PN 74427

AID/PRE - Financial Sector
Development Project

USAID/MOROCCO - TECHNICAL ASSISTANCE

FOR FINANCIAL SECTOR REFORM

FINAL REPORT

March 7, 1990

1801 K Street, N.W.
Washington, DC 20006

Price Waterhouse

March 7, 1990

Mr. Mark Kraczkiewicz
Private Sector Officer
USAID/Rabat
Agency for International Development
APO New York 09284

Dear Mr. Kraczkiewicz,

Re: AID/PRE - Financial Sector Development Project (FSDP)
Contract No. PDC-2206-Z-00-8191-00
USAID/Morocco - T.A. For Financial Sector Reform
PIO/T No. 608-0191-3-608154

Enclosed please find ten copies of our Final Report of the Financial Sector Reform project, as prepared by Mr. Edward Gordon, Mr. James Ladd, and reviewed by Price Waterhouse, Prime Contractor under FSDP. Ten additional copies have been forwarded to Sandra Frydman, AID/PRE/PD.

It has been a pleasure to work with USAID on this important study. We look forward to working with you again in the future as your plans for new projects in the financial sector develop.

Very truly yours,

Price Waterhouse

Price Waterhouse

Attachments

FINAL REPORT

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I. INTRODUCTION

A. Background

In 1984 a Moroccan program for financial sector reform was designed and implemented with the World Bank as part of an effort to deal with the crisis through which the Moroccan economy passed in the early 1980s. To build upon the progress made under that program, USAID/Morocco and the Moroccan Ministry of Finance contracted with PRE's Financial Sector Development Project (FSDP) to provide a program of technical assistance for financial sector reform. This program would review the characteristics of the Moroccan financial system and evaluate recent changes and proposed reforms.

Finally, the technical assistance program would make preliminary recommendations for training and studies to strengthen the sector. These studies and training activities would be designed to promote a restructuring of the Moroccan financial system, particularly the development and modernization of capital markets and the updating of banking and financial regulations. Specific projects would cover topics such as the stock market, a secondary debt or money market, the housing market, long-term savings, access to foreign borrowing, revision of commercial banking regulations, and insurance companies.

The overall objective of the program is to bring the Moroccan financial sector into the competitive world of the 1990s, making it more flexible, more efficient, and better adapted to the frequent and profound changes in international financial markets and to the new requirements of sound and sustained growth.

B. Scope of the Project

The scope of the project includes:

1. An examination of the evolution of Morocco's financial sector since 1984.

2. An analysis of currently proposed policy reforms, focusing on feasibility and consistency with long-term financial sector objectives.

3. Proposal of a strategy for future reforms, using the existing program as a point of departure.

4. Recommendations for follow-on studies and training to support the reform program, including an examination of the feasibility of specific measures.

C. Project Management and Staffing

The services of Mr. James Ladd, as Senior Financial Systems Expert, and of Mr. Edgar Gordon, as Senior Economist, were acquired to carry out this engagement. The field work took place during the month of October. The consultants, prior to their departure from Rabat, prepared a Preliminary Draft Report and orally briefed the Ministry of Finance and USAID on their preliminary findings and conclusions.

II. SUMMARY: CONCLUSIONS AND RECOMMENDATIONS

A. Conclusions

The primary conclusions of the consultants are:

1. Institutional lending and saving in Morocco are generally carried out or influenced by the public sector, by means of administered interest rates or direct allocation of credit.

2. Responding to a 1984 World Bank study of the financial sector, Moroccan authorities have achieved a return to real interest rates, a substantial reduction in the subsidy involved in Treasury borrowing, and increased competition between commercial banks and public sector investment banks.

3. The principal economic policy objective is to open the economy to international trade and investment, relying less on government intervention and more on market forces. This will be done by reducing the size of the public sector and eliminating certain administrative controls.

4. The main objective of financial sector reform should be to promote markets in which interest rates and share prices more accurately reflect their underlying values.

B. Recommendations

The consultants recommend a program which would help the Moroccan economy move from a largely directed system to one which relies more on market forces. This is an appropriate time to consider a strategy for future reform. The economy as a whole is doing well. Inflation is relatively low and confidence in the currency is high. The balance of payments is in better shape than it has been in years, and the economy has been growing rapidly, leading to greater investment demand.

The most important constraint on the financial sector is the insufficient use of market incentives and high reliance on controls. The sector's most notable deficiency is the absence of a secondary market for short-term debt instruments. Because short-term interest rates are not generally based on market

supply and demand, there is not a strong market basis for deciding what the long-term interest rate should be. The major objective of a reform program should thus be the creation of a market in which a more realistic interest rate can be formed as a guide to monetary and investment policy.

A program of studies and training programs designed to help liberalize the financial sector is proposed by the consultants. This program can be divided into four major phases:

Phase I: The first phase would consist of two major studies:

1. Establishment of a secondary debt or money market
2. Improvement of the functioning of the Bourse

These studies would lay the groundwork for the studies contained in phase II.

Phase II: The second phase would provide research on specific areas. These projects would be defined by the results of the studies done under phase I. Areas to be researched under phase II could include the following:

1) commercial banks
2) insurance companies, including pension funds
3) the housing market
4) access to foreign borrowing
5) long-term savings trends

Phase III: The third phase of the project would be an assessment of training needs. To do this, a management audit of the Division of Money and Credit at the Ministry of Finance would be conducted, and an assessment of human resource and training requirements made.

Phase IV: During the fourth phase of the project, a training program based on the needs analyzed in phase III would be designed and implemented.

The first phase studies, on creation of a secondary market and on improvement of the Bourse, will require approximately four to six person-months each. A time period required to complete the phase II studies will be estimated upon the completion of phase I. Phase III, an assessment of training needs, would require roughly four to six person-months. Phases I and III of the program could run concurrently; training needs could be assessed while studies

of the secondary market and the bourse are being completed. After completion of phase III, the fourth phase will be further defined and a time schedule created.

III. THE MOROCCAN FINANCIAL SECTOR

A. Background

Facing a crisis in the early 1980s, the Moroccan economy suffered from inflation, balance of payments and budget deficits, negative real interest rates, and declining rates of growth. Morocco's financial sector had four main characteristics:

1. The public sector was the dominant borrower.

2. The government had substantial control over the flow of savings

3. Lending institutions were specialized and compartmentalized.

4. Market interest rates were absent, except in the sluggish Bourse, as a means of balancing the overall supply and demand for funds and differentiating between degrees of risk. Interest rates were fixed administratively and savings were channeled by directive to specific investments.

The system was designed to give deficit financing and the public sector priority access to financial resources without competing through the interest rate mechanism. It permitted the government to decide where credit would be directed and on what terms.

This system of directed interest rates was able to decree a virtually flat yield curve and oblige various investment institutions to hold long-term bonds yielding only slightly more than short-term securities. The absence of viable secondary markets created a situation in which all institutional investments were essentially illiquid and had to be held to maturity.

In addition to administrative control of interest rates, there were a number of other principal instruments employed. These included: quantitative ceilings on lending, lending quotas for Treasury securities and other priority sectors, investment quotas for insurance companies, controls on foreign borrowing, and controls on the flow of institutional savings, including the

surplus of the social security system.

The Ministry of Finance and the Central Bank were responsible for policy and supervision. Domestic saving arising from the savings banks, the postal checking system, the surplus in the social security funds, and various escrow and pension funds were channeled through the Caisse de Depots et Gestion, an arm of the Government.

The Caisse bought long-term Treasury bonds and similar securities issued by public agencies. With these resources and the proceeds of foreign borrowing, the Banque Nationale pour le Developpement, the Credit Immobilier et Hotelier, and the Caisse Nationale de Credit Agricole were responsible for most medium and long-term lending.

To the extent that they were not required to lend to the government through compulsory purchases of Treasury bills, commercial banks largely had other loan activities controlled through lending ceilings imposed by the Central Bank. The banks were compensated with a quasi-monopoly on collection of non-interest bearing checking, other current accounts, and short term lending. The banks' large margin between the average cost of funds and the average return on lending was ample reward for the restrictions they faced.

Interest rates, set by decree, changed rarely. With the onset of inflation they became negative fairly quickly.

B. The World Bank Reform Program

As part of a program to overcome the economic crisis which Morocco faced in the early 1980s, a decision was made to reform the financial sector. The World Bank completed a study of the Moroccan financial sector in 1984. On the basis of that report, Morocco instituted a number of changes in financial regulation and the organization of institutions. During the period of program implementation inflation declined, as both the budget deficit and the balance of payments deficit were reduced, and negative real interest rates became positive. The improved macroeconomic situation permitted new measures in the financial sector; it appears this situation will continue for several years.

The general objectives of the World Bank approach were:

1. To bring real interest rates up to levels at least as high as those prevailing on the international markets

2. To persuade the Treasury to pay more competitive interest rates on its borrowings

3. To stimulate and enlarge the capital market and the Bourse by selling issues to households, and by intervening with public funds to increase the volume of trading

Morocco undertook a number of policy commitments in the second industrial and trade policy adjustment loan signed in May, 1985. The most important were:

1. A commitment by the Treasury to rely more on the money market and on individual investors to determine interest rates on government securities

2. A policy of encouraging commercial banks to mobilize more term deposits by increasing the return on such deposits

3. A policy of greater interest rate flexibility and higher interest rates for both deposits and loans

4. Encouragement of competition between commercial banks and Specialized Financial Institutions (SFIs) - This was to be done by permitting SFIs to accept deposits and commercial banks to make medium-term loans without the intervention of an SFI to ensure that the loans are eligible for rediscount.

5. A redistribution of the burden of exchange risk insurance - lenders and borrowers were to pay more and the Treasury to pay less

6. A reorganization of the Caisse Centrale de Guarantie to strengthen and redefine its role

C. The Moroccan Financial Sector Since 1984

Morocco has made progress in all areas in which it undertook commitments in the 1985 loan agreement.

Treasury Borrowing

The most important has been the willingness of the Treasury to borrow a larger proportion of its requirements at more realistic interest rates. This was accomplished in two ways: by selling bills at interest rates which were about double those it was paying to commercial banks for their obligatory subscriptions, and by selling small denomination bonds to the non-bank public.

An example of that progress is the fact that 59 percent of the commercial bank portfolio had been bought from the auction market at the end of 1988, compared to zero in 1983. Individual holdings of Treasury securities, which had averaged about 2 percent of government debt outstanding at the end of 1984, were about 5 percent in 1988.

Commercial Banks and Medium-Term Lending

The effort to push commercial banks to mobilize more medium-term resources in order to increase medium-term lending has made less progress. Term and savings deposits were 42 percent of liabilities at the end of 1988, compared to 40 percent two years earlier. In the same period medium-term lending as a proportion of credits other than those to the Treasury rose from 10 to 12 percent.

Interest Rate Flexibility

The slow growth in medium-term lending is related to the level and structure of interest rates. Positive real interest rates have been restored by the increase of nominal ones and the fall in the rate of inflation. The measures that have been taken so far to alter the structure of commercial interest rates have been marginal in their impact. These measures fall into two categories: setting maximum levels for commercial bank lending rates and progressively freeing term deposits with maturities in excess of six months from any control.

The difference between the legal rates for medium-term loans and short term deposits is crucial. At present the difference is

only 1.5 percent: a six-month deposit pays 10.5 percent and a rediscountable medium-term loan yields no more than 12.0 percent. This thin spread effectively destroys the banks' willingness to aggressively seek medium-term deposits or find new borrowers. The spread may be two to three times greater when making short term loans with demand deposits.

The preceding discussion suggests that the "yield curve" of the commercial bank interest structure is too flat to attract resources and lending into the longer end of the market. It is more profitable to borrow and lend short term than medium term; the greater risk and lesser liquidity of longer obligations reinforce this tendency. Because of this situation, removal of the interest floor on term deposits with maturities in excess of six months has had little practical effect.

Competition between Commercial Banks and Specialized Financial Institutions (SFIs)

Interest rate spreads also affect competition between SFIs and commercial banks. As long as the interest rate term structure favors short-term lending, SFIs gain greater advantage from the right to collect sight deposits from the public than do commercial banks from the right to compete in the medium-term market. The Central Bank has recognized this problem and has provided two additional incentives for banks to engage in medium-term lending. It has lowered its rediscount rate, and has provided direct access to Central Bank approval for loans of less than five million dirhams.

Redistribution of Exchange Risk Insurance

The goal of a redistribution of the burden of exchange risk insurance is to have the ultimate borrower pay a reasonable share of the exchange risk insurance. This will reduce the borrower's strong financial incentive to prefer foreign to domestic credit. Given Morocco's dependence on foreign borrowing for the foreseeable future, however, it is important to create an equitable system that does not stifle demand for foreign credits. The consultants were under severe time limitations and were unable to evaluate the reorganization of the exchange risk premium structure. This topic might usefully be included in a follow-on study.

Caisse Centrale de Guarantie

The consultants did not have sufficient time to evaluate the operations of the Caisse Centrale de Guarantie. The accounts, particularly those of older operations, are not in a state in which much analysis can be undertaken. The guarantee authority is used mainly by foreign lenders. This topic might also be included in the follow-on study suggested above.

In Summary

The experience of the past five years can be summed up as follows:

1. The most important event has been the success of the stabilization program and the accompanying reduction of inflation and return of real interest rates.

2. Of the specific commitments undertaken in the 1985 loan agreement, the commitment to reform Treasury financing policy has met with the greatest success.

3. Measures to increase competition between banks and SFIs have strengthened the latter at the expense of the former. Banks, however, are still extremely profitable.

4. The measures taken have not fundamentally altered the structural characteristics of the financial system described above.

D. The Current Reform Program

Projects are underway in a number of areas that affect the operations of the financial sector. They are:

Reorganization of the Bourse

The Bourse has been inactive for some time and is clearly not developing a risk capital market to broaden and deepen the financial sector. There are a number of reasons for this. The current structure of tax and financial incentives tends to

suppress demand for equities in favor of short term bank deposits. First, dividends are about 10%, slightly less than the yield on Treasury securities and long term time deposits. There is a withholding tax which reduces the real return even more while Treasury securities are tax free and there is no witholding on bank interest payments, making them, in practice, largely tax free. Second, the stock market is so illiquid that that selling equities is more likely to incur a serious loss than using a fixed interest security as collateral for a loan. On the supply side, companies have little or no financial incentive to seek equity capital on the market when they can obtain cheaper medium-term loan capital from specialized financial institutions without dilution of control.

A working group in the Ministry of Finance is developing a project to strengthen the Bourse. The project would increase the number of brokers and would establish a securities commission to regulate the securities market and authorize new issues. The amount of information required by companies issuing shares would be increased and subjected to regulatory oversight. These measures alone will not be sufficient to stimulate activity on the Bourse. A detailed study of the relative impact of incentives - both tax and financial - on trading in equities will be necessary.

Reorganization of the Accounting Plan

Moroccan accounting procedures have been under consideration for several years. A plan for reorganization has been approved by the Cabinet for submission to Parliament. This reorganization involves accounting standards, training of accountants, and regulation of the profession. The accounting profession's role in providing accurate and relevant information about companies is of greatest concern to a program of financial sector reform.

Privatization of State Enterprises

Privatization has become a more important policy objective in many countries, both developing and developed, in recent years. A bill to begin privatization of state enterprises is now being considered by the Parliament, and a minister without portfolio has been appointed to be responsible for its implementation. The Moroccan public sector includes hundreds of firms and produces about 20 percent of the country's GDP.

Privatization would impact on financial sector reform in two

major ways. Firstly, privatization would increase the supply of high-quality shares available to private investors, and secondly it would increase the demand for non-government financing by companies returned to the private sector. The sale of shares by profitable enterprises, even where controlled by the government, would greatly increase stock and bond market activity. The links between privatization and revitalization of the Bourse should be included in a subsequent study of the Bourse.

Restructuring of Public Financial Enterprises

A program is underway to create new entities in the public financial sector. The Caisses d'Epargne are being reorganized into a new unit independent of the postal and telecommunication service. The objective is to make Caisses d'Epargne operate like banks rather than simply deposit windows, giving them an incentive to offer more attractive products to their customers.

The fourth area of reform will have a relatively limited impact on the financial sector as a whole. The other reforms - stock exchange reform, the accounting plan, and privatization - will affect not only the financial sector but the economy as a whole.

IV. CONCLUSIONS

This is an appropriate time to consider a strategy for future reform. The economy as a whole is doing well. Inflation is relatively low and confidence in the currency is high. The balance of payments is in better shape than it has been in years, and the economy has been growing rapidly, leading to greater investment demand. The Moroccan financial sector already has sophisticated institutions and technically qualified managers.

The most important problem of the Moroccan financial sector is its insufficient use of market incentives and heavy reliance on controls. The only fully functioning market in the present system is the Bourse, which is limited and underdeveloped. The lack of supply leads to a lack of demand and vice versa, creating a vicious circle. The most notable deficiency in the financial sector is the absence of a secondary market for short term debt instruments.

Interest Rates

There is no short term interest rate based on market supply and demand, and thus no market basis for deciding what the long term interest rate should be. The only unconstrained market indicator of an interest rate is the sale of securities to households. This suggests a short term interest rate of 15 percent, but the market is too limited to accurately indicate what might occur if more participants were permitted. Without a market basis, it is not possible to determine whether administered interest rates are too high or too low, whether loans are too expensive, or to what extent those loans are being subsidized. The lack of market indicators also makes it impossible to determine whether yields on investments in securities and on deposits are too high or too low.

Because of the problems described above, the major objective of a financial sector reform program should be the creation of a market in which a more realistic interest rate can be formed as guide to monetary and investment policy.

The existence of the market would modify the techniques of monetary policy. The focus would be more on influencing levels of interest rates than limiting credit through ceilings. The object would be to create a reference interest rate which would fluctuate, reflecting the shifting relationship between supply and demand for funds.

Having a market of this kind would facilitate Treasury financing operations. Banks and other investors could purchase even the shortest-term Treasury securities, knowing that if the need for liquidity arose they could always be sold quickly and inexpensively.

Difficulties could arise, however. Because the existing policies are designed to provide the Treasury and other borrowers with subsidized credit, the initial effect of liberalization is likely to be an increase in interest rates for borrowers, and especially for the Treasury. The Treasury will probably continue to be the most important single borrower for some time. Although the deficit has declined from more than 10 percent of GDP about 5 percent in 1988, the Treasury is still obliged to find resources equal to 2-2.5 percent of GDP in the domestic capital market; the remainder is filled by foreign funding. This is a very large sum in a country which saves no more than 20 percent of its GDP and channels a much smaller proportion through the market.

The transition to a freer system will be easier to the extent that the size of the budget deficit and the Treasury's need to borrow domestically can be reduced, making more room for private sector borrowers. Another factor would be opening up new short term credits from foreign lenders.

Role of Commercial Banks

The role of the commercial banks will have to be modified; their position is one of the most distinctive characteristics of the financial sector. On the one hand they have little direct competition and make very high profits; on the other, they are obliged to invest one third of their sight deposits in Treasury bills at rates of interest that are probably below their cost of funds. Ceilings are placed on more than 60 percent of their credits for other purposes. They invest in additional Treasury bills at a more favorable auction rate, but it would be difficult to determine whether the result would be the same if all the potential suppliers and demanders of short term investments were in the same market, competing against one another.

The commercial banks currently control all channels of intermediation in the short end of the market. In addition, anyone with a potentially negotiable financial asset must either sell it through a bank acting as broker or use it as collateral for a loan. The banks are the stock market brokers and the

brokers in the inter-enterprise loan market. With only fifteen companies, of which seven do the great bulk of the business, there is limited price competition among them even where the authorities permit it.

In a money market there should be other brokers competing with the banks. At the same time, the banks should be freer to take positions in commercial paper, sell Treasury bills bought at auction, develop certificates of deposit, and innovate in other ways.

Role of Insurance Companies

The insurance companies are highly regulated. This serves the prudential purpose of ensuring that they fully pay claims on their outstanding policies. But "technical reserves" are equal to 60 percent of the investment portfolio. They must be invested in long term Treasury loans, as well as bonds issued by public enterprises and guaranteed by the State. The remaining resources are restricted to real estate, mortgages, and securities listed on the Bourse. Two percent may be invested freely, but individual transactions must be approved.

This approach eliminates competition with the commercial banks in the area of medium and long term lending. It restricts the companies to areas such as mortgages and share investment which currently offer very limited opportunities. The insurance companies could be very useful participants in a money market. They have a continuing flow of funds that need to be placed for short periods, depending upon the availability of long term investments. The existence of the market would also improve the liquidity of the companies by enabling them to sell long term bonds one to two years before they mature.

Views of Those Involved in the Moroccan Financial Sector

The views of those who work in the Moroccan financial sector and those who direct financial institutions are vital to any program for financial sector liberalization. The common denominator of those views is a fear and misapprehension about using market incentives as an equilibrating or directing force in the financial sector.

It is important to examine the validity of these views. The philosophy of control which has developed in Morocco over the

past thirty years is quite different from the view often found elsewhere that a considerable measure of freedom in the financial sector is an efficient method of promoting development. The consultants believe that the Moroccan financial sector must be regulated, because it is subject to abuse and oligopolistic behavior. The issue is to find the appropriate balance between prudential regulation and allowing market forces to work their way.

Outlined below are some of the most potentially significant views of those involved in the Moroccan financial sector. While these views are valid, other factors - also outlined below - must be taken into account.

- It is commonly felt that in a free market interest rates would rise to high levels because the demand for investment funds at present interest rates far exceeds savings.

  Interest rates would not rise as drastically as feared. The stability of the Moroccan economy and the moderate growth of the money supply result in two factors which would constrain the rise of interest rates: 1) speculation would be difficult due to a lack of support by cheap and abundant credit, and 2) the number of projects that can yield a very high real rate of return is limited.

- It is feared that as a consequence of these high interest rates, funds would go to the highest bidder and the resulting activities might not be in the best interest of development.

  There is a case for special incentives, subsidies and institutions, because some activities considered socially desirable would be squeezed out in a free market. It may be argued, however, that Morocco already has a substantial amount of such incentives, subsidies, and institutions.

- Many in the Moroccan financial sector feel that there is little likelihood that the Bourse would be able to successfully raise investment funds, because companies are not interested in using it.

  The sluggish activity of the Bourse is not due to an inherent lack of interest by companies; it is a result of the fact that incentives to use credit from public channels are more attractive than equity finance. There is also an

absence of institutions supporting Bourse activities. These problems, however, have been overcome in other countries at Morocco's level of development, and can be overcome in Morocco if regulating authorities place adequate emphasis on finding solutions.

- It is felt that a margin of two percent should be enough to encourage banks' interest in medium-term lending.

  While a margin of two percent allows banks to profit from medium-term lending, the spread may be two to three times greater when making short-term loans with demand deposits. Banks will employ their resources in the most profitable means possible - as long as possibilities for greater profit exist, growth in medium-term lending will be slow.

V. RECOMMENDATIONS

The consultants recommend a series of studies and training programs as a basis for policy reform in the financial sector. This program can be divided into four phases:

Phase I: Two major studies, one on creation of a secondary debt or money market, and one on revitalization of the Bourse

Phase II: Five follow-on studies, which would examine some possibilities for creation and strengthening of instruments to mobilize more domestic and foreign resources. Studies could include the following topics:

1) commercial banks
2) insurance companies
3) the housing market
4) access to foreign borrowing
5) long-term savings trends

Phase III: An assessment of training needs, consisting of a management audit at the Ministry of Finance's Division of Money and Credit

Phase IV: Design and implementation of a training program based on the assessment made in phase III

Over the next six months the highest priority task is to complete phase I reports on the establishment of a secondary money market and on the improved operation of the stock exchange. Outlined below are the main issues which should be included in their respective scopes of work. Two teams could be ready to begin by late February. Approximately four to six person-months will be necessary to put each study into final form by late May.

Phase II - a series of studies on institutional issues - should be deferred until the conclusions of the phase I reports have been digested and policy decisions made, because these studies are designed to support the market opening activities of the first two projects.

Phases III and IV - a management audit of the Division of Money and Credit and selected training activities for members of the

Division - could begin concurrently with phase I. The audit would require a management specialist and a training specialist and perhaps four to six person-months of work. Until the report is completed training activities could be approved on a case-by-case basis.

The program as outlined, if accepted in its entirety, would take several years to complete.

A. Phase I: Major Studies
Establishment of a Secondary Debt or Money Market

The most important element of a reform strategy would be the creation of a secondary market in short term debt instruments. This market would eventually serve as a market for new issues. Several objectives would be achieved by this project. Firstly, a secondary market would create greater liquidity in the financial sector. Secondly, in this market there would be created something much closer to a market interest rate than anything that now exists. This interest rate could serve as a reference for other rates in the system. Thirdly, a secondary market would establish a serious alternative to borrowing from banks for many enterprises.

Since the present system has an internal consistency of its own, dismantling part of it to establish the debt market will raise questions about the roles that various institutions now play. There are now two primary markets for short term debt that are the nucleus of a short term secondary market. These are the sale of billets de tresorie, or commercial paper, and Treasury bill auctions in which only banks participate. In a fully functioning money market they would represent alternative investments.

The principal points to be covered by this study can be divided into the following categories:

- Definition of the demanders of funds - The current demanders of funds are the Treasury and non-financial enterprises. Other possibilities include financial intermediaries of all kinds: consumer credit companies, leasing companies, investment banks, non-bank stock market brokers, banks with small deposit bases, etc.

- Definition of the suppliers of funds - In the existing market the suppliers of funds are the CDG, non-financial enterprises and commercial banks. Other possibilities

include insurance companies, brokers, private investment banks, public development banks, factors(i.e. brokers who buy trade bills at a discount and resell them to selected investors), and foreign portfolio investors.

- Definition of the legal and institutional framework - A number of questions should be raised. Should commercial paper and treasury bills be negotiable, giving enterprises an option for placement of idle funds and allowing banks to sell them before maturation? Should long term bonds also be negotiable in the two years preceding maturity? Who would serve as market makers and would new institutions be necessary to carry out the brokerage function?

- Effects on monetary policy and deficit financing - A number of questions need to be studied in this area. Which of the administrative determinations of interest rates in the present grid need to be eliminated or modified? Should Treasury issues have a different mix of maturities? What changes need to be made in the framework to enable banks to fully participate? Will the Central Bank engage in "open market" operations? To what extent would the Bank wish to influence interest rate fluctuations?

- Problems involved in admitting foreign investors into the market - Exchange control regulations would have to be put into effect which would permit the repatriation of investments. Issues such as whether or not exchange risk insurance will be permitted and whether or not money market instruments will be denominated in foreign currencies must be addressed.

To be fully effective, this study will require support from subsequent research into selected segments of the financial sector, such as commercial banks, insurance companies and the mortgage market.

Revitalization of the Bourse

Reform of the Bourse is one of the key areas in the liberalization of the financial sector. This reform would be one of the two subjects to be studied during the first phase of the consultants' recommended program. This study would examine the reasons why the Bourse has been so inactive and has failed to perform the functions expected of it.

The Ministry of Finance established a working group that made a report on the Bourse problem in June 1987. The report is an excellent detailed study of the legislation governing shares, the Bourse, and relevant taxes. A bill is now being drafted for submission to Parliament that will change the brokerage system and improve levels of information available to and the protection of stockholders.

Two things can be done to place the findings and recommendations of the 1987 report in perspective. Firstly, the Moroccan Bourse and proposals to change it could be compared to policies in other countries at similar stages of development. Strong stock markets in a number of developing countries, such as Brazil and Mexico, can provide examples of how market forces stimulate activity and of how regulatory policies maintain control. Secondly, policies relating to the Bourse could be related to the establishment of a secondary debt market. The working group's report points out that the demand and supply of shares depends on the relative attractiveness of other financial instruments. The development of an active secondary money market will affect both interest yields and the alternative types of investments available. It would also be useful to study ways in which the accounting plan and privatization might be related to measures that would make the Bourse a more active market.

The consultants recommend a further study of the Bourse, which would draw upon the 1987 working group report. This study could be organized as follows:

1. Selection and description of two or three countries whose stock markets could serve as models for Morocco - This would be based on written materials and direct experience of consultants

2. Analysis of the role of the Bourse in a reformed financial sector - The merits of share financing compared to debt should be studied from the point of view of public policy. This study would include the potential impact of a new debt-equity mix on the volume of Treasury and public sector borrowing at home and abroad and on the level of interest rates.

3. Analysis of the Bourse as it currently exists:

   a. Factors affecting the supply of shares

-- the relative cost of borrowing as compared to selling shares
--the number of "blue chip" companies in the public sector or controlled by foreign investors and therefore not available for domestic private investment
--the effect of capital gains taxes on portfolio sales

b. Factors affecting the demand for shares
--levels of information available to the public (financial statements, index of stock prices, etc.)
--public confidence in the regulatory apparatus
--the adequacy of the promotional and brokerage apparatus
--the existence and regulation of institutional investors, addressing questions such as whether insurance companies should be given greater latitude to invest and trade in shares and how useful new investment entities like mutual funds, investment clubs, and investment banks could be promoted
--access to the market by international investors

c. The regulatory system
--corporate information requirements
--supervision of brokers
--regulation of the stock exchanges

B. Phase II: Follow-On Studies

1. Improved Functioning of Commercial Banks

Commercial banks are extremely important to the functioning of the financial system. A study should address the changes in banking law that would be required if banks are to participate in the money market, rather than simply looking at ways to update the legislative framework governing the banking sector. It should examine issues such as how present techniques of monetary policy should be changed and to what extent the determination of interest rates on loans and deposits should be free. A related subject would be the role and regulation of consumer credit and leasing companies.

2. Improved Functioning of Insurance Companies

An examination of the regulatory framework for insurance companies is a necessary step in a program to strengthen the Moroccan financial sector. The potential role of insurance companies in a secondary debt or money market and in the Bourse would be the logical first step in such a study. Criteria must be developed which would reduce the excessive regulation of investment by insurance companies while preserving adequate prudential regulations. The long term lending role of insurance companies should also be considered in some detail.

A number of questions about the potential role of insurance companies need to be addressed. Should insurance companies be allowed to participate directly in industrial projects? Could they provide housing credit? What would be their role in the money market, where they could use their flow of funds to make short term investments while waiting for long term ones? What degree of risk would be acceptable and how much of the portfolio could be devoted to short instead of long term securities? The study should examine whether the promotion of insurance, particularly covering life, is a useful way of promoting savings in Morocco.

3. Analysis of Long-Term Savings Trends

The object of this study would be to look at the institutional savings sector as a whole to determine which measures would be most effective in increasing volume. The institutional savers in

the Moroccan economy are Caisses d'Epargne, the postal checking system, social security and other pension funds, and insurance companies. Issues to be addressed by a study include: 1) the size of investable surpluses in the next five years, given present trends; 2) factors that determine the creation of surpluses and deficits, and how they could be modified without damaging the principal purpose of the institution; 3) ways in which these funds have and should be channeled into investment.

4. Improved Functioning of the Housing Market

A related study of housing finance should also be done. This project could examine ways to a create a mortgage market as a component of the larger debt market. It could also look at the current role of the Credit Immobilier et Hotelier (the Housing Authority) compared to private lenders. Another area for study would be the feasibility of linking a system of savings to housing and where such a system could be institutionally located.

5. Widening Access to Foreign Borrowing

More foreign borrowing by the private sector would be an important source of capital to finance investment. While the regulatory framework for foreign direct investment is well established and liberal in application, foreign borrowing by the private sector is more difficult, because the domestic borrower is reluctant to bear the exchange risk, and because the foreign lender usually wants a government guarantee to protect himself against default.

It would be useful to distinguish between two types of foreign borrowing: a. credits of one year or less and b. medium and long term borrowing. In the past, the cost of exchange risk insurance for medium and long term borrowing has fallen heavily on the Treasury. Even though the original scheme has been modified, the cost of insuring future foreign borrowing is likely to remain high. This study could explore the types of foreign borrowing that would be least likely to burden the exchange risk insurance system e.g. currencies more or less related to the dirham, fixed or floating interest rates, etc.. Estimates of future costs based on predictions about the volume of commitments and on assumptions about the currency movements could be calculated.

Short term borrowing, on the other hand, could be protected by the development of a forward exchange rate market. The banks, could develop this business, but they would have to be given more

freedom to hold and invest foreign exchange assets than they have now so that they could take positions, offsetting the exchange risk guarantees that they would be selling to borrowers.

The study could also investigate the fee structure of the guarantee scheme against possible default scenarios, to determine whether fees would be low enough to be attractive while at the same time being relatively self-financed.

C. Phase III: Training Needs Assessment

The Division of Money and Credit at the Ministry of Finance, which is managing financial sector reform, would benefit from training programs. The first step in this process would be a management audit to assess specific training needs. Such an audit would examine topics such as recruitment, management methods, data banks, equipment needs, skill levels of the personnel, and training requirements. The Division of Money and Credit will also need advanced training in techniques related to its fields of responsibility.

D. Design and Implementation of Training Program

Design and implementation of a training program would begin upon completion of the management audit recommended in phase III. Training classes should be one to two weeks long. They could be carried out in Rabat by visiting experts or in short trips abroad made by the trainees. Topics would include issues such as money market management, analysis of bank operations, monetary policy, stock market operations, and analysis of project financing, among others. Institutions such as the Bourse and the Central Bank may also require training. Materials and lectures should be mainly in French but a start should be made to train in English as well.

APPENDIX

Persons Contacted

Name	Title, Institution
Ministry of Finance	
M. Mohamed DAIRI	Directeur, Direction du Tresor et des Finances Exterieures
M. Abdellatif FAOUZI	Chef, Division de Monnaie et de Credit
M. Allal Youssef AL BAKHTI	Service Marches des Capitaux
M. Abdelmoumen M'NEBHI	" " "
M. Mohamed El IDRISSI	" " "
M. Abdelghani GUEZZAR	" " "
M. OUAZZANI	Directeur des Assurances et de Prevoyance Sociale
Mlle. Zoulikha NASRI	Direction des Assurances et de Prevoyance Sociale
M. EL JAOUHARI	" " "
Bank AL-MAGHRIB	
M. Abdelouahad BELHAJ	Directeur, Controle du Credit
Mme. BENNIS	Direction, Controle du Credit
CGC - Caisse Centrale de Garantie	
M. BENJAMAA	Direction
CDG - Caisse de Depots et de Gestion	
M. DASSOULI	Secretaire General
M. SAKOUT	Fonds d'Equipement Communautaire
M. Moha BEN SATTI	Directeur de Developpement
M. IRAQUI	Service Financier
M. Mahmoud LAGHMARI	Division Portefeuille
M. Abdelhamid KAREM	Division Comptable
BNDE - Banque Nationale de Developpement Economique	
M. Mohammed AISSAOUI	Directeur General Adjoint
CEN - Caisse d'Epargne Nationale	
M. Aomar OUGMENSSOR	Chef des Services Financiers
M. Mohamed TOUIMI BENJELLOUN	Chef, Service des Cheques Postaux
M. Mohamed IZALLAGEN	Chef de Service de la CEN
CNCA - Caisse Nationale de Credit Agricole	
M.	Direction de Credit Agricole

GPBM - Groupement Professionel des Banques Marocaines

M. El Hadi CHAIBANON	Directeur
M. Azzedine BERRADA	

Bourse des Valeurs de Casablanca

M. Abderrazak LARAKI	Directeur
M. BELEMLIH	Responsable, Finances et Admin.

COSUMAR - Cie. des Sucreries Marocaines

M.	Financial Director
M.	Technical Director

OFFICE DES CHANGES

M. ELMANIANI	Attache de Direction

SNI - Societe Nationale d'Investissement

M. Abdelkrim LAHLOU	Secretaire General

Brasseries du Maroc

M.	Technical Director
M.	Financial Director

CIH - Credit Immmobilier et Hotelier

M. Abdellah HAIMER	Directeur General Adjoint
M.	Financial Director

CITIBANK Al Maghreb

M. Gopaul	General Manager

BANQUE AL MAGHREB

M. BELHAJ	Directeur, Controle du Credit
Mme. BENNIS	

IFC - International Finance Corporation

M. Sami HADDAD	Resident Representative

BCM - Banque Commerciale du Maroc

M. Omar BEN IDER	Directeur General Adjoint
M. Jamal HAROUCHI	Division du Marketing

BCP - Banque Centrale Populaire

M. Abdelhafid TAZI	Direction des Engagements des Entreprises
M. Said LEFOULI	Chef, Dept. d'Etudes

Federation des Societes d'Assurances

M. A. CHRAIBI	President
M. Habib BEL GHITI	Vice-President
M. J. KETTANI	Vice-President
M. A. TAHIRI	Vice-President
M. Said OUAZZANI	Treasurer

CNSS - Caisse Nationale des Services Sociaux

M. Fawsi BRITEL	Directeur Financier

PRICE WATERHOUSE

M. Aziz BIDAH	Partner, Casablanca
M. Abdelwaret KABBAJ	Tax Director, Casablanca
M. Farida LAMOURI	Legal Advisor, Casablanca

USAID - Rabat

Mr. Charles Johnson	Director, Resident Representative
Ms. Linda Morse	Deputy Director
Mr. Kenneth Schofield	Program Director
Mr. Mark Kraczkiewicz	Program Officer
Mr. Richard Burns	Office of Private Enterprise