



Thinking Ahead
for the Mediterranean

WP 6 - Financial services and capital markets

Financial Sector Development and Integration in the Southern and Eastern Mediterranean Towards a long-term sustainable transition

Rym Ayadi

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1. Introduction

Financial services and capital markets are at the heart of economic transition. A well-functioning financial system is essential for an efficient allocation of national savings to real investment opportunities that contribute to growth and ultimately to job creation. This view is supported by the predominant view in economic literature, which states that a developed financial system can generate significant benefits for the economy, as long as certain pre-conditions – such as an appropriate legal and regulatory framework, legal and political certainty, capital account openness macroeconomic stability – are met. When such conditions are not satisfied, the relationship between financial development and economic growth remains, at best,

ambiguous. Apart from its effect on growth, a well-developed and inclusive financial system may also have a positive impact on equality by providing poorer individuals with savings opportunities and much-needed credit.

To achieve these objectives, governments of developed and developing countries alike have undertaken a comprehensive set of financial reforms, aimed at strengthening the resilience of the financial sector and promoting a better allocation of resources within the economy. This often involved fostering integration by removing entry barriers, promoting competition, efficiency and productivity growth and ensuring financial stability in the financial industry. When all dimensions are accounted for, financial development and

Rym Ayadi is Senior Research Fellow at the Centre for European Policy Studies (CEPS) in Brussels and Coordinator of the MEDPRO project.

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integration will bring a number of benefits, which should lead ultimately to enhance economic growth.

Despite the monetary and financial regulatory reforms undertaken and various efforts to reduce the state's involvement in the financial sector, a detailed diagnosis of financial sectors in the southern and eastern Mediterranean countries (SEMCs)¹ in recent decades shows that financial development has been very uneven as a result of history, the influence and needs of the dominant actors and the specifics of economic structures in the various countries. Overall, financial-sector development has lagged behind in the region, as was displayed in poor significance of the growth-finance relationship. In practice, this has led to low access to financial services, high transaction costs and notably a clear restriction of access for micro-, small- and medium-sized enterprises (MSMEs) to finance to grow and prosper. While the micro and small firms have relied – in the majority of cases – on unorganised family finance and informal networks, the larger ones may be a good target for private equity firms, which yet remain embryonic as a lead to meaningful growth. In the same vein, capital markets are underdeveloped to be considered as an alternative source of financing to the private sector. To respond to a protracted market deficiency, credit guarantee schemes (CGSs) have been established in order to facilitate small companies' access to debt capital. CGSs are risk-sharing mechanisms under which a guarantor ensures the lender against a share of the possible losses s/he incurs when extending a loan. Despite the maturity of some schemes, credit to small companies in most countries in the region continues to lag behind.

This policy paper examines the trends and prospects in financial-sector development and integration in the southern and eastern Mediterranean countries and concludes with an agenda for a long-term sustainable transition where finance turns to be a positive stimulus to long-term growth.

2. Trends and prospects in financial sector development in the SEMCs

The emerging consensus in the economics literature is that financial development affects real growth if certain pre-conditions are met. Chief among these conditions is strengthening the resilience of the

¹ For the purposes of this study and the MEDPRO project, the 11 southern and eastern Mediterranean countries are: Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, the Palestinian Authority, Syria, Tunisia and Turkey. Due to data limitations, in some cases only a subset of these countries is covered in the analytical discussions.

financial sector and promoting a better allocation of financial resources, which can be achieved by adopting international best practices in monetary, regulatory and supervisory standards, removing entry barriers, as well as enhancing competition and efficiency in the financial services sector. To achieve these aims, many developing countries, including most notably the southern and eastern Mediterranean countries, have engaged in a variety of reforms. Although some of the reform initiatives have been ambitious, many have been less comprehensive than those in comparable regions. A fuller integration into the global financial sector and convergence to international standards are seen as the key steps needed to be taken to ensure that financial development in the region positively contributes to growth.

Casual observation shows that financial development has been lagging behind in the southern and eastern Mediterranean and hence financial systems have not been able to divert the domestic savings as funding opportunities to private enterprises (Ayadi et al., 2013a). The reasons behind this development have been investigated and identified in Ayadi et al. (2013b). First, inflation has had a negative impact on private credit and deposits. The impact of price instability on deposits and loans is simply due to the incentives of savers and financial institutions to seek better investment opportunities with secured real returns – as opposed to uncertain nominal returns, as is the case in an inflationary environment. Interestingly enough, financial openness serves to mitigate the negative impact. This is most likely due to the presence of two high-inflation episodes in the sample – Israel in the 1980s and Turkey in the 1990s. In both cases, financial openness allowed domestic financial institutions to tap international currency markets to provide exchange-linked deposits accounts and loans. In either case, an open capital account in an inflationary environment leads only to a nominal growth, which is picked up by the empirical analysis.

As far as capital accounts liberalisation is concerned, the traditional economic approach has been by and large pro-liberalisation, supported by the theory that capital mobility would promote an efficient allocation of capital and a better diversification of risk. However, an opposing view, formed in late 1990s in the midst of the Southeast Asian crisis, holds that when information asymmetries persist, an open capital account could serve to amplify shocks, leading to sudden stops, reversals, as well as currency and banking crises.²

² The 2007-09 global financial crisis has further

An emerging view is that the relationship between liberalisation and economic growth hinges on the level of development of the financial sector, institutional quality, political and macroeconomic stability, trade openness and, perhaps more importantly, an effective framework to manage capital outflows. Such a hypothesis has been tested in Mouley (2012a). Three key results must be emphasised. First, capital account openness is beneficial as long as macroeconomic stability, institutional quality, and government stability are present and country risk is lowered. Secondly, it appears that only sectors that have benefited from tariff dismantlement with the EU may benefit from capital account liberalisation, in turn, a higher investment level in any sector leads to a more open capital account, which confirms the reverse-causality argument. Finally, capital account liberalisation requires the anticipation of monetary policy reaction functions.³

Second, high public debt expansion lowers private credit growth in a significant manner. The impact of government borrowing on the provision of credit to private sector enterprises could be a simple case of ‘crowding out’. Since the government uses the financial sector for its own purposes, the institutions lend less to the private sector, which in turn will result in a chronic financial repression.⁴ The later can be reinforced amidst changing political conditions and an increasing predominance of populist fiscal expansionary policies in the short run.

Third, the Mediterranean region has been one of the leading areas of the world where extensive financial reforms have taken place. However, financial reforms have not been effective on their own and may even have worsened financial development in the absence of an environment with stable macro-

underlined the financial stability risks associated with capital flows among both advanced and developing economies as the sudden withdrawal of liquidity has led to widespread problems and challenges for the global financial system.

³ The empirical assessments show that the interest rate and exchange rate adjustments can be volatile in the region. These uncertainties add to the potential information asymmetries between domestic and foreign investors, which may further induce risk-averse investors to respond too quickly and enhance the sudden stop or reversal risks.

⁴ Although implemented in the majority of the countries, credit guarantee schemes, which were supposed to alleviate poor access to finance, do not seem to have succeeded in fostering access to credit to MSMEs, as was shown in the qualitative assessment by Ayadi & Gadi (2013).

economic policy and strong legal and democratic institutions. Indeed, the results in Ayadi et al. (2013b) show that countries that engage in financial reforms in the absence of the needed institutional set-up and the appropriate legal framework may end up hurting financial development. It is likely that autocratic governments have used the reforms in a self-serving manner for decades, to enhance politically connected lending practices or to further engage in financial repression. In those cases, the financial reforms may indeed ended up undermining the potential benefits that the reforms are supposed to have in the first place.

3. Trends and prospects in financial integration in the SEMCs

When assessing the degree of convergence and integration to international standards, it seems that monetary and financial systems in the southern and eastern Mediterranean are lagging behind compared to other regions. As was extensively explained in Mouley (2012b), the extent of convergence in monetary policies and macroeconomic conditions in the southern Mediterranean region has been below expectations as a result of the failure to use interest rates as the primary tool for monetary policy. This led to an over-reliance on quantitative approaches, e.g. monetary aggregates or credit targeting, and to effectively broadening the monetary policy instruments, with notable exceptions, namely Turkey and Morocco. In addition although inflation targeting is identified as the primary objective of many of the region’s central banks, exchange rate stability remains as an effective overriding objective. Moreover, central banks in the region are only partly independent from political influence, and act as the primary obstacle to the modernisation of the policy instruments. A chief example is the politically motivated price controls, which undermine the effectiveness of inflation targeting. Given the political uncertainties and a potential reversion to populism in the midst of the Arab uprisings, it is likely that these conditions will persist for years to come.

Empirical results for Egypt, Lebanon, Jordan, Morocco, Tunisia and Turkey shed light on the importance of different channels in the transmission of monetary policy. Although data limitations do not permit a complete assessment of all potential channels, it has been shown how inflation and output levels respond to transitory and unanticipated changes in exchange rates and short-term interest rates. According to the estimates, the exchange rate channel appears to be more active than the more traditional interest rate channel in all countries studied with the exception of Morocco and Turkey.

The results are most likely a consequence of having an anchored exchange rate as the primary operative objective for the region's central banks. The relative shallowness of financial markets, directed credit and lack of competition may also lower interest-rate pass-through. Finally, tests on the potential for convergence and policy coordination scenarios for the three Maghreb countries (Algeria, Morocco and Tunisia) paint a rather negative picture. In particular, there appears to be no convergence tendencies in real growth rates, long-term interest rates or the monetary bases of the three countries. The results are indicative of severe asymmetries in real activities, including most notably economic cycles, monetary policy practices and financial activities. Other nominal variables of interest appear to display convergence tendencies. For example, the cointegration analyses identify a single common stochastic tendency for the nominal exchange rates of the three countries. The result is not surprising: The dominance of the euro in external trade and investment for the three countries has evidently led to a form of homogeneity in the exchange rate anchoring practices. The tests also show the existence of a partial convergence in inflation rates. This is most likely a reflection of the progress that both Morocco and Tunisia have made in stabilisation policies in recent years. To sum up, the findings highlight that the potential for a common monetary or economic union in the region is weak.

Turning to the analysis of the regulatory convergence in the SEMCs with the EU, as compared to Ayadi et al. (2011), Ayadi et al. (2013) show some degree of convergence in credit information, capital adequacy and supervisory stringency, but key divergences remain in deposit insurance, entry obstacles, supervisory independence and legal rights. In particular, deposit insurance systems in many countries in the region are not explicit, which could lead to uncertainties in the provision of support to banks in case of default. Moreover, most systems do not attempt to align the banks' incentives in risk-taking with those of taxpayers by implementing risk-based premiums or co-insurance schemes. Another persistent issue is the presence of entry obstacles, in particular signs of substantial barriers to entry and continued government-ownership of banks. The comparison of regulatory systems also highlights high political interference in supervisory functions. Lastly, while creditor protection remains relatively weak, substantial improvement in credit information has occurred after 2003, in particular through establishing private credit bureaus with universal coverage.

Finally, assessing bank efficiency convergence in the Euro-Mediterranean region, Casu & Ferrari (2013) show that the EU-MED countries have remained consistently closer to the sample-wide best technology frontier than the southern and eastern Mediterranean countries, while the gap between the two sides of the Mediterranean has been widening since 2000, especially since the onset of the crisis in 2008. These results imply that these countries have consistently lagged behind their northern counterparts in adopting the best technology, which should essentially be available to them due to the presence of EU-MED institutions. In addition, formal tests of convergence reveal that the progress towards a common best technology within the southern and eastern Mediterranean region is at best very weak, if at all significant, even though all countries appear to be moving in the same direction. When the same exercise is repeated for all EU-MED countries put together, there is virtually no convergence. Similar tests for the northern and eastern European countries reveal substantially more convergence, with the gap between the two regions becoming consistently smaller starting from 2000.

4. Agenda for a long-term sustainable financial transition in the SEMCs

The findings suggest that financial-sector development in the southern and eastern Mediterranean region is not only lagging behind as compared to other developing regions but also does not seem to contribute to long-term growth. The challenge ahead is to bring positive significance to the finance-growth relationship in the region.

To benefit from the positive impacts of past financial reforms and hence of financial development, it is essential to ensure that basic prerequisites are met. Strengthening legal institutions and democratic governance and implementing and enforcing these financial reforms within a fully stable macroeconomic context, in which inflation is contained, capital account is gradually opened,⁵ and investment and trade

⁵ For the capital account opening, a three-phase plan to sequence capital account liberalisation is recommended in Mouley (2012a): In phase 1, implement measures to complete capital account liberalisation for medium- to long-term capital inflows, with particular attention to foreign direct investments to non-financial sectors. In phase 2, the countries should liberalise trade in financial services, especially with the EU, to ensure that capital inflows serve to achieve the deepening and broadening of the financial services sectors. In parallel, foreign portfolio investments should be gradually authorised. Finally, in phase 3, the liberalisation drive should be extended to

fostered, are the key conditions for a significant relationship to form between financial development and growth. Beyond that, targeted actions must be taken to enhance access to finance to MSMEs. For example, in a context of market failures, properly designed loan and equity guarantee schemes can play a role to alleviate financial constraints to MSMEs.

As for the financial regulatory reforms, it is important to strengthen financial infrastructure through a continuing upgrade of the credit information systems and private monitoring and the establishment of market mechanisms to develop the capital markets such as clearing and settlement, and to develop and implement collateral, insolvency regimes, investors and consumer protection rules. These reforms should provide better protection for lenders and investors and contribute to banking and stock/bond market development. Besides, developing the money market, improving the liquidity of the government bond market, developing the investor base and opening the stock market to foreign investors should improve liquidity and depth. Together with reinforcing the regulatory frameworks, monetary policy should act to mitigate high volatility in interest movements, while using a flexible exchange rate regime to counter volatility in more mature markets.

As far as financial convergence and integration are concerned, the regulatory and supervisory frameworks on both shores of the Mediterranean should not display severe and persistent differences in key areas.⁶ A long-term agenda for far-reaching regulatory harmonisation in financial markets is needed to start the process of financial integration and convergence in the southern and eastern Mediterranean countries. Such an agenda should have as essential initial steps the diminishing the unproductive influence of the public sector on the financial sector, ensuring full independence of central banks, and harmonising the regulations and infrastructure in financial services and capital

bank loans to non-residents and portfolio investments abroad.

⁶ As was proposed by Ayadi et al. (2013c), taking the European Union as a benchmark, inflation in the southern and eastern Mediterranean should be confined at least to 3.5% and the income per capita increased to an average of \$22,000. Moreover, the capital account should be opened gradually and reinforced by 2.5 points using the Chinn-Ito index and institution quality should be improved substantially, in particular, investor protection strengthened by at least three notches in the IRCG rate scale (1 to 5), democracy index by two grades, corruption by one and half grades, bureaucracy index by 1 grade and rule of law by only half a grade.

markets to promote access to efficient, competitive and safe financial services to companies, investors and individuals. The future policy should promote competition, efficiency, financial inclusion and financial stability simultaneously.

In view of the EU experience in this area since the inception of the 1999 Financial Services Action Plan that sets the building blocks for financial integration in the EU, we recommend the launch of a Euro-Mediterranean financial market initiative whose purpose would be to promote and monitor Euro-Mediterranean financial market integration. Such an initiative would bring together financial and market regulators from all shores of the Mediterranean to agree on a Euro-Mediterranean financial services action plan that would set the building blocks towards a more integrated Euro-Mediterranean financial market – one that is competitive, safe and inclusive and that would benefit both the EU and the southern and eastern Mediterranean countries. Such a proposal is in line with the scenario framework proposed by Ayadi & Sessa (2011).

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About MEDPRO

MEDPRO – Mediterranean Prospects – is a consortium of 17 highly reputed institutions from throughout the Mediterranean funded under the EU’s 7th Framework Programme and coordinated by the Centre for European Policy Studies based in Brussels. At its core, MEDPRO explores the key challenges facing the countries in the Southern Mediterranean region in the coming decades. Towards this end, MEDPRO will undertake a prospective analysis, building on scenarios for regional integration and cooperation with the EU up to 2030 and on various impact assessments. A multi-disciplinary approach is taken to the research, which is organised into seven fields of study: geopolitics and governance; demography, health and ageing; management of environment and natural resources; energy and climate change mitigation; economic integration, trade, investment and sectoral analyses; financial services and capital markets; human capital, social protection, inequality and migration. By carrying out this work, MEDPRO aims to deliver a sound scientific underpinning for future policy decisions at both domestic and EU levels.

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EC Scientific Officer	Dr. Domenico Rossetti Di Valdalbero, DG RESEARCH
Website	www.medpro-foresight.eu
Contact e-mail	medpro@ceps.eu