). Saudi bankers anticipate strong growth in the coming years, supported by a strong oil drive and a young, increasingly well-educated population. The CEO of the Arab National Bank, Nameh Sabbagh, said: "We believe there will be continuing positive development in the supervisory and regulatory environment, which will further support growth and development of the banking sector. We are already seeing this in the development of the new capital market law, the government's privatization program, and by the new development of retail and institutional investment products."

Currently, the range of products and services offered by the banks is largely similar in nature as far as traditional banking services are concerned. They include checking account facilities, trade financing, loans, and advances. However, some have introduced more innovative, value-added services for institutional and corporate clients. The Saudi British Bank, for example, recently launched a 24/7 financial service, the Hexagon, enabling customers to access their accounts from anywhere around the world through the HSBC Group Private Data Network equipped with data encryption technology. The Saudi American Bank also offers electronic banking, enabling institutional clients to view transactions with the bank, send electronic communications, and carry out limited banking services (Al-Dukheil, p.317).

Dr. Khaled al-Fayez, CEO of Gulf International Bank, estimates that the liberalization of Saudi Arabia's financial sector is inevitable, as illustrated on the following page. Like other sectors, the future depends on product innovation and competitiveness. As the general public becomes more knowledgeable and informed, especially through round-the-clock news channels and internet access, they will demand better-quality services at competitive rates (www.planning.gov.sa,p.12).

Liberalization of



Source: *Dr. Khaled al-Fayez. Saudi Arabia's Globalization Challenges: The Role of Banks and Capital Markets [slide presentation] www.planning.gov.sa.p.8.*

Recovery from the historically low oil prices of 1998 was particularly difficult for Saudi Arabia, as well as for Kuwait, registering zero or negative growth rates. Saudi Arabia had to contain its public debt and fiscal deficits by significant cut-backs in public expenditure, which in turn constrained economic growth. The country was ill-equipped to face these challenges, unable to focus on microeconomic performance, and had to intensify efforts on economic reform through:

- human resource development;
- promotion of export of non-oil related products; and
- state reform and private-sector empowerment (www.erf.org.eg).

Of crucial importance was the training of personnel to reach competence in various sectors. Saudi Arabia realized that to achieve its ambitions and economic goals under uncertain regional circumstances required perseverance and a degree of willpower. A steady flow of technicians and expertise was needed; therefore, a decisive step was to welcome foreign capital and invite participation in economic development projects in cooperation with Saudi partners. In parallel, there was a relaxation of the banking sector. The government decided to limit interference in financial institutions, grant them certain levels of freedom to maneuver, and respect private ownership

(www.saudi-online.com,p.1). The new policy for the banking and financial sectors was not to impose restrictions on the movement of capital into and out of the country. Long before 9/11, the Saudi government had taken important measures to safeguard the financial systems. Unlawful activities were checked and suspicious transactions from the Saudi banks were monitored. When news circulated that the 9/11 attackers had been financed by Saudi organizations, the government thus checked its sources and could verify that financing did not emanate from Saudi banks but from welfare and charity associations.

Lately, Saudi Arabia's rating score for business environment has improved. This reflects expected improvements in taxation and policies toward private enterprises. However, infrastructure and labor remain on an average level, while the score for macroeconomic environment has fallen due largely to continued high dependence on oil exports. The overall improvements indicate that the financial and banking sectors are now secure and there are no visible threats that could hamper their operations. Saudi Arabia is the largest market in the Gulf. The banking system is now regulated and there is high per capita income. The US State Department says in its website that prospective investors will find the country attractive (www.state.gov/e/eb/ifd,p.1).

One of the main threats Saudi Arabia had to face since 1990 was Saddam Hussein. When Kuwait was invaded, Saudi Arabia was suddenly beset with a dangerous situation. Saddam's ambition had no limits and its army was near Saudi territories. Since the fall of the Baathist regime and the capture of Saddam Hussein, Saudi Arabia no longer faces this ominous threat. However, it must deal with the growing risk that Iran will soon become a nuclear power. Washington and Tel Aviv are putting pressure on Iran to drop its nuclear program. If the situation persists and the tension escalates, it might lead to confrontation.

The most urgent security threats to the country no longer consist of hostile military forces.

With Islamist extremism and terrorism on the rise, there have been numerous attacks against foreign interests, including the attack against the US consulate in Jeddah. Although the authorities have fiercely fought against Islamic militants and warned that all Islamist campaigns that try to destabilize the country will be eradicated, attacks could take place again and active cells remain (www.home.aig.online.com,p.1). On the other hand, the Saudi government continues to secure a positive environment and foreign investors who fulfill the requirements of the foreign capital investment code enjoy the same privileges and are entitled to the same treatment, protection, and incentives accorded to national capital (www.saudia-online.com,p2). With such guarantees, investors are flocking to the country. Provided the national capital is at least 25%, industrial and agricultural projects enjoy an income-tax holiday of up to ten years from the commencement of commercial production, as well as land ownership according to regulations for non-Saudis. In addition, industrial projects have the same privileges as those enjoyed by Saudi capital under the National Industrial Protection Encouragement regulations (www.saudi-online.com,p.2).

Global risk consulting company Kroll Inc. released a recent report on business risk in the GCC states in response to client concerns over stability in the region. The key finding on Saudi Arabia was summarized by Andrew Marshall, head of Kroll's Middle East Practice: "Saudi Arabia faces a dilemma, investing heavily in business infrastructure, reforming its banking sector to attract international investment because they need to ensure future economic and social stability. Bringing in investors from foreign countries means reducing risk" (Cordesman, Obeid, p.1). The Saudi Agency for General Investment Authority - SAGIA has approved several changes to the Executive Rules of Foreign Investment Act, making the provisions more business-friendly and flexible for foreign investors, while strengthening the legal framework for investor rights (Country Report-Saudi Arabia-Legal Risks, p.1).

Standard & Poor's newsletter on financial institutions says that one of the main risks for Gulf banks is their exposure, whether direct or indirect, to the region's booming equity and real estate markets. Asset price inflation emphasizes high oil prices, improved regional stability, structural reforms, and renewed confidence and investment opportunities in the region (Hassoune, Volland, p.1). Standard & Poor's predict that this is partially an artificial bubble that can deflate or burst. Banking sectors in the Gulf, especially Saudi Arabia, rated A/Stable/A-1, are more exposed to these markets than banks in other GCC countries (Hassoune, Volland, p.1). The rating firm believes that the region's markets have unique features, though their limited size and high concentration, as well as the limited knowledge and exposure of local investors, pose additional risks. On the other hand, if the conditions were tense during 2002-2003 with the onset of war in Iraq, optimism is back. The agency believes that the development of the capital market contributes to the economic transformation of Saudi Arabia. By February 2005 estimates, Saudi Arabia's 15%-20% of retail loans were used by lenders to acquire shares. If conventional banks are more conservative about lending margins, Islamic banks are very active in this market (Hassoune, Volland, p.5).

A few years ago, Saudi Arabia announced its intention to review the legal system. There had been concerns that legislative institutions lacked efficiency and consistency when settling commercial disputes. The new legislation, including changes to copyright and competition laws, represented significant progress towards economic liberalization and a more transparent legal system. However, foreign firms are still finding the Saudi legal system difficult to deal with due to its basis in Islamic jurisprudence and slow resolution of cases, making arbitration the preferred option. Consequently, many appoint local attorneys who are well versed in Saudi law and have an understanding of a legal system which is dominated by Islamic texts and customs (Country Report-Saudi Arabia-Legal risks, p.1).

In its determination to attract foreign direct investment, the Supreme Economic Council has opened, in part or fully, a number of sectors and economic activities foreign investors had previously been barred from participating in. They include insurance, power transmission, certain segments of the telecommunications sector, and publishing. In addition, an institutional mechanism for handling commercial disputes is being set up. This was among the conditions for Saudi Arabia to be accepted to join the WTO (Country Report-Saudi Arabia-Legal Risk, p.2).

6.3 Overall Assessment

The Saudi rulers are caught between social conventions and reforms – on one hand, they want to preserve socio-religious traditions; on the other hand, they are aware the country's future relies on economic and political reforms. Analysts believe that a gradual transition to a more market-oriented economy is unlikely to cause serious disruptions.

According to Transparency International, corruption in various forms is rampant in Saudi Arabia. The core of the problem is that members of the royal family have increasing dominance over entire business sectors, and there is no independent body or institution to oversee activities and monitor gains – whether legal or illegal. The royal family are essentially above the law and, more alarmingly, affiliated partners often take advantage of their connections and exploit the situation. However, the general public has openly voiced its frustration at the high level of corruption, prompting King Abdullah to crack down on the problem.

Saudi Arabia is affected in one way or another by the escalating violence and the claim of supporting terrorist groups. This claim accounts for a political risk factor that affects the image of the Saudi banking system by weakening investor confidence. However, foreign banks are still interested as the economy is largely dependent on oil prices and production, which are expected to

increase in the coming two years. Besides, the Saudi authorities have taken initiatives to develop the banking system and strengthen the country's economic outlook through liberalizing trade and investment regimes, improving banking services, giving more responsibility to the private sector, and reforming the legal framework. These measures are contributing to a large extent to supporting the banking system in confronting such serious claims.

Today, despite some partial setbacks in earlier attempts at liberalization, the economic reforms that have thus far been maintained are liable to remain in place and to serve as a basis for further, gradual openings to foreign banks and companies. The positive outlook was strengthened when Saudi Arabia was accepted as member in the WTO. This has led more foreign financial institutions and banks to open branches and set up operations in the country.

Chapter 7: Sudan – The Banking Sector

There is a wide contrast between the Saudi and the Sudanese banking sectors. In Saudi Arabia, financial institutions are advanced and fairly well equipped to meet the challenges of today's finance world. In Sudan, civil war and uprisings by rebel forces have hindered economic progress. Furthermore, these events have negatively affected the government's ability to deliver social services and damaged the infrastructure of the country. Despite the introduction of robust reform programs and the country's oil reserves, which hold future potential for economic growth and investment, the economy is still largely agrarian. This presents further risk to investment due to negative climatic conditions. Political and security risks also remain high. Since the internal situation plays a crucial role, it is difficult under these circumstances to expect any breakthrough in the country's banking sector.

7.1 Overview

Sudan projects a poor image internationally – that of a country governed by an Islamist fundamentalist regime which has scant regard for human rights. Thus, Sudan has been barred from international financing, prevented from attaining debt relief, and has faced political and economic sanctions imposed by the USA. The country has been paralyzed by two civil wars, which are having wide implications:

- A civil war between the Arab Islamist government in Khartoum and the Christian African Sudanese People's Liberalization Movement and Army - SPLM in the southern portion of the country has been waged on and off for many decades. Due to external diplomatic pressure, exhaustion on both sides, and a common desire to

benefit from the country's vast oil resources, real efforts have been exerted to resolve this conflict.

- An ethnic conflict between the Arab Muslim government and black African Muslim rebel groups in the western Sudanese region of Darfur has been ongoing for years. News reports about genocide are circulating in foreign countries, including the USA. Even though this conflict is more recent, its development and the frightening pattern of genocidal attempts have alarmed public-sector opinion in most Western countries (www.heritage.org/research/p.1).

The recent signing of a final comprehensive peace accord between the government and the southern rebels, the SPLM, in January 2005, has brought hopes of a lasting peace. Furthermore, the USA has invested considerable political capital to resolve the conflicts. When both the war and the Darfur crises are resolved, the USA, along with bilateral donors, is ready to offer substantial aid package to Sudan. However, the death of John Garang, the leader of the southern rebel group, in a helicopter crash at the end of July 2005 and the persisting violence in Darfur do not bring hope for peace (www.viewsire.com/countryoutlook).

Despite the uncertain political outlook, real GDP growth remains strong as it is driven by sustained high oil production and prices, buoyant levels of investment, and rising consumption. Since the end of the 1990s, the economy has relied on the oil sector, now the main pillar of the Sudanese economy. According to a confidential report prepared by BNP-Paribas, the increasing oil revenues, as well as more disciplined economic policies, have helped improve macroeconomic indicators like acceleration in GDP growth, lower inflation, and reduced budget (Vulliez, Bouillard, p.1). Sudan is currently threatened with possible international sanctions if the regime is further implicated in the internal conflicts. These could harm the development of the oil sector. Hence, if

the peace deal collapses in the near future, the present government will likely become more firmly entrenched and hopes for a federal polity in which the regions will have a degree of autonomy, will rapidly fade (McCrum, Uziyel, EIU Limited 2004, p.1). According to the BNP-Paribas report, country risk is still very high despite new oil discoveries and the implementation of IMF-proposed structural reforms. Moreover, the economy is exceedingly vulnerable to fluctuations in international oil prices due to lack of diversification (Vulliez, Bouillard, p.20).

7.2. The Banking Sector

After World War II, the region of present-day Sudan prospered and demand for an increasing number of commercial banks rose. There was no central bank and the currency rate was tied to that of Egypt. Following independence in 1960, the Bank of Sudan, founded a year earlier, began issuing currency, assisting the development of banks, providing loans, maintaining financial equilibrium, and advising the government. The banking system was nationalized and an Islamic banking system introduced. However, both Islamic and conventional banks operated side by side. Subsequently, political risk threatened foreign financial institutions and leading banks like Citibank and Abu Dhabi National Bank were obliged to leave the country in 1998, with most remaining banks becoming government-controlled (www.countrystudies.us/sudan.p.1).

In order to encourage foreign capital investment, foreign banks had in the mid-1970s been urged to establish joint ventures. Banking transactions with foreign companies operating in Sudan were facilitated under the so-called 'open-door' system launched after an unsuccessful Communist coup. Several foreign banks took advantage of this opportunity, most notably Citibank, the Faisal Islamic Bank, Chase Manhattan Bank, and the Arab Authority for Agricultural Investment and Development. Numerous specialized banks were set up to promote agriculture and private industry,

and provide housing loans. Though the system was quite efficient, there were soon balance-of-payments difficulties, spiraling external debt, and increased corruption, and the scheme discontinued (www.countrystudies.us/sudan.p.1).

The banking sector has been victim of years of neglect and war, in addition to extensive political interference in operations. Today, Sudan's banking sector is in the process of extensive reform. Four state-owned banks dominate; the remainder are small, privately-owned, and cater mainly to local businesses (www.arabcomconsult.com/sudan,p.1). Banks follow Islamic finance principles, which ban the charging of interest – one of the few banking sectors to do so, according to the Economist Intelligence Unit. Islamic banking was initiated after the 'open-door' policy was discontinued, thus offering Saudi Arabia and other Muslim countries the opportunity to increase investment in the country. This has strengthened Sudan's financial position (www.heritage.org/research/features.p.1).

The theory of Islamic banking is influenced by the writings of the Quran. It is derived from the Prophet Muhammad's exhortations against exploitation and the unjust acquisition of wealth, interest, or usury (www.countrystudies.us/sudan.p.2). The theory focuses on the Islamic concept of property. Since state-owned banks dominate the sector, Islamic banking has considerable following in Sudan. In order to respect both the legal and religious points of view, common terms are in use:

- *musharakah*: partnership for production;
- *mudharabah*: silent partnership when one party provides the capital, the other the labor;
- *murabbaha*: deferred payment on purchases, similar in practice to an overdraft, and the most preferred Islamic banking arrangement in Sudan (www.countrystudies.us/sudan.p.2).

The appeal of Islamic banking has enabled such institutions to acquire an important percentage of Sudanese deposits. Additionally, their popularity and wealth have provided financial basis for funding and promotion of Islamic policies in government (www.heritage.org/research/features,p.3).

Overall, the most significant problem facing the banks are narrow capital and deposit bases due to high inflation rates during the past years. The Central Bank recently confirmed that ten banks were classified as undercapitalized, i.e. capital adequacy ratios below 8%. Non-performing loans are also high, representing 18% of total loans (www.arabcomconsult.com/sudan,p.1). Thus the sector could face significant crises if Basel II is implemented, as most banks simultaneously would require additional capital. One the other hand, the government has tried to improve its governance by liberalizing the trade and exchange-rate regimes to enhance efficiency and productivity. It phased out price controls, while adopting new measures to privatize public enterprises and renovate the banking system. Strong revenues from the buoyant oil sector have enabled the government to achieve significant progress in the implementation of programs. The IMF is monitoring these attempts closely and remains, despite a deteriorating political climate, broadly satisfied with Sudan's economic performance and ongoing compliance with the reform programs (Mc Crum, Uziyel, p.4).

These reforms, though limited to a few areas, have generated good results so far. The country succeeded in putting an end to the strong inflation of the 90s and prices have experienced a strong downward trend between 1997 and 2001. However, the ability of local authorities to maintain a tight stance concerning prices has yet to be proven. Similarly, banking indicators are improving, but on a low level. Capital adequacy ratio increased from 7% in 2000, to 10.6% in 2003; while the ratio for non-performing loans fell from 17% of total loans in 2000, to 14.5% in 2003 (Vulliez, Bouillard, p.6). However, future success in key sectors and bank performance are linked to the political situation, and the civil war is dramatically affecting the resources of the country.

There is guarded optimism regarding the ongoing cooperation with IMF Staff-Monitored Programs and since 1997, substantial progress has been achieved in stabilizing and restructuring the economy. Sudan has also indicated a wish for normalization of relations with international financial institutions. Consequently, in 2002 and 2003, a strengthened economic reform program to further consolidate macroeconomic stability, reinforce the reform momentum, and modernize the macroeconomic regime was adopted (IMF Public Information Notice, p.1). However, economists still believe that the banking sector is financially weak, and recent setbacks include:

- An astonishing 85% of past loans to the sector of agriculture are unrecoverable, according to the IMF.
- The cost of borrowing has remained high, with interest rates at 17% in real terms in 2000, while rigidities of some modes of Islamic financing have served to constrain lending.
- Inadequate local legislation is leading to difficulties for local banks in collecting loan repayments (www.arabcomconsult.com/sudan,p.2).

Progress has been made in implementing fiscal reforms, but some measures have been delayed; however, the first structural reforms in the monetary areas were hailed by the IMF. The Bank of Sudan has been working hard to establish a Monetary Operations Unit - MOU, and a new government security has been launched. The Government Investment Certificates is a second-generation government security that complies with Islamic finance principles. In contrast to earlier instruments, the certificates pay investors a fairly stable income and provide structure for long-term maturities. In parallel, the central bank law was amended by Parliament and enacted by presidential decrees to establish independence for the Bank of Sudan. It includes:

- an anti-money laundering measure and anti-terrorism clauses; and

- a new banking regulation measure to allow for supervision of financial institutions that are partly engaged in banking activities (IMF Public Information Notice, p.12).

In keeping with the trend of past years, banking soundness indicators are to some extent improving. In a recent interview, the governor of the Bank of Sudan, Dr. Sabir Mohammed Hassan, said: "The main challenge for the Bank of Sudan and the banking sector is how to reform and restructure ourselves to be able to cope with the very fast change within the Sudanese economy and on an international level" (www.arabcomconsult.com,p.2). Dr. Hassan explained that the Sudanese economy was undergoing a major transformation with the discovery of oil and resumption of foreign direct investment. He believes that this, in turn, will create new challenges for the banking sector regarding the demand for bank financing and services.

One of the most important goals has been to reduce inflation and maintain stability of the local currency, the *dinar*. The Bank of Sudan has been promoting minimum reserve requirements and begun to expand its own market operations in order to better allocate resources and develop the inter-bank market. The objective of increasing domestic credit to the private sector is reflected in an average rise in lending to that sector. Concerns over asset quality appear not to have curbed lending policies (McCrum, Uziyel, p.4).

The Bank of Sudan expects, through the enforcement of capital adequacy requirements, that banks will be forced to restructure their internal operations, while smaller banks will either merge or be liquidated. There have been no mergers as yet, but two undercapitalized banks have been liquidated. Though Dr. Hassan was proud of the recent achievements, he also stressed other priorities: "I believe that Sudan's competitive advantage is not just in oil. It's true that we have started production and exportation of oil and discoveries of reserves are increasing, yet I believe our real competitive advantage is in the production of food with the cultivable land. We can really create

lots of benefits for ourselves and provide services for the whole world" (www.arabcomconsult.com/Sudan,p.5).

A noteworthy initiative is the multi-level coordination between the Bank of Sudan, the Ministry of Finance, and the National Economy Agency. The objectives are clear: to establish a non-petroleum credit guarantee export development institution; and to set up a body for developing and financing the industrial sector (www.bankofsudan.org/english,p.1).

Of concern is Sudan's relations with the World Bank, which has no active lending portfolio in the country due to default on its financial obligations. This led to the suspension of disbursements in April 1993. However, discussions between the World Bank and the Sudanese authorities continued in order to normalize relations and re-open relations, and since July 1999, 'good faith' payments of US$1 million per month have been made (WorldBank-Sudan, p.1). The amount of the payments has not been sufficient to prevent a continued accumulation of arrears, which currently stands at several hundred million US dollars. In addition, Sudan has an outstanding debt, including arrears over US$1 billion. However, recent financial analyses confirm that despite the odds, Sudan is emerging as the fastest-growing African economy. El Fatih Ali Siddig, head of the Ministry of Finance agrees: "Everyone in the country knows that market forces are key. Everyone also understands that we are entering the era of globalization in which efficiency is most important" (www.internationalspecialreports.com/Africa/01/sudan, p.1).

Banks no longer have government control over their sectoral lending, the strict monetary policy is proving effective, and tariffs on imports have been reduced to 40% from the highest rate of 120%. Wise management of petrodollars means that oil reserves are spent according to pre-determined national priorities: 60% on infrastructure investments in power, roads, and irrigation so as to attract foreign investment; the remaining 40% on debt payments as well as to a fund for

education and health (www.internationalspecialreports.com/africa/01/sudan,p.3).

In the British magazine The Banker in January 2004, Mr. Musa Abdalla, general manger of Omdurman National Bank, one of the few significant banks in Sudan, stressed the general reform process and shed light on the bank's strategy: "the two main drivers of our strategy are raising capital to cope with the forthcoming Basel Accord requirements given before and the off-site surveillance system objectives; and orientation toward rapid progress in IT in the banking industry" (The Banker-Sudan, p.69). These signs indicate that efforts are being made to face globalization and becoming a more open economy. The actions of the banking sector have been enhanced by the deep structural reform in the Sudanese economy and changes that have resulted in high rates of growth. Investment flows increased considerably, especially foreign direct investment. Today, the country is encouraging more investment by offering incentives, as it needs further funding for the many infrastructure and development projects in the pipeline. Sudan is regarded as one of the first in the region to be a receiver of capital.

A positive result of globalization is the tightened cooperation between Sudanese and Western bankers. Currently, the state-owned El Nilein Industrial Development Bank Group - NIDB has strong links with the banking community in London. Overseas transactions are done through London as many bankers there have working knowledge of Islamic law as applied to banking (www.worldreport.ind.com/sudan,p.1). This relationship allows NIDB to simultaneously operate under Islamic law and conventional Western banking systems. Another positive aspect is the widened use of IT technology and communications tools. Nearly every official institution, including the Bank of Sudan, has internet websites providing information on recent events, statements, and upcoming conference news. Sudanese embassies abroad have web pages, headlined "Economy and Investment", that describe the investment climate and promote investment opportunities. The section

"Why Invest in Sudan?" includes the following:

- The most recent reformatory steps taken by the state have freed investment in Sudan from all restrictive acts. The Sudanese economy is a market-driven economy, and there is [a] rapid shift towards privatization in all sectors.
- Big market at home and abroad, especially to the neighboring nine countries. The unique geographical location of the country makes it an ideal marketing center and transit point for supplying neighboring countries with commodities and services.
- Organized business sector ready for joint ventures (www.sudanharare.org.zw,p.1).

7.3 Overall Assessment

Recent figures indicate concrete achievement in many sectors, not just for Sudan but all across the African continent. Indeed, after decades of underperformance, Africa is finally starting to attract more foreign investment. According to bankers, buoyant commodity prices and rapidly growing investments in oil and gas exploitation are clearly the main drivers behind the increase of 28% in foreign direct investment in 2003 compared to the previous year. The UN Conference on Trade and Development - UNCTAD also attributes the improvement to ongoing regional liberalization of investment policies and an increase in merger and acquisition transactions (www.viewswire.comp1).

The Bank of Sudan is being hailed for having endorsed new technologies that allow for flexible operations; and proposed and executed monetary and credit policies within the framework of the macroeconomic policy of the state, taking into consideration international developments and the importance of developing the system to comply with the financial and banking standards (www.bankofsudan,p.1). In 2003, an explanatory circular on governance, transparency, and

disclosure, as well as on institutional control was issued. Guidelines for risk administration were also published. The monetary and credit policy framework stipulates the following:

1. Each bank should determine the reasonable amount of liquidity in cash of its branches to meet the daily withdrawals of its customers, bearing in mind the 10% of the total deposits as an indicator.
2. Each bank should retain a legal monetary reserve in local and foreign currencies at a percentage rate not less than 14% of the total deposits in local and foreign currencies (www.bankofsudan.org,p.1).

The signing of the final comprehensive peace agreement between the government and the southern rebels, the SPLM, was hailed by observers in foreign countries. It has allowed the oil-rich south to attract the attention of regional and international investors. Thus, all eyes are set on this fertile region, rich in natural resources. If the country witnesses the emergence of an institutional, legal, and regulatory framework, southern Sudan could have the resources to eventually build a self-sustaining economy with a promising private sector. According to analytical documents, the importance of oil for the area is hard to overstate: in the coming years, it is estimated to contribute around 95% of GDP and nearly 100% of government revenues for the south, expected to reach $US1 billion or more in the year 2005 alone (Sudan: Risks of Investing in Southern Sudan, p.1).

However, the country continues to be marked by severe operational obstacles. One key reason is that government officials have since long been wary of overseas involvement in the Sudanese economy. Furthermore, the legal system is paralyzed by inconsistencies in the application of competing *sharia* and secular laws. In addition, there are questions regarding impartiality and quality of the judiciary as the courts do not ensure due process; thus foreign parties are often worried they may face discrimination, particularly in a dispute with the state. Like in other MENA countries,

corruption and bureaucracy are widespread throughout the public administration, and due to the civil war and long years of under-investment, the infrastructure is very poor. However, the government hopes that investment will flood in following the signing of the Comprehensive Peace Agreement.

Foreign direct investment remains directed towards the oil sector, though Western companies have been deterred by the violence and bad press-coverage of organizations accused by human rights groups of collaborating with the government's main rights abuses. Asian firms, particularly Indian, Chinese, and Malaysian, are the major investors in the energy sector (Sudan: Risks of investing in Southern Sudan, p.1). The authorities now appear to put their hopes on Arab investment, relying at the same time on the positive developments of the peace treaty. Nevertheless, as long as the crisis in the Darfur region is not resolved, threats of international sanctions continue to loom. Foreign institutions have been pressing the government to hasten the reforms or face further deprivation. Nearly a year ago, Sudan finally said it was ready for foreign investments to pour into the country, though under tough internal conditions such as constraints on public expenditure. There is a massive development underway, but without reforms and international economic assistance Sudan is surely headed to failure.

Chapter 8: Conclusion

Following the attacks of 9/11 and the US-led wars against Afghanistan and Iraq, investment opportunities and markets throughout the MENA region have begun to feel the negative outfall of these events. Accordingly, the region has braced itself to face the consequences and made several reforming attempts. However, such attempts seem to have failed to a certain extent due to several reasons, among them: the allegations against Saudi Arabia that it had financed the hijackers who crashed into the twin towers, the paroxysm of violence on the Israeli-Palestinian front, and the surge of terrorist groups and suicidal bomb attacks to topple current Arab regimes. These events, in fact, have paralyzed the peace process in the region and remain obstacles preventing the development of investment opportunities.

Nevertheless, there are expectations of improvements in investment climate in those MENA countries where international financial institutions provide know-how and facilitate ongoing reform efforts. Some foreign investment groups have started to develop and steer result-oriented investment action programs to upgrade policy standards and capacities. They, along with local counterparts, act as catalysts to provide impetus and support to investment-related policy reforms, share their expertise and experience, ensure a better dialogue on multiple levels, and track progress through internationally-recognized benchmarks.

One of the risks foreign investors encounter when entering a host country is political risk, i.e. the possibility political decisions or events in that country will negatively affect business performance. Thus, investors are advised to conduct thorough assessment of a multitude of factors related to politics and society in the host country before risking personnel and capital. Investors should be informed of the structure, stability, and effectiveness of the legal system in

order to conduct transactions and enforce contractual obligations. Furthermore, investors should be aware of the background and experience of prospective partners and study the market's progress on privatization.

A significant tool to help foreign investors reduce exposure and potential losses is a political- and country-risk forecasting system. It is high time for banks and financial institutions interested in moving into the MENA region to institute and strengthen the process of setting up an elaborate risk-assessment system and include the following factors in its model: political stability, social cohesiveness, corruption, the legal system, and progress on privatization; as well as external factors such as war and vulnerability to fanaticism. When given a set of facts, an outcome has a high probability of following. In other words, political risk analysis is not a prediction but rather a forecast. The analysis will make the investor either proceed with the proposed project, or cancel if the projected risk is too high.

Challenges in the MENA region are enormous; however, the biggest is not identifying what needs to be done, but rather establishing the process of change. In doing so, MENA countries can maintain support and track the progress of implementation. In addition, they can provide capacity-building assistance. Foreign organizations have long experience in tackling policy change and development, and their tested methodologies and tools can contribute to the achievement of real goals for the MENA countries. Moreover, the business community of the region has to deal more than ever with issues like regulatory reform, project financing, trade liberalization, and the integration of capital markets.

Some MENA countries have adopted a number of practical steps to set up an action-oriented process for developing and implementing investment-related reforms within a specific timeframe. The banking systems have had to restructure to meet international criteria and

standards, and such measures have opened opportunities for potential investors (Lancaster, p.32). Moreover, closer regional cooperation has been fostered. The region's banking sector should promote investment strategies in support of diversification and improve transparency in corporate governance. Some MENA countries are now better positioned to attract foreign investors as they have ensured a positive investment climate and strengthened their banking sectors to avoid negative impact related to political risk. However, other countries need to endorse strategic action programs, ensure coherence, and coordinate with the World Bank and other foreign institutions. Moreover, private banks, in coordination with central banks, have to absorb political risks and play a more active role in the future of the region through job creation, spurring economic development, and reducing dependence on natural resources.

To what extent can foreign investors sustain the negative outlook of the MENA region? Are they be able to endure this tense situation, or will they shift into other regions which may be able to offer higher returns on their investments?

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