The impact of financial reform on development of industry in Algeria.

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Abstract :

The current changes towards privatisation in Algeria requires major financial reforms. The re-alignment and restructuring of financial sector requires a better structured, managed, and regulated financial system. In order to assess the current reforms as well as the transition process towards an improved financial system, several important factors have to be considered. So, an evaluation of the past and present financial markets operating in Algeria, as well as a consideration of the political and social climate that would accommodate future changes.

Furthermore, an assessment of the alternative financial systems present in the developed economies has to be made in order to evaluate which reforms would be most suitable so to satisfy the needs and demands for the Algerian economy as a whole in the face of international competition. In this paper, I will address the main issues of financial reforms that not only be able to accommodate the current privatisation policies but also promote the overall development of the industrial sector.

ملخص

علقت الجزائر آمالا كبيرة على الإصلاحات الاقتصادية من أجل الخروج من الأزمة الحالية التي تتخبط فيها، تسعى هذه السياسة إلى إعطاء نفس جديد للاقتصاد الوطني بعد الأزمات المتوالية التي عرفتها. إن التحولات الجارية تجاه الخوصصة بالجزائر تتطلب تغيرات مالية جذرية. إن إعادة الهيكلة، الخوصصة والتحول إلى اقتصاد السوق هي عمليات ضرورية تهدف إلى خفض الاختلالات الهيكلية وإزالتها. إن تعديل النظام المالي يصبح ضرورة ملحة يجب أن تؤخذ بعين الاعتبار في أي سياسة مالية، الهدف منها إعطاء مكانة للاقتصاد الجزائري ضمن المنافسة الدولية.

Introduction

The current changes towards privatisation and deregulation in Algeria inherently requires major financial reforms. Like other countries undergoing similar changes, it seems almost a prerequisite that the re-alignment and restructuring of non-financial sectors require a better structured, managed, and regulated financial system than is present at the moment (Kaser & Allsopp, 1992;Rybczynski, 1991; Corbett & Mayer, 1991). In order to assess these reforms as well as the transition process towards an improved financial system, several important factors have to be considered.

The comprehensive three year development plan (1967-1970); four year development (1970-1973),four year development plan (1973-1977).Since both of the banking and industrial sectors were owned by the government although the role of the banks increased their work became very passive. Their activities became almost purely accounting in nature; their role in credit evaluation and allocation were almost absent. These include an evaluation of the past and present financial market operating in Algeria, as well as the political and social climate that would accommodate future changes. Furthermore, an assessment of the alternative financial systems present in the developed economies has to be made in order to evaluate which reforms would be most suitable, of the needs and demands for the Algerian economy as whole in the face of international competition.

In this paper I will address these issues such that the right direction for financial reform should be taken in order. These reforms should not only be able to accommodate the current privatisation policies but also promote the overall development of the industrial sector. In section two we briefly outline the development of the financial markets in Algeria. Over the years, the political ideology has often strongly dictated the structure of the financial system; Algeria reverted to a more centralised system in the mid-1960titsni laicnanif niam eht fo desilanoitan eht ni gnitluser s|u-tions.

From the end 1990s, however, there has been a gradual liberalisation that has resulted in an increased involvement of private and foreign institutions.

In section three, an over view of the financial systems in the developed economies is presented. Depending upon the extent of the banking sector's involvement in the firms activities, systems can be characterised as either bank-based or market-financial systems. Each of the financial system in Japan and in Germany, for example, can be thought of as being a bank-based system, whereas financial structures in the United Kingdom can be classified as market-based systems.

In section four I will address the most suitable financial reforms required for the Algerian financial system during the period of the liberalisation; the main advantages and disadvantages of alternative approaches are examined such that proper changes in terms of financial structure and policy should be taken.

Finally a conclusion, regarding the main policy considerations required for financial reforms, is presented.

1. Financial structure in Algeria.

Since independence in 1962, Algeria undertook the construction of a socialist economy supported by heavy industrialisation and substantial investment in human capital. Most of the financial institutions, namely the banks and the insurance companies were nationalised. The first was the establishment in 12 December 1962 of a central bank with close links to the government without any degree of independence.

The second sector of the banking sector consisted of the purely Algerian owned and run primary banks. In this regard, was created the " Algerian Fund for development" (CAD) on 7 may 1963 which looks like financing investment projects. Thus, it participates on the launching of the first industrial companies such as Sonatrach (the state-owned oil company), SNS (state-steel company), CNAN (state-owned shipment company). It has been mentioned that the CAD has been replaced by the Algerian Bank of Development (ABD) in may 1973 to finance the aims of the economic development and to clean up financial state of firms in trouble. However, both the central bank and the ABD were unable to manage the whole public investment. For this reason, was crated the " Caisse Nationale d'Epargne et Prévoyance on 10th of August 1964 as a Saving Fund to give a boost of the housing policies.

In 13 June 1966, was created the first national bank namely the BNA(Algerian National Bank).This was the first bank to be created to finance industrial development. Although the bank was extremely successful in financing and monitoring industry, it could not satisfy the increasing financial needs, due to the increased demand for Algerian goods. Thus, in the same year in 29 December, it was created the "Crédit Populaire d'Algérie" to promote and developed industrial specialised activities; and for enhancing activities with foreign firms, was created in 1st October 1967 the "BEA"(Algerian Foreign Bank).

It is clear that the process of Algerianisation and thus the nationalisation of the main financial institutions and their incorporates in the public sector allowed the government to directly own and control the main flow of credit. A similar development of nationalisation also occurred regarding industry; Algerianisation occurred from 1965-1975 and so complete government domination of the main firms earmarking the beginning of. Banks had relatively little autonomy; firms which performed badly still had access to bank loans, since the government never allowed firms to reduce their activities or liquidate (Soliman, 1984).

In summary, during these years banks played a passive role with respect to industry. They simply became the financing sector of the government's plan by automatically issuing credit and loans to approved expenditures.

2. Recent liberalisation policies.

This will be the key to the whole reform effort. The financial system remains broadly underdeveloped and heavily controlled by the government (95% of assets and 90% of lending). Despite some progress in opening up the sector to foreign banks, and a few private banks, initiated over the last three years. Its core is composed of the central bank and six state-owned banks, plus a marginal participation of foreign financial institutions with small operations mainly focused on high profit low risk transactions. With bank owned by the state, credit allocation is inefficient, while interest rates are not market based. Portfolio quality is poorly known, due to of lack up to date bank audits.

Banks loans to state owned companies constitute high contingent liabilities, as cleaning up the public bank's loan portfolios has been achieved through a massive government repurchase of bad loans to state enterprises, totalling more than DA600 billion (30% of average GDP for the 1993-1997 period). The new authorities are committed to undertaking a reform of the financial system.

The reform agenda is huge: introducing competition and modernisation; moving the banks from directed credit to market-determined allocation of credit; reducing state domination and governance; strengthening banking supervision; and completing portfolio restructuring. Privatisation of a few banks is also key to change past behaviour.

As regards other financial institutions, there has recently been promoting the birth of the stock exchange in order to implement any future privatisation programme. It is argued that it will help to sell shares issued in the sell-off of public firms; and also it will improve access of efficient firms to investment funds; and finally it is argued that it will increase external discipline exerted by market forces on the management of participating firms.

3. Financial structure in developed economies.

The main role of financial systems is to mobilise the funds of a large number of individual savers towards the funding of larger-scale enterprises. The way such funds are mobilised and allocated varies from one economy to another ; furthermore, the process of mobilisation may heavily influence the activities, directions, growth and even success of individual firms or even industries at large.

Although it was shown theoretically by the classic papers of Modgliani and Miller(Modgliani and Miller, 1958), that by applying competitive equilibrium analysis to corporate finance, there is no relation between corporate finance and the performance of the firm in the absence of taxation and capital market imperfections. However, as early as 1962, it has been recognised that the varying approaches in financing significantly affect economic development and industrial enterprise.

Gerschenkron (1962), when comparing the English and German banking systems, wrote : "between the English bank essentially designed to serve as a source of short-term capital and bank designed to finance the long-term needs of the economy there was a complete gulf. The German banks, which may be taken as a paragon of the universal bank, successfully combined the basic idea of credit mobilier with the short term activities of the banks". Furthermore, German banks, in addition to industry nurse, advise and maintain interest in corporate activities, and if need be provide technical support and market know-how accumulated by bank staff (Pollard, 1989).

Indeed there are significant differences in terms of financial activities existing between the various economies of the developed countries. Systems may be characterised as either bank-based or market-based financial systems, depending upon the degree of involvement of the banking sector in corporate finance and activities, the size of equity and bond markets, the equity holding by the institutions and individuals, the gearing proportions of the corporate sectors, etc. Although such a characterisation may be an oversimplification and indeed there are models of classification it serves to illustrate the important differences in the operating of financial systems of the developed economies. Germany and Japan, for example are clear illustrations of economies which have developed banked based systems. On the other hand, the United States and the United Kingdom are typical, yet rare examples, of market-based financial systems. In this section we briefly describe the main characteristics of the alternative financial systems; the form in which firms receive their finance, their structure of ownership and who has direct control on corporate activities.

Bank-based systems therefore may be considered as insider systems, since their share ownership is concentrated in a group of insider investors, banks and related enterprises; even if there are outsider shareholders they have limited voting rights and hence little control. Market-based systems may be considered as outsider systems since firms have dispersed ownership between shareholders (Corbett & Mater, 1992).

3.1 Ownership and control in bank-based financial systems.

In bank-based systems, banks generally hold corporate equity and have members on the board of directors, often holding important positions. Thus, they not only provide long-term capital, but also play an active role in the financing and general directions of corporate strategy. Germany and Japan are typical examples following such a system. In Germany, for example, banks not only provide long-term loans but also own equity, either in their own name, or as representative shareholders of private investors. Furthermore, banks handle new issues or marketable securities (placing substantial proportions directly with their customers). They also provide advisory and brokerage services for both individuals and firms; about half of all shares are deposited with banks, thus they not only minimise transaction costs, but also act as custodians of these shares by for example utilising their voting rights. These conditions lead the bank to hold considerable control over a firm activity (Cable, 1985). In Japan, although no bank is allowed to own more than 5% of a firm's capital, the behaviour of the bank by helping substantially in terms of long term borrowing facilities results in an especially close relationship between investors and borrowers.

Corbett (1987)for example observed that is not only the credit evaluation of prospective borrowers at the initial long stage and the terms on which finance is provided distinguished them from most other banks in the world, but also subsequent monitoring. Unlike the usual practice of monitoring the accounting performance and management, it is quite usual for Japanese loans officers to visit firms on a regular basis, often more than once a week. Another distinguishing factor of Japanese banks is that when firms encounter financial hardship direct managerial control by banks can occur; in which the firm’s main bank can organise the response of creditors, re-schedule loans and even provide specialised personnel.

In summary, in bank-based systems, banks, related companies and employees have a very close and long term relationship with a firm’s activities. Moreover, there is almost always only a small nucleus of dominant investors who have direct control; outsider shareholders often have limited voting rights and hence little control of corporate activity. Direct ownership, long term borrowing facilities and representation on the board of directors, result in related parties having a direct influence on corporate activities. Although they may not intervene directly in the affairs of the firm, they play an important in its direction, and may intervene, especially in times of poor performance. In Japan for example, banks may directly intervene to help troubled firms of both financing and providing specialised personnel. Furthermore, even when there is little direct ownership, in bank-based systems there is often cross-shareholding of related firms resulting in mutual interests. However, such a system of industrial financing can be viewed as a "quasi-internal capital market" with important informational and transaction cost implications (Cable, 1985).

3.2. Market-based financial systems.

Here capital markets exert control over the management activities of the firm. Control is generally associated with takeovers; this process acts a discipline on firms allowing control to be transferred from inefficient to efficient ones. Here banks hold little or no equity, and hence often have no representation on the board of directors and hence little controls other than through the normal lending and re-financing procedures. In the United States and the United Kingdom, corporate equity is usually held by other financial institutions such as insurance companies and pension funds or by direct private investors who have little direct control on the firm's activities. Moreover there is usually a large quantity of listed companies; shares are often held by large amount shareholders who are continuously changing in market trading. Furthermore, unlike the bank based system, there is little cross-shareholding between related companies.

The above forms of ownership lead to a distinct separation of ownership and control, especially when there is a large amount of shareholders. Instead of firms being controlled by their investors, they are indirectly controlled by other firms. Here competition for control by other firms, through takeovers, suggests that corporate efficiency must increase since inefficient companies would always be under pressure. Such conditions in these stock market economies, would theoretically suggest that it would be a remarkably efficient system of self-control through competition. However, in practice, it has been proven to be deficient in several respects especially since it often results in hostile takeovers. In addition to being an extremely provocative and aggressive process of publicly demonstrating incompetence of the rival management, it is very costly in terms of resource and time and distraction of other management duties. In other words, firm control is subject to free-rider problems; the only effective control being exercised through exit or through takeover. Neither is good for long term development nor profitability.

Furthermore, takeovers can often be at the expense of other stakeholders; managers of firms take responsibility of corporate activities but are ultimately accountable to the shareholders; since related parties, such as employees and other related companies, have no form of representation on the board their position may be compromised. This problem has led to strict regulatory bodies in the United States to safeguard the interest of related parties during takeovers (Franks & Mayer, 1990).

Moreover, since shareholders are primarily interested in the rate of return of their stock, they do not usually have the long-term patience for their firm to incur short-term losses for longer term growth, research and development, and development, and have no interest or incentive to actively participate in corporate affairs. Managers therefore follow short-term policies to satisfy their shareholders, especially since they are under the constant threat of hostile takeovers. This short-terms is often first felt in the research, development and training in the firm's strategy.

4. Financial reforms needed for privatisation and industrial development.

4.1. The need for financial reform to accommodate the privatisation process.

The current changes towards the privatisation of state-owned firms require a coherent policy that embarks on a strategic re-alignment and restructuring of industry (Soliman, 1991). There needs to be a simultaneous reforming of the financial structure in order to accommodate such changes; the financial system will, furthermore, determine the consequent development of the industrial sector as a whole.

As shown in section two, the present financial system in Algeria is inadequate to accommodate the break-up of the industrial public sector; there needs to be a better structured, managed, and regulated financial system than is present at the moment. The alternative financial system operating in the developed countries namely the bank-based system typical in Germany and Japan, or market-based system that is prevalent in the United States and the United Kingdom have to be assessed in order to evaluate the reforms in the financial system that would be most suitable, yet realistically obtainable, for the needs, demands and development of the Algerian industrial sector.

4.2. Would a market-based system be viable in Algeria?

As discussed earlier, the stock exchange in Algeria has been very passive in the development of the industrial sector.

The January 1998 bond issue of Sonatrach, was the first operation on the Algerian capital market. It outstanding success had opened the way for other operations such as ERIAD/SETIF(capital increase through an IPO in November 1998) and SAIDAL group as well ELAURASSI hotel(capital opening through the stock exchange successively in February and June 1999).

The first trading session was held on September, 13th 1999 with the successive listing of the companies. After 52 sessions, the trade number increased only one transaction during the first session to 354 during the 24th one. Trading value has reached more than AD 217.039.600 (US$ 3.252.017) during the 19th session.

The market capitalisation reached AD 217800000000 (US$ 290322580) on September 04th 2000.

Several companies will be listed, according to the current ambitious privatisation programme. This may contribute to boost capital market in Algeria.

Without doubt, revival of a vibrant stock exchange would be a contributory factor in the overall development of the financial system; even in a bank-based system such as in Japan there is a mature and vital stock exchange.

However one needs to ask whether this should be the main strategy that is needed to implement the privatisation programme and at the same time promote industrial development. Indeed serious doubts have arisen which imply that this mechanism may obstruct the long-term growth of firms quoted in the stock exchange (see section market based financial market).

In regard to the present stock market as a device to promote development, it can be said to have negligible influence on industrial firms. Personnel have no experience in dealing with a large a number of companies, or the operational aspects of running an effective stock exchange. In addition, there is little technological development in data acquisition and distribution, or the technical know-how to proceed important information accurately, quickly and effectively. If, however, such conditions were to be satisfied as is present in the mature and effective stock-markets of the developed economies important questions have to be asked regarding the issue of new shares of the time involved in the privatisation programme. Will the government be able to sell the issued shares? Who will buy the shares? Who will have effective control of the firm?

As regards the selling of issued shares to the public, there are several questions; it has to be asked whether the Algerian public at large has either the willingness to invest its savings into such joint ventures or indeed has the ability to do so in view of their low income. Indeed even in developed countries such as the United Kingdom

(during its privatisation programme), there has often been difficulty to induce ordinary people to participate in such activities. In addition, in the case of Algeria, the recent experience has shown little concern of the public to deal transaction operations in the stock market. Hence the possibility of selling a large amount of shares to a large number of small investors is extremely remote.

The other likely main participants are employees, wealthy individuals or financial institutions, such as banks, pension funds organisations or insurance companies.

As regards wealthy individuals, there may be a danger in transferring a government monopoly to a private monopoly. Furthermore, without strict regulatory bodies there may be a tendency to drastically alter the firm's activities which may not only be detrimental to the government policies of industrial development but also to other no participating stockholders, such as the employees, as often happens in the hostile takeover battles in the United States (Corbett & Mayer, 1992). In the selling of shares to the main financial institutions, since the majority (in terms of assets) are state owned, this process may result in a "privatised" firm being owned by a public sector institution i.e. it may result in no change of ownership and control. As regards the role of private financial institutions in mass privatisation, their ability to buy large stocks is limited. For the case of selling large amounts of shares to employees, although this would have a beneficial effect on performance (Grout, 1987) there still needs further analysis whether this would be viable for Algerian employees regarding their ability to do so in view of their low income.

4.3. Is a bank-based system a better approach for Algeria?

The current policy in Algeria has mainly focused attention on the market-system as the main instrument for the implementation of the privatisation programme. However, less attention has been paid to the feasibility and consequences of such a policy. The concerns of basing industrial development on such a system for the case of Algeria have been discussed above. Furthermore in the US and UK there is now growing concern regarding the long-term performance of firms, due to the threat of hostile takeovers (see section: financial structure in developed economies).

Furthermore even in the newly developing economies of Eastern Europe concern has been growing since privatisation of industry which has been independently pursued without appropriate financial re-structuring (Stiglitz, 1989).

However an alternative approach, based on a bank-based system, may be more appropriate when re-structuring the Algerian industry. Indeed it may not only be suitable in the implementation of privatisation but may indeed provide a better structure for long-term development. Examples such as Germany and Japan which have adopted such a system, have seen longer term success, stability and development in the main core industrial sector. In UK for example there has been recent drastic reductions in the activities of well established firms such as Rolls Royce, Ford and British Aerospace. Indeed it has been argued that banks may have contributed to certain segments of British industry failing (Forrest & Collins, 1992) due to their limited role.

In Algeria, such problems may even be more acute for firms chosen for privatisation which face severe competition if they are left without protection; a bank-based financial system, with firms receiving long-term financing, monitoring, advising and supporting in times of difficulty may offer a better alternative than a market-based financial system.

Indeed Algeria has had an established banking system for many years. There are a variety of commercial and investment banks. Furthermore there are new private banks (Khalifa bank), joint-venture (Baraka-bank), and branches of foreign banks(City bank) existing with the main state-owned banks, and hence there is a quasi-competitive environment.

In summary, there still needs to be a complete restructuring of the Algerian banking system in order that banks may be able to accommodate the transfer of ownership; and consequently have the ability to play an active role in terms of monitoring and support of the firm, investment banks; whether they be state or privately owned, have limited participation in financing industry; private banks participate in trade and commerce. It has usually been the main state-owned banks that have directly

Financed industry; however they have played a passive role in industrial development and direction. They may simply be considered as the financing agent of government policies by automatically issuing credit and loans to approved expenditures

Conclusion.

The privatisation of state-owned firms requires a coherent policy that embarks on a strategic re-alignment and re-structuring of industry. There needs to be a simultaneous reforming of the financial structure in order to accommodate such changes; furthermore the financial system will contribute to the subsequent development of the industrial sector as whole.

In considering the arguments put forward in the previous sections it seems that since there is already an established infrastructure of a developed banking system, privatisation and industrial development could be implemented through reforms of the banking structure towards a bank-based financial system. This would require better managed and structured banks that provide new services and take on additional responsibilities, than is present at the moment. Indeed, banks supported the industrial development which can be seen that in a way Algerian banks have the ability to proceed in such a direction.

However, in order that such development be successful, important financial reforms that accommodate the social and political climate have to be considered:

(1)Restructuring of the banking system: since it is argued that privatisation of industrial firms will lead to greater efficiency and development, so too there will be need to be a simultaneous liberalisation, and hence consequent privatisation, in the main state-owned banks which provide their finance. Such restructuring inevitably requires a better trained and sophisticated personnel that will not only provide a more efficient service with respect to normal bank practices, but will also be able to offer new services and take on additional responsibilities. The banks should be able to screen and monitor firms since they will play an active role in the firms finance. These include (I) credit evaluation (II) representation of the board of directors (III) monitoring the activities of the firm (IV) provision of support in times of difficulty, in terms of both finance and expertise personnel. With regard to other activities personnel should be trained in order to provide customers with brokerage services; such as unit trusts, share issues, etc...

(2) Establishment of regulatory bodies; to safeguard the rights all participants through the establishment of new laws which protect the depositors, banks, firms, etc. Recent bad experiences with respect to few banks, companies might have been avoided if there had been regulatory bodies monitoring their activities.

(3) Religious considerations: Furthermore, reforms have to be in line with religious practise. Since there is now a resurgence of Islamic trends, people are reluctant to deposit their savings in banks with fixed interest rate institutions.

Hence the new role of the banks should be able to provide potential customers who prefer to directly (through shares) or indirectly (through unit trusts) finance firms as in accordance with Islamic practise.

Such reforms may help to mobilise large scale funds from small investors for implementing the privatisation, and subsequent industrial development.

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In 6th December 1990 was created the Baraka bank which is a joint venture between Saudi Arabia and Algeria.

In 19 th June was created the Joint Offshore Bank (BAMIC), between Lybia and Algeria.

In 7th may 1995, was established a private bank the Union Bank.

Now there are several private banks.

ABC (Arab International Bank), AIB (Arab Investment Bank), City Bank, Société Générale, Natexis, Ryan Bank,

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