Financial Sector Reforms in Morocco and Tunisia

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Morocco and Tunisia have made determined efforts over the past decade to reform their financial systems. How much progress have they made, and what remains to be done to ensure that their financial sectors efficiently mobilize and allocate savings?

IN MANY developing countries, financial sector reforms have been pursued over the past two decades as part of structural reform programs aimed at promoting growth and financial stability. Reforms of financial systems in Morocco and Tunisia generally started later than those in many East Asian and Latin American countries, although they were among the earliest undertaken in the Middle East and North Africa.

During the 1970s and much of the 1980s, the two Maghreb countries pursued inward-looking development strategies with the state playing a prominent role. Financial systems were heavily controlled; interest rates were set administratively and were usually negative in real terms; monetary policy was conducted primarily through direct allocation of credit and refinancing; money markets were underdeveloped; and bond and equity markets were virtually nonexistent. Commercial banks were often obliged to lend to priority sectors with little concern for the borrowing firms' profitability. Capital flows were tightly regulated, and foreign investment in the financial sector was restricted.

The inefficiencies and distortions of this system became apparent and were exacerbated by the emergence of severe macroeconomic difficulties in the two countries in the late 1970s and early 1980s. In order to tackle their mounting financial difficulties and enhance growth prospects, the governments of the two countries embarked on comprehensive stabilization and structural reform programs that were supported by the IMF and the World Bank. Financial sector reforms became an important element of these programs, supporting and complementing reforms in other areas aimed at establishing open and market-based economies driven by the private sector.

Financial reforms, 1986–96

Key objectives of the reforms were to reduce direct government intervention and strengthen the role of market forces in the allocation of financial resources, improve the capacity of financial institutions to mobilize domestic savings, enhance competition among banks, and strengthen their financial soundness. More broadly, governments also sought to strengthen the supply side of their countries' economies and to support other structural reforms, such as trade liberalization, reform of the incentive system, and, eventually, privatization. Initial steps concentrated on the banking system, monetary policy, and domestic financing of the budget, and were followed by reform of the stock exchange in parallel with the privatization of public enterprises.

Raising administered interest rates to positive real levels was an important initial step in the reform process, which was followed by a gradual liberalization of interest rates. These moves implied reduced reliance on financial repression to finance government deficits and typically were undertaken in combination with fiscal consolidation and a move to more market-based mechanisms of financing the budget. By 1996, deposit and lending rates in the two countries had been fully liberalized, although limited controls on some deposit rates (namely, those on small savings deposits and sight deposits) remained in force.

In parallel with fiscal consolidation, a gradual relaxation of requirements that banks lend to the treasury and to priority

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sectors of the economy was supported by the move to a more market-based financing of the budget, typically through auctions of treasury bills to financial institutions and public offerings of bonds tradable on the stock exchange. Investment rules for insurance and social security funds, however, implied the persistence of some captive markets for government paper. By the end of 1996, banks in Morocco were still required to hold the equivalent of 10 percent of their short-term liabilities in government paper at below-market interest rates.

The move away from quantity rationing and direct credit controls in the two countries was accompanied by efforts to develop indirect and market-based instruments of monetary policy. As direct and discretionary forms of credit control were phased out, the monetary authorities started to manage liquidity through a more market-based allocation of refinancing, mainly through regular repurchase auctions in the interbank money market.

At the same time, efforts to deepen the financial markets focused on introducing new instruments and reforming the stock market. Stock market legislation was updated, the bourses were privatized, and independent supervisory institutions were established. The legal framework for the emergence of private financial instruments (certificates of deposit and commercial paper, open- and closed-end mutual funds, corporate bonds, and—in Morocco—privatization bonds) was put in place. Also stimulated by the privatization program, stock market capitalization and turnover have increased markedly since 1993.

As liberalization and deregulation of financial activities allowed market participants to assume greater risks, a strengthening of prudential regulations and bank supervision became necessary. New banking laws granted increased autonomy to the central banks and strengthened prudential regulations in line with international standards. Capital-adequacy rules in line with the recommendations of the Basle Committee on Banking Supervision were to be met by all banks in Morocco by 1996, and in Tunisia by 1999.

Measures to increase competition among domestic banks included the opening of some banks' capital to private participation (domestic and foreign), abolition of sectoral specialization of financial intermediaries, and the granting of greater autonomy in lending decisions. Competition has nonetheless remained limited, and a measure of moral suasion seems to have persisted.

The reforms have been accompanied by steps to better integrate the domestic financial systems with international markets. Virtual full convertibility has been established for foreign investors, and restrictions on some capital transactions by residents (foreign borrowing and certain outward investments) were relaxed. At the same time, the two Maghreb countries made efforts to tap the international equity and bond markets, which highlighted the increased integration of their domestic financial markets with international financial markets. In 1996, a Moroccan bank issued equities in international capital markets using Global Depositary Receipts (GDRs), and a private Moroccan enterprise issued corporate bonds in the European market. The Tunisian government has been issuing long-term bonds on the Japanese capital market since 1994, and these have received favorable ratings from international rating agencies.

Indicators of financial sector reform and macroeconomic performance
(percent)

	Pre-reform [1]	Reform [2]
M2/GDP		
Morocco	40.3	53.4
Tunisia	39.9	48.8
Real interest rate [3]		
Morocco	-2.3	5.5
Tunisia	-4.3	2.0
Credit to the nongovernment sector [4]		
Morocco	17.5	23.6
Tunisia	40.3	54.1
Reserve money/deposits		
Morocco	55.6	42.1
Tunisia	36.2	25.1
National nongovernment saving [4]		
Morocco	19.0	21.7
Tunisia	14.5	17.6
Nongovernment investment [4]		
Morocco	15.5	18.3
Tunisia	21.5	19.6
Read GDP (percent change)		
Morocco	4.8	3.3
Tunisia	6.0	4.1

Sources: IMF, *International Financial Statistics, various issues;* and *World Economic Outlook, various issues.*
[1] Morocco: 1970–85; Tunisia: 1970–86.
[2] Morocco: 1986–95; Tunisia: 1987–95.
[3] Central bank refinancing rate deflated using the consumer price index.

The establishment of interbank foreign exchange markets in Tunisia in 1994 and in Morocco in 1996 marked an important step toward decentralizing the management of foreign exchange and allowing market forces to play a greater role in exchange rate determination.

The *sequencing* of the different elements of financial sector reform was similar in the two countries and was broadly in line with the experience of many developing countries. The reform process has been relatively gradual, partly reflecting policymakers' desire to avoid shocks that could have undermined the stability of the financial system. Accordingly, increases in administered interest rates, followed by greater interest rate liberalization, were undertaken in parallel with strengthening the financial situation of banks (through restructuring and recapitalization) and implementing enhanced prudential regulations and bank supervision. This has provided the monetary authorities with greater room for maneuver in phasing in other changes without losing control of the reform process. Full capital account liberalization is envisaged as the last stage in the process, thus allowing sufficient time to complete bank restructuring and enhance the soundness of the financial system.

The sequencing of changes in the financial sector with other macroeconomic reforms, however, has not always been smooth. In Morocco, setbacks in fiscal consolidation, partly related to droughts, have delayed the elimination of mandatory bank lending to the government, and in Tunisia, nonperforming loans of state enterprises have slowed the liberalization of interest rates. Nonetheless, despite temporary surges in private sector credit in Morocco in 1991 and in base money in Tunisia in 1996, which were quickly brought under control, the liberalization of interest rates and the elimination of credit rationing did not result in destabilizing shocks to the financial system.

Effectiveness of reforms

One of the central objectives of the reform was to promote saving, investment, and growth. Deregulation of interest rates and the increased availability of financial instruments were expected to stimulate saving and investment, while improved allocation of resources was to come from efficiency gains in financial intermediation. Of course,

saving, investment, and growth were also determined by nonfinancial factors, such as structural reforms and fiscal policy.

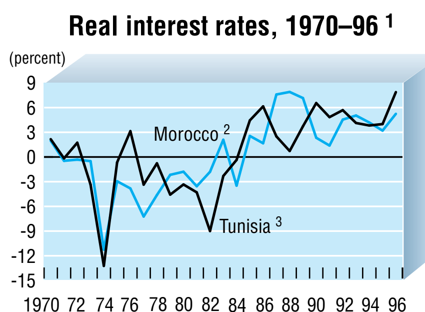
As expected, the reforms implemented over the past decade have had a substantive impact on financial intermediation and the structure of the financial sector (see table). Monetization and the volume of intermediation increased, as reflected in a rising ratio of the money supply (M2) to GDP; credit to the nongovernment sector rose, indicative of an improved allocation of financial resources, and real interest rates became positive (see chart). In the two countries, the decline of the ratio of reserve money to deposits points to greater efficiency of financial intermediation. Also, nongovernment saving rose significantly during the reform period compared with the 15-year period before reforms.

Examination of the correlation of nongovernment saving with a number of financial indicators (M2/GDP, credit to the nongovernment sector, reserve money/deposits, and the real interest rate) suggest that financial sector reform has encouraged nongovernment saving. The impact of financial sector reform on nongovernment investment and growth is more difficult to measure. Nongovernment investment increased only in Morocco, and the real GDP growth rate in the two countries actually fell in the reform period, compared with pre-reform trends. This may be related to the peculiar circumstances in each country, including the exceptionally frequent droughts and the impact of the economic recession in Europe in the early 1990s, all factors that may have eclipsed the positive effects of financial sector reform. Other studies (Morrisson and Talbi, 1996 and Goldsbrough and others, 1996) have found that indicators of total factor productivity improved in Morocco and Tunisia following the reforms, thus pointing to increased efficiency of factor allocation.

Further reform

Morocco and Tunisia have made important progress over the last decade toward establishing sound and efficient bank intermediation; deepening their financial markets; mobilizing domestic financing; and using indirect, market-based monetary policy instruments. In many respects, however, their financial sectors still fall short of achieving the dynamism, efficiency, and depth of full-fledged market-based financial systems in industrial countries or in the most advanced developing countries. This reflects the fact that some of the key reform measures were implemented only partially,

Real interest rates, 1970–96 [1]



Sources: IMF, *International Financial Statistics*; *La Vie Economique* and IMF staff estimates.

[1] Deflated by the consumer price index.
[2] Interest rate on 6-month treasury bills.
[3] Rediscount rate of the central bank.

while others were introduced only recently and therefore have not yet produced their full impact. Thus, although most of the necessary legal and regulatory reforms are now in place in both Morocco and Tunisia, the challenge they face is to ensure that their financial systems operate fully on the basis of market mechanisms underpinned by deregulation and increased competition among financial institutions. Other, longer-term reforms should aim at enhancing the mobilization of domestic savings and the deepening of financial markets.

Reforms to simplify the design of government paper and improve settlement systems are already under way in Morocco and Tunisia, and should help strengthen secondary markets for government paper and provide meaningful yield curves. This, in turn, should facilitate the use of open market operations by the central banks. In addition, the remaining mandatory lending requirements should be abolished and interest rates fully liberalized. Moreover, measures to enhance competition among banks and reduce the cost of financial intermediation would require enforcement of competition regulations, the privatization of state banks, and greater exposure of domestic financial institutions to international financial markets. The latter should also contribute to a more rapid acquisition of technology and know-how.

To promote long-term financing of investment, which traditionally has been provided by the development banks, complementary reforms are needed to mobilize contractual savings while enhancing markets for commercial paper, mortgages, and other long-term financial instruments.

Further development of equity markets in Morocco and Tunisia will require greater liquidity and transparency, including through an acceleration of privatization and strict enforcement of transparency requirements for publicly traded companies. The central depositories and the electronic settlement systems that are being set up in both countries should further improve the efficiency of stock markets. Recent regulatory reforms in Morocco and Tunisia have also laid the groundwork for the development of mutual funds and brokerage houses, and the establishment of investment banks and investment advisory institutions. The latter could provide a range of fee-based services to private corporations that could help them become familiar with innovative long-term financing instruments.

An important issue is how to develop financing for small and microenterprises in poor urban and rural areas. To this end, innovative schemes similar to the Grameen Bank in Bangladesh are being explored in both countries.

Establishing full convertibility by liberalizing outward investment by residents will be crucial to fully integrate the financial systems of the Maghreb countries into world financial markets. Further strengthening of macroeconomic stability and domestic financial sectors are essential prerequisites to help minimize the potentially destabilizing effect of short-term capital flows and enhance the capacity of the domestic financial sector to face foreign competition. F&D

This article is based on a paper that will soon be published in the IMF's Working Paper series.

Suggestions for further reading:

David Goldsbrough and others, 1996, Reinvigorating Growth in Developing Countries: Lessons from Adjustment Policies in Eight Economies, *IMF Occasional Paper No. 139 (Washington: International Monetary Fund).*

Christian Morrisson and Bechiv Talbi, 1996, "Long-Term Growth in Tunisia," OECD Development Center Studies (Paris: Organization for Economic Cooperation and Development).

Saleh Nsouli and others, 1995, Resilience and Growth Through Structural Adjustment: The Moroccan Experience, *IMF Occasional Paper No. 117 (Washington: International Monetary Fund).*

Saleh Nsouli and others, 1993, The Path to Convertibility and Growth: The Tunisian Experience, *IMF Occasional Paper No. 109 (Washington: International Monetary Fund).*