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Analysis of Investment Opportunities in Jordan's Financial Services Sector

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Authors ; Yoshitaka Hayashi, Yousef Mouashe, William Thomas



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ACRONYMS

AMIR	Access to Microfinance and Improved Implementation of Policy Reform Program
ASE	Amman Stock Exchange
ASEZ	Aqaba Special Economic Zone
CBJ	Central Bank of Jordan
FI	Financial Institutions
FS	Financial Services
IMF	International Monetary Fund
JD	Jordanian Dinar
ME	Middle East
MENA	Middle East & North Africa
QIZ	Qualified Industrial Zones
USAID	U.S. Agency for International Development
SEZ	Special Economic Zone
WB	World Bank

EXECUTIVE SUMMARY

Given the current tension at their doorstep resulting from both the war in Iraq and ongoing enmity between Israel and the Palestinians, businesses can be forgiven for not identifying Jordan as an optimal market for investment. The international goodwill and successful reform programs initiated first by King Hussein and, now, by his son King Abdullah have greatly benefited the economy; however attention, both domestically and internationally, has often been taken away from these efforts in light of more pressing social and geopolitical matters.

Foreign investment is predicated on firms identifying politically stable nations with positive economic indicators and foreign market access. For Jordan, it is crucial to emphasize to investors that the existence of tension which scares off many (especially in the West) does not mean there are not profits to be made in their markets, and that the advantages of an emerging and positive business climate in a potentially revived region outweigh the perceived risks. However, economically, even the most optimistic analysts view Jordan's immediate prospects with concern given their geographic vulnerability. They are in the unenviable position in that success or failure in procuring investment, in many ways, hinges on factors completely out of their control. However, the 9% GDP growth experienced in the country immediately following Gulf War I is also hard to ignore, especially given the steps taken to develop the investment infrastructure since the early nineties.

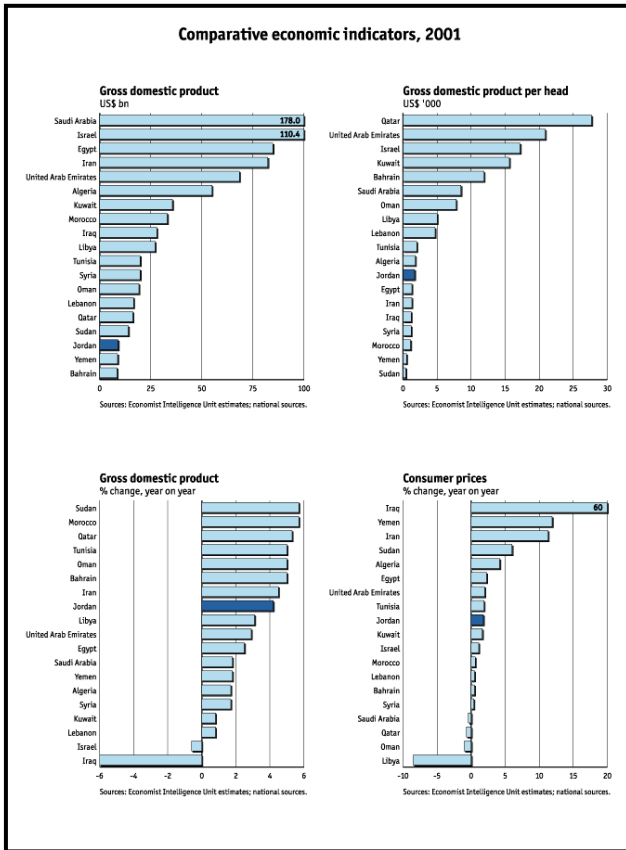
To date, the government has struck a delicate balance between promoting favorable relations with the West (specifically the United States) while maintaining its legitimacy among Arab states. The young monarch, King Abdullah, has managed to maintain a hold on his people and not allowed chaos to ensue in a recent period marked by war in Iraq and the ongoing intifada. The future prospects of almost all sectors in Jordan are generally positive if peace is allowed to prevail.

This report will analyze the financial service industry's place in the future of the Jordanian economy and, more specifically, addresses the banking sector which is the primary provider of financial services in the country. The report will assess what the options exist for regional as well as international banks in this market, while providing background on the macroeconomic fundamentals, investment climate, business practices, and the financial sector (including stakeholders, the industry's saturation, ease of entry, profitability, etc.). It will also discuss trends in the sector itself and analyze recent moves towards regulatory reform, liberalization, and transparency, as well as discuss the emerging areas of business that foreign firms may take advantage of. In the end we propose to come up with firm recommendations and a realistic assessment of what the near-term and long-term prospects are for profitability and expansion in Jordan's banking sector.

I. JORDAN'S MACROECONOMIC FUNDAMENTALS

Background

Jordan is a small developing country with many conflicting features. It is a stable country in a politically volatile region, barren of natural resources, yet able to develop various industries while expanding exports. Jordan is currently undergoing major economic reforms and is struggling to define its role within the region, as well as an increasingly global and competitive economic environment.



Jordan is improving its local labor skills, especially in the IT arena, structurally changing its monetary and fiscal engine, as well as freeing up its trade policies. At the same time it is trying to balance the socioeconomic impact of such changes and reforms. The industries which are targeted as the engines of growth and that currently comprise the highest

portion of Jordan's GDP include tourism, construction, manufacturing, and information technology.

Recent Economic History

In 1989 the JD collapsed due to high government expenditures on infrastructure as well as the accumulation of significant foreign debt. The IMF interceded in 1989 for the first time to help reduce foreign debt and improve balance of payments in the country. The JD was pegged to the dollar and after several years confidence in the currency was reinstated. Jordan was a star pupil in taking the IMF “Pill” of liberalization, including the reduction of government’s excessive salary spending, and the reduction of customs and quotas. In addition, the 1990 Gulf War shocked the country with an influx of refugees from the Gulf which became an economic burden.

A major financial and fiscal change was the introduction of the 7% sales tax. Additionally, oil and bread prices were increased to sustain the loss of government revenue from its reduced tariffs due to an open trade policy. Deficits have traditionally been high, but are receiving attention. Inflation of 1.8% has been under control for the past 7 years, partly due to pegging of the currency with the dollar. Stability is a priority for growth, even if pegging the currency leads to lower export opportunities.

The intifada in 1999 was another shock, especially after the surge in the tourism industry between 1996 and 1998. The final blow to Jordan before the new war with Iraq was the “Shamayleh” banking scandal (to be discussed at length later in this report). In short, stabilization and socio-economic restructuring has not truly “trickled down”. Even now, unemployment and

poverty levels are still high in the country, but reforms are slowly addressing this.

Jordan Today

Jordan is a young country that is quickly developing. Some key facts about Jordan include:

- **25% estimated unemployment**
- **5 million, total population**
- **US\$9 billion GDP**
- **89% literacy rate - highest in the region**
- **Modern Jordan was created in 1946 after British rule.**
- **Jordan lost part of its land to Israel in 1950 (West Bank)**
- **Currency is fixed to dollar at .71 JD = One US\$**
- **70% of population under 30**

Fairly or unfairly, politics plays a major role in Jordan's economy and stability. Uncontrollable factors such as regional geopolitical developments are main obstacles to Jordan's image, attractiveness to foreign investors, financial stability, economic stability, and development. Furthermore, Jordan is currently in a crisis stage of witnessing its two biggest trading partners (Iraq and the US) at war with each other. Iraq supplies oil at cheap rates and is a major trading partner to Jordan, and U.S. is recently responsible for the 4% GDP annual growth that Jordan is currently witnessing due to the FTA agreement. This unique situation in the midst of such reforms comes at a very bad time. Jordan's recent stance is against any war in Iraq and in favor of dialogue and increased U.S. involvement in the settling of the ME peace process.

Jordan's current economic standing is mixed. On the one hand, GDP is rising noticeably, exports are increasing, foreign reserves are at a record high,

and currency is extremely stable due to constricted central bank policies focused on stability and reducing fraud (often at the expense of expanded growth). However, poverty, unemployment, foreign debt, and budget deficits remain a chronic problem. The current deficit is forecast drop to a 3% of GDP by 2007. Government salary spending was 22% of total government expenditures in 2002. In 2002 a deficit of US\$410 million was recorded, down from a previous level of US\$608 million.

Jordan's current economic strategy is to focus on building a skilled labor force in order to become a global player and attract foreign investments. Another reform is the combination of dynamic and deep structural legislative and regulatory reforms aimed at paving the way for a free economy with free trade and increased privatization and the development of sophisticated capital markets. Jordan's attempts are to create a comparative advantage for itself and exploit its location in the region as well. Jordan's deregulation, privatization, and introduction of new property right reforms have also helped to create over 10,000 jobs in the IT industry over the past 3 years. While Jordan also suffers from a balance of payments situation and foreign debt, it is hoped that this will be resolved through increased exports. Of course, with that free trade, increased competition threatens local industries.

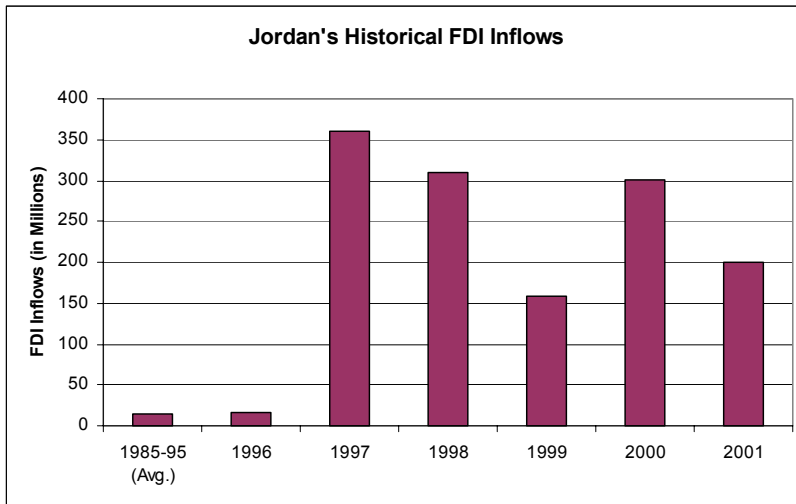
Generally, Jordan's economic growth is completely unaligned and uncorrelated with the rest of the region because of the lack of well-coordinated economic blocks and/or trade agreements within nations in the Middle East. Iraq was a major trading partner (20% of exports), but now Jordan

is no longer reliant on them and is currently building relations with the U.A.E. and the U.S., among others. There is a shared openness and individual goals, specifically with UAE, to build trade, growth and an educated labor force. A “free” Iraq is sure to benefit Jordan on many levels, however, most significantly in oil imports as well as expanded export markets. Jordan has swiftly and carefully positioned itself as a self-determining and harmonious nation amidst a tumultuous region, an attitude that can be defined by King Abdullah’s recent “Jordan First” initiative. In a stable regional environment, Jordan appears ready to reap significant macroeconomic benefits

II. JORDAN’S BUSINESS INVESTMENT CLIMATE

Introduction

As a region, the Middle East only absorbs 0.5% of the world’s Foreign Direct



Investment (FDI), with two-thirds of that amount going to Saudi Arabia and Egypt. Levels in Jordan, a small country of only 5

million people with minimal natural resources, remain low, but have grown tremendously, if not linearly, since the early/mid- 1990s. FDI in Jordan fell to US\$ 200 million in 2001 (from over US\$ 300 million in 2000) due primarily to the

intifada. Future FDI prospects looks promising given the ongoing economic reforms and opportunity for regional peace. Strides made through almost all sectors of Jordan's economy make it an appealing option for foreign business investment. This section will discuss the factors which have provided a road-map to foreign investment opportunity. Understandably, firms, especially those in an industry as complex as financial services, must consider a variety of factors when assessing investment options. This section will analyze the current climate in Jordan and opportunities and obstacles going forward.

Assessment of Jordan's Current Market Conditions

Existing foreign investment in Jordan has historically been from within the region. Businesses from the developed world (i.e. the West) are being aggressively pursued, yet they continue to exhibit hesitance. Below are some recent developments and trends that will impact future investment:

Expanded Markets through Trade Agreements and WTO Entry: In December 2001, Jordan became one of only four countries to have signed a Free Trade Agreement with the United States, primarily as a reward for their role as a regional model for reform and their peace agreement with Israel. 2002 exports to the U.S. totaled US\$ 450 million and accounted for most of the 25% growth in national exports, contributing to recent GDP growth. Additional agreements have been reached regionally, and are being considered with the EU. In January 2000, Jordan's swift rise to world trading legitimacy was complete as they were admitted into the WTO;

Privatization: National industries in Jordan have been or are in the process of being privatized (e.g. Telecommunications, Potash, Electricity), an important step developing nations must take to increase efficiency of institutions for their citizens and make the economy more appealing for long-term investors; and

Policy Reform: Formerly rigid laws governing foreign company investment levels, ownership, and operation within the Kingdom are being rewritten to the benefit of foreign investors. More work must be done, and help is needed at the local level, but there is a strong foundation.

Obstacles to Foreign Investment

Foreign Debt Levels: Debt was measured at US\$8.3 billion in 2001, an extremely high percentage of the US\$9 billion GDP. In 2002 they managed to reschedule US\$1.4 billion of the debt in accordance with the Paris Club. Japan is Jordan's largest creditor, followed by France, the UK, and the IMF. Jordan is dependent upon international donors but remains in good standing;

Corporate Tax Rates: Given the high levels of debt servicing and high government expenditure to GDP ratio, the fiscal burden on the government requires high levels of taxes, especially on corporations. Jordan offers tax breaks to new domestic and foreign companies (35% for FS firms over an introductory period of up to 7 years), however in the long-term these rates are a deterrent;

Start-Up Difficulties: One of the primary areas of frustration for foreign firms doing business in Jordan is that after initial government enthusiasm, the reality of red-tape and lack of official decision-making impedes firms getting

operations off the round. Efforts to address these “micro” issues are ongoing and will undoubtedly take time and attention from officials;

Potential Instability: Anti-western sentiment is very real in the country. Potential investors are especially weary of this as they consider their investment options and many have chosen to wait for easing of the current Iraq conflict and the Palestinian/Israeli tension before committing to invest;

Weak Corporate Governance: Increasingly sophisticated domestic businesses have not kept pace in applying uniform concepts of accountability and transparency (accounting and auditing standards are especially problematic). There is talk that quarterly reporting might be introduced as an alternative to annual reporting for publicly listed companies. Joint-venture partners and international investors alike see this as a glaring weakness in the investment climate; and

Unemployment/Poverty: High levels are considered undesirable, and Jordan, while improving, is still struggling with this. Unofficial rates and estimates point to 25% unemployment and significant poverty.

Attractive Features

Incentives and Exemptions: Jordan offers immediate tax breaks to foreign investors. As mentioned previously, FS firms can expect to receive a 35% corporate tax break through an introductory period of up to 7 years. Additionally, customs and taxes on imported materials used for initial set-up of operations are waived. Local ownership is not required, repatriation of profits

has been simplified, and firms can expect to operate relatively freely in the market-place;

Post-War Growth Potential: Many analysts agree that the regional opportunities post-war will lead to an up-tick in growth in Jordan beyond 2003 as significant flows of foreign investment reach the region and economic reform continues to take hold. Jordan’s position as a stable Coalition ally in close proximity to a resource-rich Iraq, armed with a comprehensive package of incentives for foreign businesses bodes well for the nation. Foreign firms are beginning to set up in Amman in anticipation of further positive regional developments;

Low Inflation/Interest Rates: Currently at 1.8%, inflation has held steady since 2001, despite regional tensions. Interest rates, at the prompting of the Central

INDEX	RANK	WHAT IS MEASURED?	INSIGHT
ECONOMIC FREEDOM <i>(Heritage International/Wall Street Journal)</i>	45 th (out of 161 countries)	Broad indicator of overall economic freedom	Jordan ranked 45 th out of 161 countries. 3 rd in ME region behind Bahrain & UAE. Implies success of recent reforms.
STANFORD RESEARCH INSTITUTE	77 (maximum score of 100)	Scores measure “policy competitiveness” and business friendliness	Jordan finished 2 nd in the region, behind Lebanon. Highest scores in incentives and import policies, lower in start-up and tax rates.
CORRUPTION PERCEPTIONS INDEX <i>(Transparency International)</i>	4.9 (out of 10)	Ranks corruption levels worldwide based on various sources	Finished 2 nd out of 4 Arab countries surveyed. Corruption, while a problem, is seen to be improving as the business climate evolves.

Bank of Jordan (CBJ), have trended downwards recently, providing some stimulation to the economy. Gaps between deposit/lending rates remain high;

Investment “Zones”: Jordan has reaped undeniable benefits through their use of Qualified Industrial Zones (QIZ) and Free Zones, which have provided needed stimulus to investment and export levels. For example, the goods produced in the QIZ can be exported, duty-free, to the U.S. In the Free Zones, goods may pass through, exempt from customs duties or import taxes, and industrial facilities may be leased from the government at reduced rates. Asian investors, less skittish about the regional tensions, have been quick to take advantage of these Zones. Notably, in 2001 Jordan established the Aqaba Special Economic Zone (ASEZ), a liberalized, low-tax, duty-free development area located in the south of Jordan. The 650 sq. km ASEZ will offer businesses and residents a planned environment consisting of high quality core infrastructure, facilities, and support services built at international standards, designed to attract and serve local and foreign investors;

Human Resources: A comparatively skilled workforce: 89% literacy rate, 17% receiving higher education, 70% of the population under age 30, and competitive wage rates; and

Capital Markets Development: The ASE and its development is a major step in building on an image of corporate stability in the country. Increased transparency, liquidity and frequency of annual corporate reporting will enhance the attraction of FDI in securities. Foreign portfolio growth doubled in 2001.

III. BUSINESS PRACTICES

Introduction

Overall, Jordanian firms tends to be conservative in their business practices. The language of money is the same worldwide; however the methodology of accomplishing mutual goals (whether it be in starting a new company, procuring loans, or establishing partnerships) is different in Jordan than in much of the international business community. This section will discuss business practices in Jordan, specifically in the financial sector:

Business Practices in the Financial Arena

The local Jordanian culture makes it difficult for foreign banks to penetrate the market effectively because Jordanians favor local banks and tend to be trusting and comfortable with them. In addition, there is little entrepreneurial spirit and the small investor base tends to be followers of developed economies and leading industry players. Consumers also tend to be less experimental in trying new things. Differences in the climate can also be explained by the following:

Traditional Methods of Borrowing: A high percentage of businesses are family owned and traditional borrowing and the raising of capital does not go through conventional channels. Rather, close friends and relatives tend to support each other and provide capital to finance business. Efforts are being made through donors, especially USAID, to provide microfinance assistance that might help change this way of doing business on the small business and entrepreneurial level. Overall, these traditional methods are changing as the

culture becomes more comfortable with banking services and begin to demand expanded services;

Fiscal Conservatism: Jordanian business-people are conservative in nature, both in spending and borrowing, which is reflected in the large collateral requirements of banks as well as the huge interest rate spreads and conservative central bank regulatory policies. Furthermore, long term loans are almost non-existent. Few loans of more than 7-years have ever been granted, and when they have it is at extremely high interest rates;

Lack of Large Businesses: Jordan has few large corporations. It is an accepted fact that that economies which develop large corporations and the resulting corporate structure tend to exhibit higher development and economic well-being;

Tendency to Follow Rather than Lead: Jordan is generally a victim of outside political situation. This regional political volatility has showed the short-term nature and expectations of the investor base in Jordan. The average payback period on investments for Jordanian investors is 2 years which is very short by international standards;

Local Favoritism: One of the most criticized aspects of Jordan's traditional way of doing business is the existence of personalization and favoritism. Although this is not corruption, per se, it a gray area. This is prevalent in situations such as getting licenses, having property waived as debt repayment out of the collateral, knowing people in "high" places, being released from prison out of pity, etc. While not as prevalent as it used to be, it still exists. Nevertheless,

these kinds of problems are not as prevalent in Jordan as elsewhere but they can make Jordan incompatible with international standards, which hurts economic development;

Status Issues: The domestic labor force, even though it is relatively well-educated, is nevertheless, untrained and status oriented. For example, Jordanians that work as garbage collectors tend not to disclose that information to their families as they see it as shameful. Jordanians have a sense of self pride and dignity that they just simply cannot disassociate from their tasks and job identification even though there is a demand for many of these kinds of services.

Overall, Jordan is a unique place to do business, and future entrants should be cognizant of the myriad differences in culture before choosing to enter the market. Companies intent on entry must see significant benefits in a project that outweigh the differences in business practices, as well as the geopolitical vulnerability.

**IV. FINANCIAL
SERVICES/BANKING
SECTOR ANALYSIS**

Introduction

Middle East/North Africa Financial Development Rankings

The comprehensive index allows MENA countries to be ranked according to their level of financial development (2000-2001).¹

Level of financial development		
High	Medium	Low
Bahrain	Algeria	Iran, I.R. of
Jordan	Djibouti	Libya
Kuwait	Egypt	Sudan
Lebanon	Mauritania	Syrian Arab Republic
Oman	Morocco	Yemen
Qatar	Pakistan	
Saudi Arabia	Tunisia	
United Arab Emirates		

Source: IMF, Banking & Development (MENA)
¹Based on the comprehensive index of qualitative and quantitative data; the index ranges from 0 to 10, with 10 being the highest level of financial development. Within each category, the countries are arranged in alphabetical order.

Under King Abdullah's powerful economic reform program consisting of liberalization, privatization, and investment promotion, the Hashemite Kingdom of Jordan has established the second largest economic market in the ME region, after the United Arab Emirates (UAE). Paralleled with its economy, the financial sector has also maintained steady growth supported by the strength of the banking sector as well as the growth of the Amman Stock Exchange (ASE), created in 1999. This section analyzes current environment surrounding financial service industry in Jordan.

“The Players”

Jordan has a moderately well developed financial services sector, and what is considered the most transparent and well-regulated banking sector in the region (thirty-first worldwide) by Moody's Investors Services. Overall, the banks can be characterized as well-established, conservative, and profitable. Currently, the banking sector is served by 21 domestic and foreign banks with 471 branches/offices, including:

- Nine commercial banks (including Arab Bank Corporation, Bank of Jordan, and Jordan Kuwait Bank);
- Five investment banks (including Arab Jordan Investment Bank, Middle East Investment Bank, Philadelphia Investment Bank);
- Two Islamic banks (including the Islamic International Arab Bank PLC and the Jordan Islamic Bank of Finance and Investment);

- Five foreign banks (including HSBC Bank Middle East, Citibank, Standard Chartered)

Relative Importance of the Components of the Consolidated Balance Sheet of Licensed Banks				
(Percentages)	1998	1999	2000	2001
Foreign assets	24.4	25.2	28.7	30.6
Claims on public sector	7.5	8.0	8.1	8.4
Claims on private sector (resident)	36.9	35.1	32.8	33.3
Cash in vaults and balances with Central Bank	19.3	20.7	19.5	16.8
Other	11.9	11.0	10.9	10.9
Assets = Liabilities	100.0	100.0	100.0	100.0
Capital, reserves, and provisions	11.3	11.4	10.7	10.1
Foreign liabilities	20.9	20.2	21.0	21.1
Private sector deposits (resident)	40.3	39.8	39.3	38.9
Borrowing from Central Bank	3.4	2.9	2.5	2.4
Other	24.1	25.7	26.5	27.5

Arab Bank dominates the sector, with US\$ 2.3 billion market capitalization, about 60% of all assets, 39.9 % of customer deposits, and 36.8% of sector's total profits. It is also the only domestic bank to have made inroads internationally, primarily in, East

Asia. Arab Bank is followed by Housing Bank, which has raised its capital to US\$140 million and has been making serious efforts to develop into a real competitor to the Arab Bank. HSBC Bank Middle East, part of UK based HSBC, is the most widely represented international bank in the Middle East. In Jordan, it offers a wide range of services for both corporate and consumer customers. This success is shown in its profits which grew by 59% in 2001, reaching US\$ 4.4 million. American bank Citibank has a limited presence in the region but is making steady profits (US\$ 2.3 million on US\$ 80 million deposits in 2001). It is also currently involved in microfinance programs targeting small

Businesses and entrepreneurs, coordinated by USAID. The non-regional foreign banks in the market are stable and established, but none are pursuing significant growth.

Other stakeholders consist of non-banking institutions, such as specialized credit institutions, loan guarantee corporations, and mortgage refinance corporations. There are five long-established specialized credit institutions dealing with agricultural

Institutions	
0	Central Bank of Jordan
Commercial Banks	
1.	Arab Bank PLC.
2.	Arab Banking Corporation (Jordan)
3.	Bank of Jordan PLC
4.	Cairo Amman Bank
5.	Export & Finance Bank
6.	Jordan Gulf Bank
7.	Jordan Kuwait Bank
8.	Jordan National Bank PLC
9.	The Housing Bank for Trade & Finance
Foreign Banks	
10.	Standard Chartered Grindlays Bank Ltd.
11.	Egyptian Arab Land Bank
12.	HSBC Bank Middle East
13.	CitiBank
14.	Rafidain Bank
Islamic Banks	
15.	Islamic International Arab Bank PLC
16.	Jordan Islamic Bank for Finance and Investment
Investment Banks	
17.	Arab Jordan Investment Bank
18.	Jordan Investment and Finance Bank
19.	Middle East Investment Bank
20.	Philadelphia Investment Bank
21.	Union Bank for Saving & Investment

credit, housing, rural and urban development and industry. These have been joined by the Jordan Loan Guarantee Corporation, which provides guarantees to cover bank loans in support of small and medium-sized local industries, and the Jordan Secondary Mortgage Refinance Company, which was established in 1996 to refinance medium and long term housing loans extended by the banks. Jordan also has 76 authorized money changers, who play an important role in private transfers from expatriate Jordanian workers and foreign workers in Jordan.

Jordan's Stock Market

The nation's first irregular capital market was formed in 1930s. In the market, some real estate officers and freelance brokers were dealing with the stock of public share holding companies. However, as a result of Irregular transactions in government bonds, dealers were faced with high costs and fluctuations in selling and buying prices. The second regular market, the Amman Financial Market (AFM), was established in 1976. The main objectives of the market were to promote savings and to organize and control issues and registration of the dealings. Ultimately, the AFM was drastically transformed into the Amman Stock Exchange (ASE) in 1999 as a non-profit, private organization which has the sole authorized agency to operate the securities market. Simultaneously, two organizations were formed to regulate the stock market. Jordan Security Commission (JSC) was organized in an attempt to regulate and monitor the insurance and dealing of securities while the Securities Depository Center (SDC) was in charge of insuring deposits, regulating securities, settling payments, and accepting shares as deposits.

In 2001, 161 companies were listed on the ASE and the number of shares traded increased by 49% from 228 million to 341 million and trading value increased from JD 335 million to JD 669 million (US\$ 942 million). Market capitalization increased by 28% to JD 4.51 billion (US\$ 6.35 billion) and the ASE index rose by 39.6 points. Taking a closer look, the banking sector was the driver of growth, with an increase of 30%, although there were also solid contributions from industry (22%), insurance (11%), and services (10%). Foreign

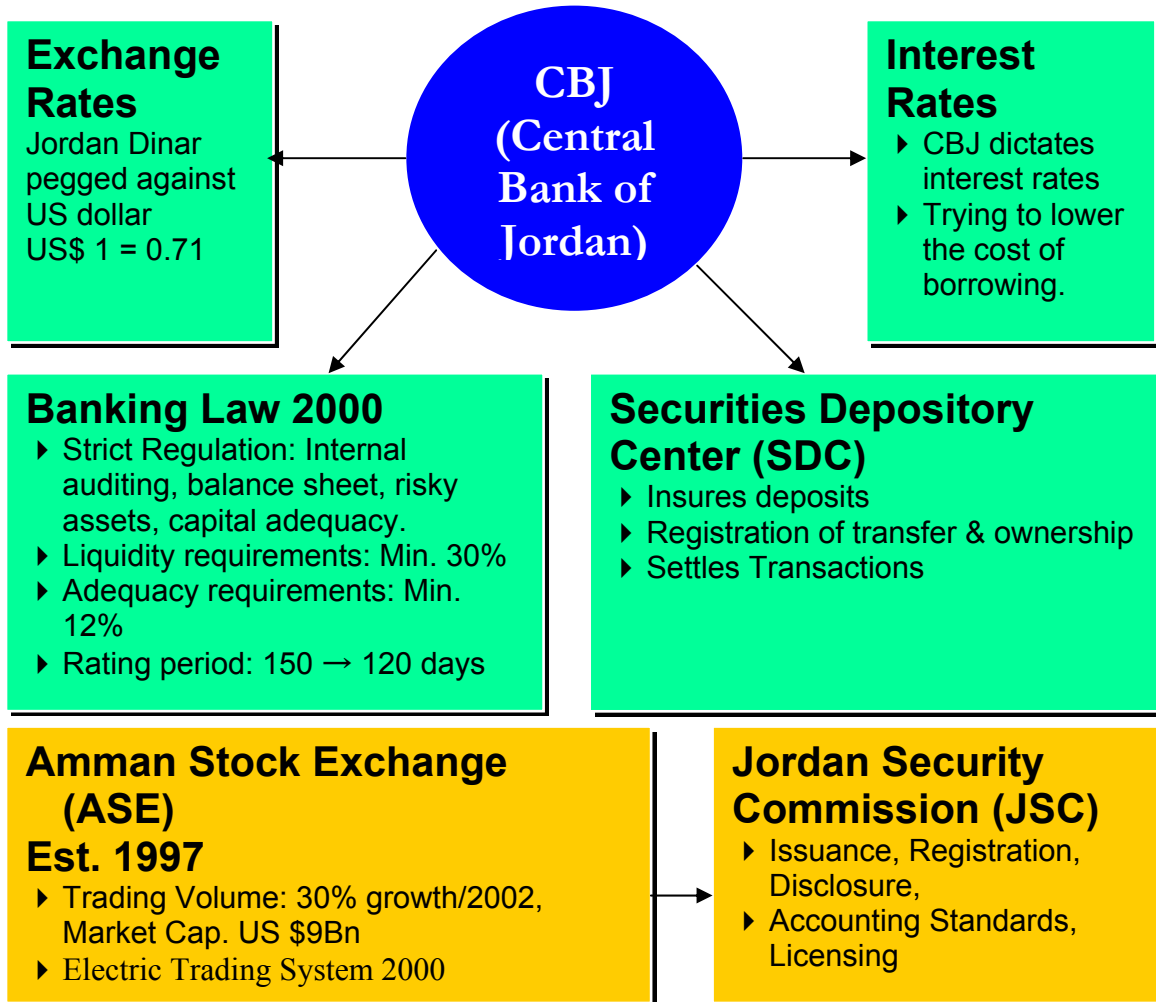
investor activity rose sharply, especially non-Jordanians bought stock a total JD 105 million in 2001, compared with JD 53 million in 2000. However, the net position deteriorated, with the non-Jordanians selling JD 212 million, compared with JD 65 million in 2000. Non-Jordanian trade constituted 15.6% of the total in 2001.

Activity of Amman Stock Exchange (1997-2001)

Year	No. of shares (million of shares)	Trading value (million JD)	ASE index
1997	191.1	355.2	169.2
1998	247.4	464.4	170.1
1999	271.1	389.4	167.4
2000	228.4	334.7	133.1
2001	340.6	668.7	172.7

For the purpose of improving the efficiency, flexibility and maintaining sound dealings in securities, an electronic Trading System at the ASE was officially launched in March 2000, which canceled all manual operations regarding shares, bonds, and mutual investments. In addition, remote trading system was introduced to improve intermediation efficiency at the ASE and grant further flexibility in trading operations. Therefore, dealing with securities trading by brokers, became possible with no need to be directly at

the dealing hall. Moreover, the internal information net at the ASE was launched, which connected all broker companies and employees operating at



the ASE to provide them with information. Also, the ASE initiated a website to provide the necessary information for investors wherever they were. On the activity side of the ASE, consistent with economic developments in Jordan and the positive role played by the market in financing the different economic activities, the ASE witnessed a great growth in its activities.

Banking Laws in 2000

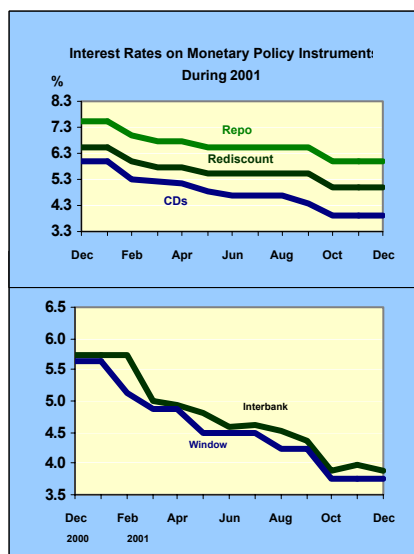
As a part of Jordan's move to upgrade its capital markets, a Securities Law was passed in mid-1997. The Law completely separated the regulatory

body from the role of execution of market operations. It played a role in helping solidify the structure and legislation of Jordan's capital market by enhancing efficiency. As a result, ASE was created along with JSC and SDC. In order to strengthen supervision in the financial arena, the new banking law was passed in 2000. CBJ implemented strict regulations, with attention focused on bank lending policies and provisioning as well as clarifying procedures for the licensing of new banks. Its regulations range from internal control and auditing, balance sheet and risky assets, to capital adequacy.

- **Minimum capital requirements of JD 50 million (US\$ 71.4 million)**
- **Minimum adequacy ratio is 12%.**
- **Minimum Liquidity requirement of 30% of total deposits**
- **Rating period for the non-performing loans to be gradually reduced from 150 to 90 days.**

An associated law cleared the way for the establishment of a depositors' insurance company. However, flaws in the supervision were pointed out when a major banking fraud came to light in early 2002 (to be discussed later)

Interest Rates



Interest rates in the banking system were at the center of the CBJ's policy in 2001. In light of interest rates developments in international financial markets and the objective of lowering the cost of borrowing to prop up the domestic economy, the CBJ carried out a number of cuts in interest rates on its instruments.

Effective January 2001, the reserve

requirement ratio was reduced by 2 points, from 10% to 8%. The interest rate on repurchase agreements of CDs was reduced from 7.5% in February to 5% on October. The interest rate on the overnight deposit window was reduced from 5.625 % on February to 3.75% on October. The impact of these cuts was most noticeable on CD rates during 2001 (these declined by 210 basis points on three month CDs). The CBJ was aiming at encouraging licensed banks to undertake a parallel and gradual reduction in their average lending rates commensurately with base interest rates to stimulate investment.

However, banks responded by reducing interest rates paid on deposits and interest rates charged on loans, albeit at a slower pace than cuts on CBJ base rates. For example, the weighted average interest rate on overdrafts declined by 118 points to stand at 10.42% by the end of 2001. Also, the weighted average interest on “loans & advances” and “discounted bills & bonds” dropped by 93 points to reach 10.45% and 11.88%, respectively. Moving on to deposit rates, the weighted average rate of interest on time deposits witnessed a significant decline of 136 points to stand at 5.19%. Likewise, the weighted average interest rate on saving and demand deposits dropped by 85 and 14 points to reach 2.91% and 1.06 %, respectively. Nonetheless, prime lending rate declined by 150 points during 2001. In addition, the CBJ adopted a series of measures geared towards developing the activities of licensed banks, strengthening their soundness and improving their competitiveness.

Recent Sector Developments

Corporate Scandal: In January 2002, one large-scale loan fraud shook national financial institutions. Majd Shamayleh, a successful local businessman fled the country, leaving as much as US\$ 100 million in outstanding bank loans to a number of local banks, after being accused of falsifying contracts with government departments to gain credit. This case was quickly handed to the State Security Court for further investigation. This scandal implies that local banks will have a major problem in relying on the connections of clients in lending decisions. In the wake of the scandal, the Central Bank ordered that three banks, Jordan Gulf Bank, Jordan Investment and Finance Bank, and Jordan National Bank, raise their capital requirements. Overall, this will have major ramifications on the future of banking;

National Bank of Kuwait (NBK) Entry: NBK entered the market in 2002, receiving a license from the CBJ and setting up with the minimum capital requirement. Their goal is to help service Kuwaiti citizens in the market, but they appear to be positioned to expand operations if opportunities emerge. It stands to reason that they have identified further opportunity in the market and may consider expanding operations; and

Investment Bank Mergers: In line with the CBJ's call for consolidation, Arab Bank started merger talks with Jordan Gulf Bank (JGB) in late 2002 while Philadelphia Bank was in discussions to but the Housing Bank for Trade & Finance. These mergers could pave the way for more action in the banking sector, and other industries, as traditionally M & A in Jordan has been quite

rare. The CBJ has continued to encourage consolidation as a means of keeping the banks competitive in lieu of inevitable outside competition.

Summary

Overall, Jordan's financial sector, driven by the strength and profitability of its banks as well as a growing equity market, is strong. It is highly ranked in the region for its transparency, and reforms continue to address weaknesses in the system. The following sections will analyze the five year outlook for Jordan in general, then move on to a discussion of these factors on the financial sector in the near- and long-term.

V. FIVE YEAR OUTLOOK

Due to Jordan's tenuous location, it is necessary to assess realistic conditions which financial firms might encounter as they consider investment. This section will discuss three likely scenarios based on current geopolitical reality:

The "Dick Cheney" Scenario

- ✓ Gulf War II ends, peace/stability reigns in Iraq. Resources are tapped, regional trade begins;
- ✓ Israeli/Palestinian conflict subsides, negotiations ensue. Tensions ease;
- ✓ Jordan, Bahrain and countries supporting the war initiative will stand to gain more than many Arab counterparts;
- ✓ Jordanian government can focus on reforms and garnering investment; and
- ✓ FDI flows to newly stabilized region in the near-term - Jordan is an immediate beneficiary.

A highly unlikely, but highly positive outcome of the recent turmoil is described above. Undoubtedly, this would lead to tremendous opportunity both in the country and in the region

Macroeconomic Impact: Over a five-year period, assuming stability on all fronts, investment in the region would sky-rocket and Jordan would be an immediate beneficiary in light of their location and the reformed economy. GDP growth rates of 5% - 8% may be reached and needed attention would be paid to ongoing reforms.

Investment Impact: Perhaps most importantly, this scenario would allow the government to focus solely on the nation's economic infrastructure without having to constantly address security and political concerns, while also courting potential investors. Given that a prime deterrent to investment in Jordan, along with geopolitical instability, are the "micro" issues in firm's operational set-up, this attention is crucial. While anti-Western sentiment in Jordan is unlikely to disappear even in the best-case scenario, if the overall climate is positive, firms will be much more likely to consider entry and drive up FDI levels.

Financial Sector Impact: Continued emergence of the ASE, as well as consolidation and continued profitability in the banking sector are very likely in this case. Competition will increase as new participants enter, driving efficiency and encouraging borrowing by domestic businesses as well as the emerging middle-class. Some domestic banks are likely victims, but the gains for the citizens seen in improved borrowing rates and expanded bank services.

PESSIMISTIC - The Doomsday Scenario

- ✓ Iraq in chaos, civil strife, radicalism and resented U.S. presence. U.S. moves into Syria/Iran.
- ✓ Palestinian Intifada continues, dividing the region & continuing to scare off Western investors
 - ✓ U.S. economy damaged, Iraqi economy in flux. Exports to 2 main partners freezes, growth stagnates
 - ✓ Government focused solely on maintaining security of nation, not investment and reforms.

This is the worst case scenario and would lead Jordan down a very difficult road. Once again, they would be victimized by their sensitive location and uncontrollable factors:

Macroeconomic Impact: Growth levels plummet in the region and especially in Jordan, now surrounded by conflict on all sides. King Abdullah would be primarily focused on maintaining rule in this situation given his pro-U.S. stance on many issues considered controversial in the Arab world. Economic reforms are either cast aside or abandoned altogether.

Investment Impact: Quite simply, companies not in the market will stay away and companies with a presence in Jordan may leave. This will have a dramatic effect on FDI, both long and short-term and be potentially devastating to the country given the effort that they have made to make themselves appealing. King Abdullah and other regional leaders will do all they can to prevent this.

Financial Sector Impact: The ASE would rapidly lose steam as the recent growth of foreign participation in the market dries up. The banks would likely survive, given their strong position serving the existing citizens and businesses.

Unfortunately this may also mean even less efficiency and local businesses and citizens paying the price. An important consideration is that planned unification of markets between Arab countries would undoubtedly be put on hold, to the detriment of each of them. The CBJ would need to institute very strict measures to control inflation and interest rates in the face of what would likely be economic crisis.

The Economist Scenario

- ✓ Gulf War II ends, slow move towards Iraqi stability/implementation of effective governance;
- ✓ Enmity between Israel/Palestine continues, dividing the Middle East and discouraging firms;
- ✓ Government continues to balance economic reform efforts with more pressing social concerns; and
- ✓ Many Western firms remain hesitant to enter, await resolution, view longer-term options.

This is the most realistic of all the scenarios, and the one which we will use to make our projections for financial sector trends moving forward. Importantly, it predicts a slower, but consistent, rebuilding of Iraq on both economic and political levels, and some continued regional tension.

Macroeconomic Impact: An expected short term dip in the GDP (due to lost FDI and DDI) will undoubtedly occur. 2003 projections for GDP growth (~3%) will turn into 5%-6% growth by 2004 and continues onwards given the reconstruction of Iraq and renewed hope for the region. The government can devote time to both the economy and political considerations. Businesses grow and the middle class continues to emerge.

Investment Impact: Some firms moving into the region take advantage of Jordan's location and incentive packages, however other firms remain on the sidelines due to tensions in the West Bank. The continuation of conflict between the Palestinians and the Israelis is considered a more polarizing issue to the citizens of Jordan and other Arab countries, and a prime deterrent to potential investors.

Financial Sector Impact: Based on careful analysis, these are the trends we see in the next few years. Continued development of the stock exchange seems very likely. This will lead to increased trade volume, transparency, and capital liquidity. In addition, we foresee a continued trend of MENA region investment and the development of cross border equity transactions. In addition, we see better integration of IT and internet services with the domestic banks, along with further modernization of the local banking industry. Further development of capital markets will lead to introduction of more financial instruments and supporting legislation to tackle cross border transactions, mutual fund creation, convertible bond, issues and other government bonds and debt instruments. Another difficult challenge, yet a highly rewarding area, is the local market potential for banking. As the conservative approach to banking in Jordan changes and the interest spreads reduce, we see that as a least probable yet potentially rewarding development. Other likely trends:

Change in Corporate Culture: Most of Jordan domestic licensed banks are family owned institutions with conservative attitudes which have made their businesses less efficient. As the recent corporate scandal case showed, this

can cause collusion based on business connections. CBJ is trying to bring about more effective corporate governance.

Utilization of IT: For more efficiency and flexibility, ASE launched the Electronic Trading System, the remote trading system, and the internal information net in 2000. At the banking level, Jordan already established comprehensive network of over 3,770 ATMs. In addition, other IT-related services have been introduced into the market. For example, the Jordan Kuwait Bank offers a full range of automated services using the Internet. CBJ also regards IT as a first priority for all banks, especially as the upgrade their facilities to offer better services to customers. The sector is fairly conservative, meaning that large-scale implementation of IT and internet-based banking will take some time. Pioneers (Jordan Kuwait Bank) and foreign firms are likely to drive this efficiency in response to customer demand.

Consolidation: CBJ has offered incentives to encourage smaller institutions to merge. But overall, it has not been particularly successful until recently, since Jordanian banks have a strong tradition of family ownership and owners are reluctant to cede control to larger institutions. Over the years, activity has been constrained by the conservatism of the banks, which have tended to prefer the short-term risks of trade finance and property development to longer-term industrial ventures since capital base should remain proportionate to the volume of available business. As mentioned earlier, Arab Bank started merger talks with Jordan Gulf Bank (JGB) in January 2003, with the idea that

Arab Bank would take over the JGB, aiming to rehabilitate JGB's administrative procedures as well as enhancing Arab Bank's presence in Jordan.

Areas of Growth:

Retail Banking: It is an emerging area for Jordan financial sector. Banks also has realized the potential of middle-income borrowers as well as the untapped local market (estimated at 60% of the population) that does not use banking services and instead use more traditional means of borrowing, investing, and raising capital. The largest bank, Arab Bank PLC, has heavily embraced retail banking. Overall, banks are concentrating on expanding their retail services. Moody's predicted retail banking rapid growth may be outpaced the banks' ability to manage lending risk and to develop appropriate support with lack of enough IT infrastructure, but as more sophisticated banks move into the market and drive this efficiency, that risk should be addressed. Another development includes the introduction of legislation that allows for movable goods to be used as collateral, spurring the growth of this area of banking.

Mortgage Financing: Local banks will continue to embrace mortgage financing, mainly targeting middle and low-income customer segment. For instance, Jordan Mortgage Refinance Company (JMRC) provides medium-and long-term refinancing of housing loans extended by banks and financial institutions to low-income group and has so far provided US\$ 81 million for over 7,100 loans.

Credit Cards: There are approximately one million credit cards issued in Jordan (predominantly Visa) and there was US\$800 million in credit card action in 2002. Growth between 2002 and 2003 was over 25% (issuance of new cards),

meaning that this is a tremendously rich area of opportunity. All cards are issued through commercial banks licensed in Jordan. Given the relatively small size of the population, however, firms must recognize that entry needs to take place soon in order to capitalize on the rapid growth levels.

Areas to Avoid

Investment/Commercial Banking: An area of banking in Jordan that is not growing rapidly is the investment banking/commercial banking area. There are not enough large businesses in Jordan to support more entrants, and this would not be a profitable area in which to enter the market. The large businesses, despite efforts being made to change this, have tight relationships with domestic banks and are comfortable with their lenders.

Stocks and Bonds: The ASE is growing impressively while the bond market can generally be considered underdeveloped. There does not appear to be enough demand in the market for firms to offer assistance in the buying and selling of these to the general public. If the ASE, specifically, continues its spectacular growth and the population becomes increasingly sophisticated financially, this may be a future area of opportunity.

Other Considerations

Advising on Privatization: In 2002 Merrill Lynch helped advise on the privatization of Jordan Telecom. As there appear to be many more opportunities in other industries (Potash, Electricity, Jordan Airlines).

Public Offerings: J.P. Morgan (along with Arab Bank) helped take a 15% share of Jordan Telecom public last year, a move which was very successful and

makes JT the second largest listed company on the ASE. Further public offerings may provide opportunity for profits for firms outside the country.

VI. CONCLUSIONS AND RECOMMENDATIONS

Conclusions:

1. Barring anything unexpected in the region, higher investment levels and economic growth in Jordan appears inevitable. As businesses enter or contribute funds to domestic firms, deposit rates will undoubtedly increase as will the level of borrowing on the business, and consumer, level.
2. Despite the claims of the CBJ and members of the banking community in Jordan, the sector is not over-banked. This is clearly visible in the profitability that banks (both domestic and foreign) have had in recent years. Consolidation will only allow existing firms to be even more profitable, but efficiency in the sector (to the benefit of businesses and consumers) will only occur with more competition, not less. Analysis tells us that the sector is actually under-banked, and the efficiency brought by IT and efficient internet services can help reduce deposit and lending spreads (currently 6%, regional average 5.2%), allowing customers to lower their cost of capital and stimulating borrowing. These services are in demand from bankers in Jordan, as can be seen by the rapid rise of the Jordan Kuwait Bank, the only domestic bank offering comprehensive service.

3. Firms with core competencies in modern banking services will be most likely to succeed in the market. The reluctance of the sector to embrace modern banking techniques will prove to be dangerous in a competitive environment.

4. Despite the relatively small size of the market, the ease of entry and relative sophistication of Jordan's financial sector will be attractive to firms, especially regional firms considering entry. Recognizing that the market is relatively untapped (60% of Jordanians do not bank), the demographic profile (young and increasingly sophisticated population). Deposits have increased 25% in the last 5 years, an indication of the emerging comfort of the average Jordanian banker.

Recommendations:

1. Regional banks should be the first to consider entry into Jordan's market. Politically, this is more viable in the near-term as there is a shared culture and there will be less resistance to their presence in the market (from the other banks as well as the general public). Also, there is less fear, justified or unjustified, about the geopolitical vulnerability of the country. The National Bank of Kuwait's recent foray into the market can be seen as a step in this direction and, if successful, we believe that we can expect to see more entrants.

2. Given the level of incentives and ability to operate freely in the market, it is recommended that any foreign bank looking to enter the market does so on their own terms and does not seek acquisitions or mergers. M & A is rare in the market, and has only just begun amongst domestic firms.

3. Large, international banks and FS providers will most likely choose to wait to see what develops. The market may be considered “small potatoes” to some of these large institutions, and the limited profits (Citibank’s profits in 2001 were US\$ 2.3) may not be worth the risk, unless entry is part of a regional strategy to enter a newly peaceful Middle East.

4. As stipulated in the recent FTA between Jordan and the U.S., U.S. firms can limit their risk by becoming involved in large syndicated loans and securities issuance in the country without having to establish any sort of business presence inside Jordan. This type of limited risk entry may prove to be an intelligent way to approach the evolving market while monitoring it for future opportunities.

**APPENDIX A:
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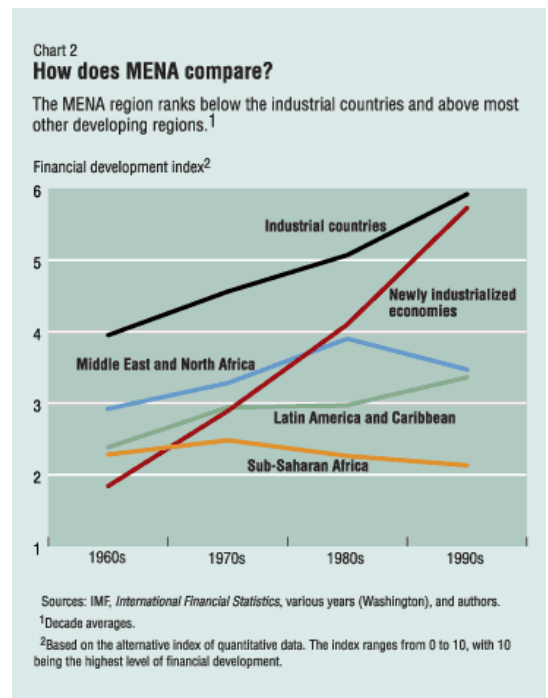
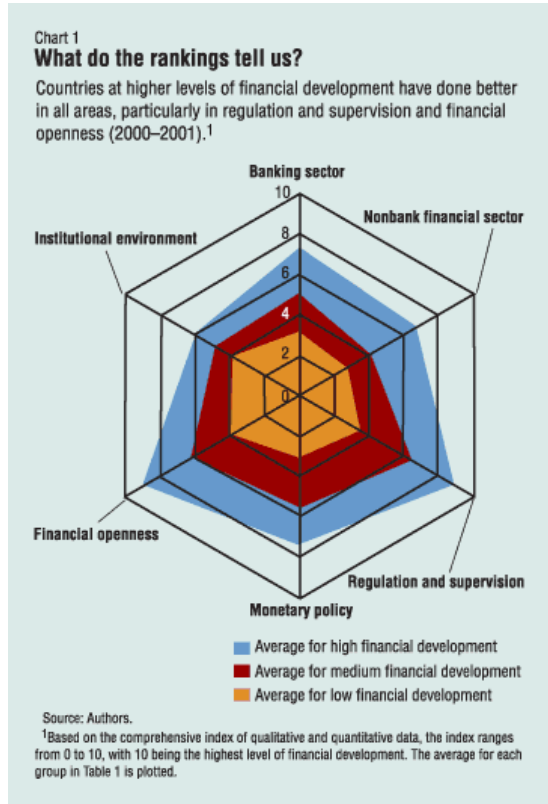
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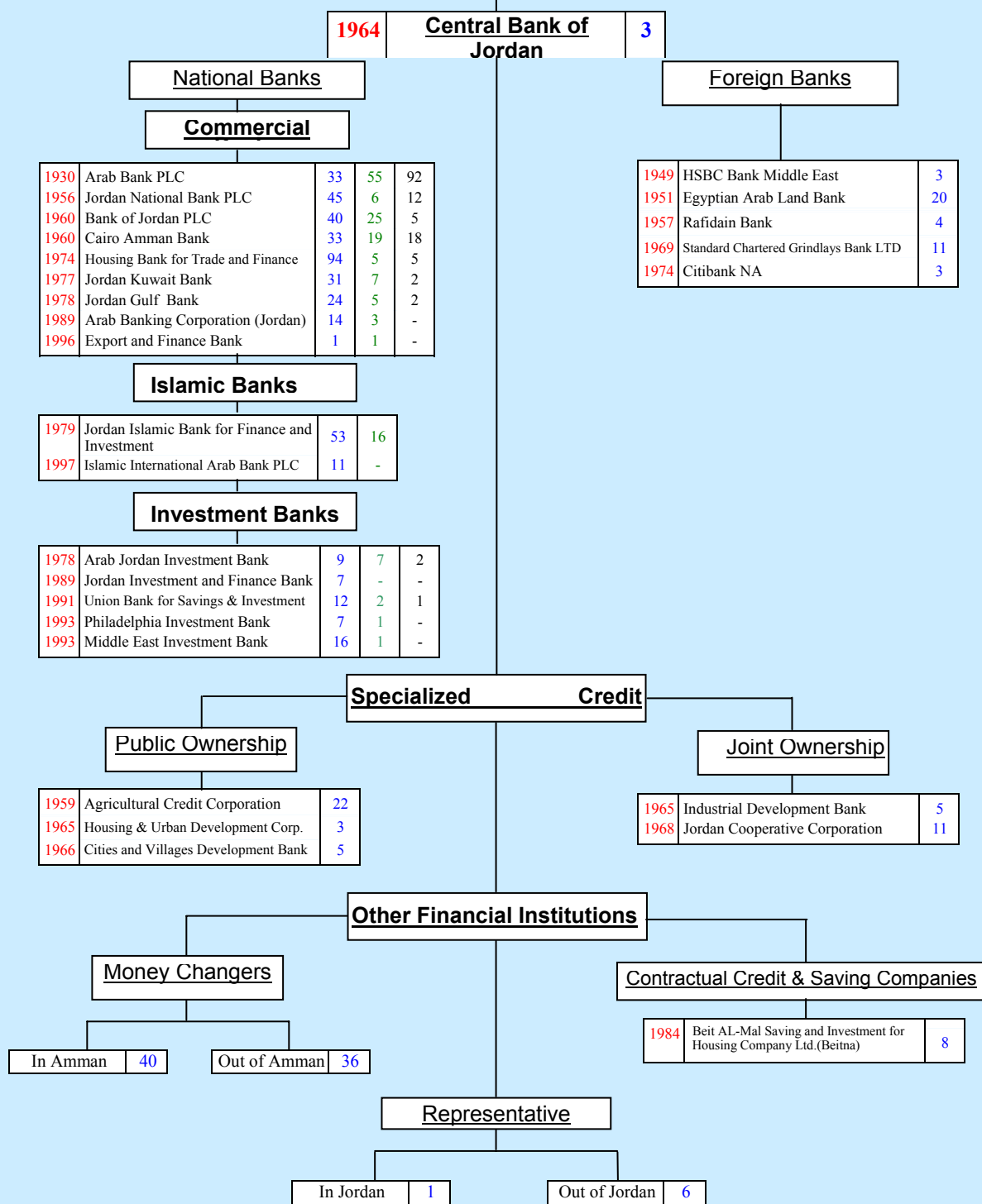
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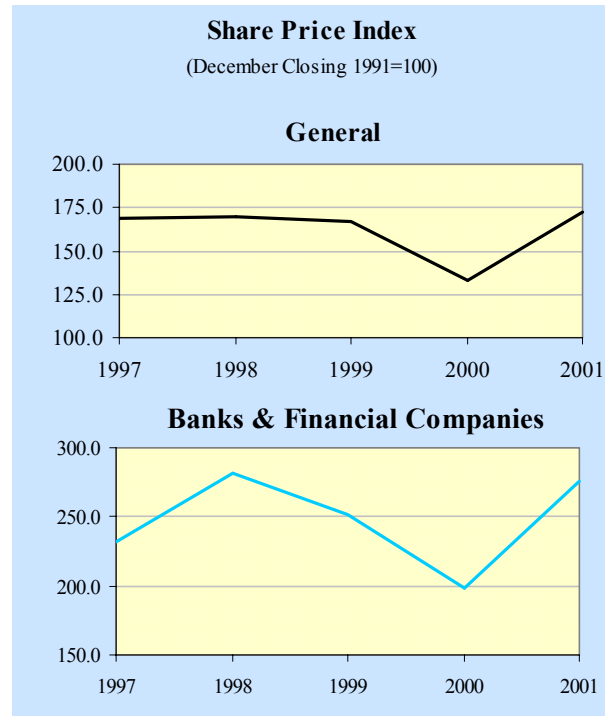
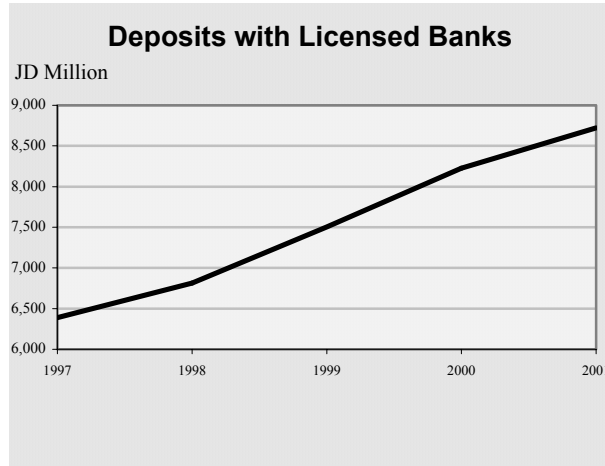
APPENDIX B Additional Charts and Tables



The Jordan's Banking System 2001



- Year of establishment.
- Number of branches including headquarters.
- Number of mini-branches.
- Number of branches outside Jordan.



APPENDIX C
Primary Resource Information

Mr. Jim Barnhart
Senior Economic Officer
AMIR Project
USAID/Amman
P.O. Box 940503
Shmeisani
Amman 11194
Jordan

Mr. Suhail J. S. Jme'an
Senior Financial Analyst
World Bank
1818 H Street NW
Washington, DC 20433

Dr. Dara Khambata
Professor of International Finance
Kogod School of Business - American University
4400 Massachusetts Avenue N.W.
Washington, DC 20016

Ms. Elisabeth D. Sherwood
Operations Officer/ Financial Sector
Middle East and North Africa Region
World Bank
1818 H Street NW
Washington, DC 20433

Mr. John Speakman
Senior Private Sector Development Specialist
Middle East and North Africa Region
World Bank
1818 H Street NW
Washington, DC 20433