Financial integration in the four Basins: a quantitative comparison

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Abstract

This paper presents some stylized features of the financial integration of the four basin regions (Baltic Sea, Black Sea, Caspian Sea and Mediterranean Sea regions) and discusses the developments, trends and features of the IIP in the regions. Chapter 3 identifies the gaps in them, distinguishing the EU e non-EU members and provides an overview of the asymmetries and the convergence as a result of the financial integration in the different markets. After the review the trends the final chapter points to areas where further efforts are needed for achieving greater regional integration.

JEL Classification

Keywords: international financial integration, convergence, asymmetries, current account openness, FDI, financial development, portfolio investment

1. Introduction

Since the 1990s the European Union undertook a series of reforms in order to complete the full liberalization of capital transactions among the member states and with third parties. The aim was to realize the full financial integration of the European capital markets along the same principles of the common market for good and services[2]. In 2004, the Wider Europe and the ENP projects proposed a "comprehensive prudential regulatory framework for the financial services area"[3], that would reinforce the undergoing benefits of the capital account liberalization in the partner countries.

In combination with the completion of the internal market and the implementation of the EMU, the original conceptual framework suggests, that over time, more financial integration will promote the stability of financial markets and help enhance the overall economic performance with financial innovations and organisational improvements.

One of the main benefits of financial integration is the development of the financial sector, allowing domestic financial markets to become deeper and more sophisticated. Thus, banks and financial institutions may increase the financial alternatives for borrowers and investors[4].

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[2] European Commission (1996).

[3] European Commission (2004), pp. 15-16. "It will be key to the creation of business and the promotion of investments that these countries ensure that companies are able to operate on a level playing field. In combination with the above measures, access to European financial markets should, over time, add to the stability of partners' financial markets and help enhance their overall economic performance. The further liberalising of capital movements will provide new opportunities."

[4] For a critical analysis of the benefits of capital liberalisation see STIGLITZ (2004), in particular the different impact between FDI and short-term capital flows.

This paper takes a comparative look at the patterns of international financial integration and addresses the thematic issues with the aim to benchmark the four basin regions. It is well known that they represent four groups of countries with different institutional and economic characteristics.

In particular the regions are the following:

The Baltic Sea region: EU: Estonia, Latvia, Lithuania, Denmark, Finland, Sweden, Germany, Poland; Non EU: Russia, Belarus

The Black Sea region: EU. Bulgaria, Greece, Romania; Non EU: Turkey, Georgia, Russia, Ukraine, Moldova, Armenia, Azerbaijan

The Caspian Sea region: EU: none; Non EU: Iran, Azerbaijan, Russia, Kazakhstan, Turkmenistan, Georgia, Armenia, Turkey, Uzbekistan

The Mediterranean Sea region: EU: France, Greece, Italy, Slovenia, Spain, Malta, Cyprus; Non EU: Turkey, Lebanon, Syria, Israel, Egypt, Jordan, Libya, Tunisia, Algeria, Morocco, Bosnia and Herzegovina, Croatia, Montenegro, Albania, Serbia, Macedonia.

There are some overlapping among the groups: Russia and Turkey have borders in three basins, while Azerbaijan and Greece are in two basins.

2. Two questions

The first question is related to the theoretical models of financial integration.

The standard economic theory suggests that liberalisation of capital flows, in particular long-term capital flows, and financial development are important policy instruments, because they provide a favourable support for the integration of neighbouring countries on a regional scale. In this regard, capital flows play a crucial role, in terms of fostering accelerated growth, technical innovation and enterprise restructuring[5]. In recognition of these potential benefits, governments of these countries have undertaken widespread capital account liberalization over the past quarter-century.

In the 1990s, capital account liberalization was an important part of the market reforms introduced by governments in the transition economies[6]. Because of the capital account liberalization, these countries attracted large amounts of foreign capital and the main benefit was the development of their financial system, which involves more complete, deeper, better-regulated financial markets and more credit to foster the transition and the economic growth.

There are two main channels through which financial integration promotes financial development. First, financial integration implies that a new type of capital and more capital is available to neighbouring countries. Among other things, new and more capital allows these countries to better smooth consumption, deepens financial markets, and increases the degree of market discipline.

Second, financial integration leads to a better financial infrastructure, which mitigates information asymmetries and, as a consequence, reduces problems such as adverse selection and moral hazard[7].

The second question is addressed to the empirical measurement of the financial integration and it call for quantitative analysis for accessing how open are the capital markets of these countries and how is progressing the financial integration among the basins.

The definition of "financial integration" consider two broad categories of indicators: *Quantity or volume*-based indicators are used to investigate the extent to which investors have internationalised

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[5] See PRASAD, 2003 and EDISON, 2004.

[6] Capital account liberalization is considered an important precursor to financial integration. See KOSE et al. 2009.

[7] See SCHMUKLER, 2004 and the criticism of STIGLITZ, 2004. See also MASSAD, 2000.

their portfolios. In financially integrated markets investors will increase their holdings of non-domestic assets in order to benefits from the international diversification.

Instead, *price-based indicators* measure discrepancies in asset prices on the basis of their geographic origin. In a perfectly integrated market, prices of assets with similar characteristics should be the same or at least largely influenced by common area factors.

In this paper we approach the comparison using volume-based indicators.

3. Financial integration in the four basins

3.1 The evidence and the practices

Liberalization of capital flows is a general feature in almost all countries of the four basins, but the degree of openness and its timing has been the subject of specific policy decisions. Most neighbouring countries undertook a series of market reforms and adjusted their monetary policies to allow for a higher openness of the capital account openness over the decade. Only 7 countries decided to lift all capital controls according to the acquis communitaire and became full members of the EU.

While the integration policies of the European Union (EU) had the explicit aim of removing legal barriers on capital cross-border transactions[8] and promoting the financial integration in the single currency area, the non EU partners adopted a broad variety of different exchange rate regimes and capital liberalisation policies.

Only four partner countries opted for pegging the euro with currency boards arrangements (Bulgaria, Bosnia) or conventional fixed peg arrangements (Macedonia, Croatia). The large

[8] The EU Banking Directives (1977, 1988), the Financial Services Action Plan (1999), the White Paper (2005).

majority of partners opted for a fixed peg arrangements anchored to the US dollar (Belarus, Jordan, Kazakhstan, Lebanon, Morocco, Russia, Tunisia, Turkmenistan) or to the SDR as Libya. Other countries decided to pursue a more flexible approach and introduced a crawling peg system with a composite basket of currencies as Iran or a managed float system as Turkey, Ukraine, Algeria, Egypt, Moldova and Romania.

Capital account liberalisation was also mixed, with the Baltic states proceeding towards the accession to the EU and the Caspian and Mediterranean countries lagging behind.

In order to obtain a comparable measure of capital account restrictions of the 17 EU members and 29 non EU countries we use the annual data from the IMF's *Annual Reports on Exchange Rate Arrangements and Exchange Restrictions* (AREAER)[9], as suggested by the majority of studies on capital account liberalization. These data, from an institutional point of view, or a de jure measure, have several advantages: they provide a consistent measure of restrictions on capital account transactions as well as foreign exchange arrangements; they are available on an annual basis across a wide range of countries. Their major disadvantage is that such "rule based" data generate a simple "on-off" indicator, which doesn't not tell us the relative degree of capital restrictions (or capital mobility) or how legal restrictions are enforced.

However, the recent empirical research tried to overcome these shortcomings. For example, Chinn and Ito[10] proposed a composite index (KAOPEN) which incorporates information not only on restrictions on capital account transactions, but also on current account transactions and exchange rate arrangements. The index takes positive values when the level of restrictions is low and negative values when the countries have a higher intensity of capital controls.

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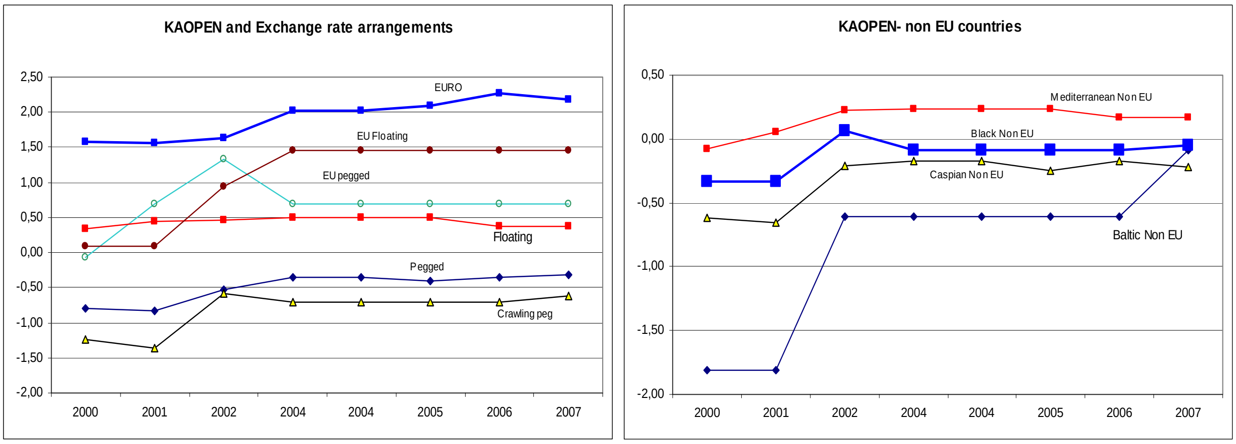
[9] Among others, de-jure measures based on information on the AREAER have been developed by QUINN 1997, JOHNSTON and TAMIRISA 1998, MINIANE 2004, CHINN and ITO 2002, 2008.

[10] CHINN and ITO 2002.

Figure 1: Capital Account Openess (KAOPEN) and Foreign Exchange Regime



The analysis presented in table 1 shows that countries which adopted the Euro or pegged their currencies to Euro during the period of observation from year 2000 to year 2007 had the best growth of financial integration (Kaopen index higher than 1,50). Instead those counties that pegged their currencies to US dollar or SDR or other composite baskets (in particular the Black Sea and the Caspian Sea regions) had the lowest growth of financial integration, with negative Kaopen indices. Not surprisingly, countries with pegged their rates to the EU had considerably higher financial integration, confirming the conventional discipline. When the national rules converge to EU norms, regional financial integration improve substantially with greater participation of domestic banks and private investors.

These are, of course, simple observations. It is, however, possible to suggest how much financial integrations was in fact due to the introduction of euro (the highest level) or the pegging to euro. In particular the Baltic Sea region shows the best experience, not only for the large concentration of EU members, but also for the "Russian factor" which has been supported by the institutional liberalization of the capital accounts in the most recent years and the consequent convergence shown in figure 2. Also in the Mediterranean countries, as capital controls have been progressively eased in recent years, the financial integration has increased significantly with positive values of the endex[11].

The history of the European Union and of some individual countries has recognized the importance of financial cooperation, which has been institutionalized in three regions: the EIB, FEMIP for the Mediterranean (the oldest and the largest), the Nordic Investment Bank (with the extension to the three accession countries in 2005), the Black Sea Trade and Development Bank (the smallest). Only the Caspian Region has not yet received due attention. The level of regional cooperation has increased over time, adding new projects on the portfolio and increasing the resources to the planned needs.

However, the financial resources are limited and the total asset exposure is only a small fraction of the total capital flows in the regions. Consequently, over time the resources have been properly addressed on projects of mutual interest, from energy, to transport, to environment, to SMEs, keeping a marginal role, while capital liberalization, combined with market deregulation, was creating opportunities in term of economic growth and employment. The result is that the savings of the EU economies had the possibility to finance investments in the neighbouring partners, to differentiate the risk and attain a more efficient allocation of capital. However, capital outflows have also less desirable side-effects. In a context of incomplete structural reforms, as in the Mediterranean and Caspian Sea regions, the international capital flows carry considerable risks which could magnify the underlying macroeconomic and structural weaknesses.

In brief, the empirical evidence shows that capital flows are influenced by many factors, some of them general, other more country specific: liberalisation of international capital transactions; regulatory reforms of capital markets; improvements in the macroeconomic performance of

[11] MÜLLER-JENTSCH 2004; LAGOARDE-SEGOT and LUCEY 2008.

countries; rapid progress in communication technologies, and privatisation and structural economic policies in countries.

3.2 The domestic perspective

Financial market integration plays a special role in neighbouring countries which are all transition or emerging countries. It is widely known that the financial market is one of the most important elements of the transition, as it is the central institution for transforming savings into investments and thus generating long-term economic growth.

Previous studies have shown that the financial integration can be analysed from two different perspectives.

From the domestic perspective, financial markets in neighbouring countries still remain underdeveloped and rudimentary, which is clearly shown in Table 1.

The Baltic Sea basin has the highest average level of GNI per capita compared with the other regions, followed by the Mediterranean Sea basin. The difference between EU and Non EU member states, measured by the standard deviation, is also lower in the Baltic Sea basin then in the Mediterranean, with the highest differences in the Black Sea basin.

The ranking remains essentially the same if we look at the two other indicators of financial development: the Market capitalisation of the listed companies and the Share of lending to private sector.

The indicators show two different aspects of the financial divide between EU and non-EU members, and between regions. Where the process of financial liberalization is more advanced, as for the stock exchange, the gap is much smaller. But where national restrictions prevail on the harmonization to international rules, as in the commercial banking system, the gap is much wider and more resistant over the decade.

The share of private claims on GDP can help to access the degree of financial liberalization and financial deepening. Table 1 indicates that the gap in financial deepening has been reduced during the decade, but it still remains considerably high, one third in average of the euro area. Also the differences among the countries or region are important: a low 20-35% in the Caspian and Baltic region, with the predominant presence of Russia, compared to a 50% in the Mediterranean region which has a relatively well developed commercial banking system.

Instead, for the market capitalization index, the differences disappeared during the decade as a result of the improvements of the corporate governance of the listed companies and the government policies. Financial activities have been boosted by increased listings of companies, mostly made possible through privatization of state-owned enterprises. In addition, the growth of their economies has been well above that of the EU, and the attractiveness of these new stock markets has grown considerably in size and volume. For example, the Egyptian equity market is one of the most *developed* in the Mediterranean region with 306 listed companies in 2009 (down from 1148 in 2002), a respectable number comparable to the listed companies in the Stock exchanges of Turkey and Russia, 315 and 333 respectively. The cumulative result is that the average capitalization index in the four regions increased to 50-60% in 2007 from 10-15% in the nineties, compared to the high 80% of the Eurozone. Therefore, considering the good performance of these markets, some of these countries have been included in the MSCI composite index[12]. According to the classification of markets and the accessibility measures that reflect the international investors' experience and

[12] MSCI, 2010

excluding the Eurozone countries, 12 countries are defined as frontier markets[13]; other four as emerging countries, and one, Israel, as developed market.

In this context of large differences in volume and in scale, the international financial integration has provided additional resource to supplement domestic savings and increased the competition in domestic financial systems. On the way to adapt their rules and regulations to the new environment, these countries faced several problems that concern not only the development of a national financial intermediation system but the economy in general.

Some of these problems have an institutional nature, as the low profitability of the economy and its industries, the lack of a common corporate and economic culture or the inadequate protection of the minority shareholder rights during the privatisation phase. And on more than one occasion, the monopolisation of some sectors of the economy had a significant and negative influence in the financial markets.

Table 1: Domestic financial integration

	GNI per capita PPP		Market capitalization of listed companies (% of GDP)			Domestic credit to private sector (% of GDP)	
	2000	2009	2000	2007	2008	2000	2008
EU Baltic	16.790	27.051	72,6	69,0	27,0	55,6	105,2
Non EU Baltic	5.615	13.790	7,5	58,0	39,4	11,1	34,9
EU Black Sea	9.357	17.683	32,0	55,5	17,7	22,2	68,8
Non EU Black Sea	3.510	8.337	11,2	36,2	16,0	11,4	35,9
EU Caspian Sea	0	0	0,0	0,0	0,0	0,0	0,0
Non EU Caspian Sea	3.758	8.582	6,3	25,6	13,6	10,9	21,2
EU Mediterranean Sea	19.297	27.990	66,6	91,7	30,4	94,3	138,5

[13] Frontier markets: Estonia, Lituania; Kazakhstan; Romania, Bulgaria, Ukraine; Croatia, Lebanon, Jordan; Serbia, Slovenia, Tunisia. Emerging markets: Russia, Turkey, Egypt, Morocco; Developed markets: Israel and the Eurozone countries.

Non EU Mediterranean Sea	5.524	11.144	12,3	53,9	27,7	35,9	48,9
Euro Area	23.275	33.193	86,9	85,0	37,9	97,9	126,4

3.3 The international perspective

From an international perspective the main contribution of integration is the source of financing, with the traditional tripartition of international capital flows: (1) Foreign direct investment (FDI) which are flows between firms and their foreign subsidiaries or foreign partners and may be the result of earnings of the same foreign subsidiary that are retained abroad; (2) Portfolio investments, which are private transaction in equity securities and debt securities between banks and financial intermediaries; (3) Debt instruments, which are financial flows between financial intermediaries and firms and governments which supports trade and investment activities.

All indicators of cross-border transactions from the IMF of the BIS suggest an ever increasing interdependence within the countries of the four basins and the EU.

For the analysis we use the database of Lane and Milesi-Ferretti (2000-2007)[14] with the update for the year 2008. According to the authors' methodology, international financial transactions are divided into broad categories: portfolio equity investment, FDI, foreign exchange reserves, and debt (which includes portfolio debt securities as well as other instruments, such as loans, deposits, and trade credits).

The analysis will consider stocks, which is typical for such kind of structural analysis, instead of flows. The net external position, given by the difference between total external assets and total external liabilities, measures the net creditor or debtor position of the four regions vis-à-vis the rest of the world. Therefore, the net external position is similar to the IMF definition of "Net International Investment Position", which is the measure of the cross-border financial net flows

[14] The database is available on line at http://www.philiplane.org/EWN.html

(over time) plus the changes in the value of the holdings of these assets. We used the Lane Milesi-Ferretti database because the IIP statistics diffused by the IMF do not yet cover all neighbouring countries of the four basins.

From the elaboration of data we can derive a number of broad trends or stylized facts.

3.4 Two big trends

The pattern of international financial integration have changed significantly over the decade. It seems that the direction of capital flows is no longer a one-way, top-down element of the European pyramid of external relations. There are some partner countries with the highest assets close to the highest liabilities, resulting in almost flat net position and others with increasing unbalances, positive or negative. The traditional characterization of capital-rich and capital-poor no longer follows the EU's external borders, so as to emphasize the traditional separation between the North and the South that has governed the debate in the seventies. Today the role of financial intermediation will hold for both: not only supplementing the domestic savings as proposed by the traditional European institutional literature, but mobilizing the accumulated financial resources in some countries or “swapping” assets and liabilities in order to diversify the risk.

In presenting the data, we divide countries into four basins. In addition in order to identify the EU members within each group, we subdivide the 4 Seas groups in EU e non EU. The separation is necessary in order to remark the different institutional character of the country and its association with the foreign exchange regime.

The indicators follow the definition proposed by Lane and Milesi-Ferretti (2003)[15] for measuring the International Financial Integration as a stock to GDP ratio:

[15] LANE and MILESI-FERRETTI 2001; LANE and MILESI-FERRETTI 2003.

(1) IFI = (FA + FL) / GDP

where FA (FL) denotes the stock of external assets (liabilities). This ratio is a volume-based measure of international financial integration.

The indicator can also be expressed as a difference between gross foreign assets and foreign, as defined by the net external position, and GDP.

(2) NEP = (FA - FL) / GDP

Figure 2 plots the IFI ratio, as a weighted average, for each of the four groups of countries over the period 2000-2008. Since most of the adjustment of the liberalization of the capital accounts were implemented rather quickly in the nineties, the share of capital flows has finally stabilized at a ratio between 1,0 and 1,5, while continuing to increase in the euro area.

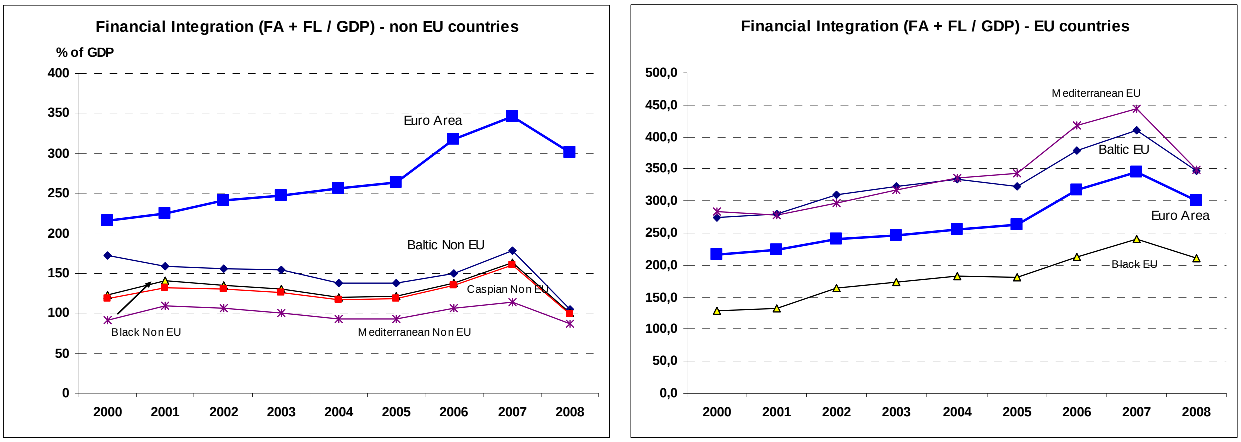
For the non-EU economies, we notice a deceleration of the financial integration that stops in 2004 with a resumption of bilateral flows that led these countries to overcome the initial levels of integration. The financial crisis of 2008 has dissolved the progress achieved in a decade. The development is however not comparable to the strength and the speed of financial integration within the Union, with a ratio three time higher than the GDP.

This is, of course, consistent with the theory of financial harmonisation pursued by the Union since the end of the seventies: no doubts that the *international financial integration has increased markedly, particularly among the EU economies*. While the trend towards increased international asset trade has been visible since the early 1970s, it has accelerated in the mid-1990s with the implementation of the three stages of the EMU (Economic Monetary Union). Total assets of the Euro Area increased from 6.590 billion USD to 19.239 billions in 2008. The IFI ratio increased from 210 to 300% of GDP. In the EU, the increase in cross-border asset holdings has been strong for both debt and equity instruments (the latter including FDI and portfolio equity) and in other debt instruments.

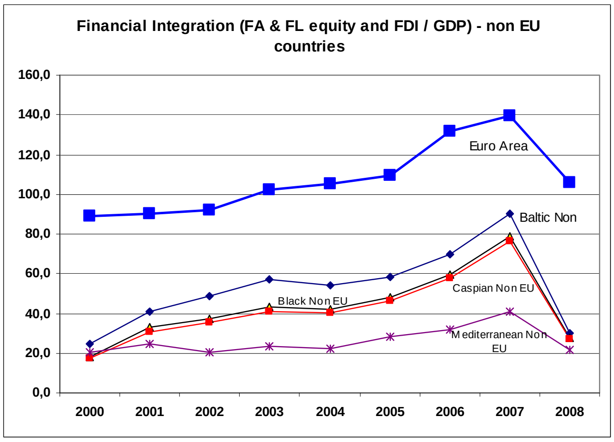
The situation is completely different in the non-EU countries. We observe a general increase in cross-border equity holdings, particularly FDI, but the overall stock of debt instruments on GDP (debt assets and debt liabilities) has decreased over the decade. The pattern are similar for the four basins, while we notice important differences in term of intensity. The non EU Baltic economies have the highest IFI index for FDI and Portfolio equity instruments, 90% of GDP in 2007, while the lowest 50% is reported by non EU Mediterranean countries. Furthermore, all four Neighbouring regions show a common trend towards a smaller share of debt instruments, which is also converging to 50% of GDP.

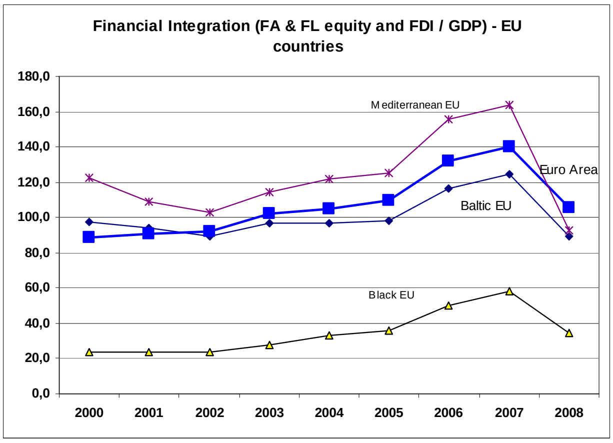
Figure 2: International Integration Index (Gross position)

a) Gross capital flows

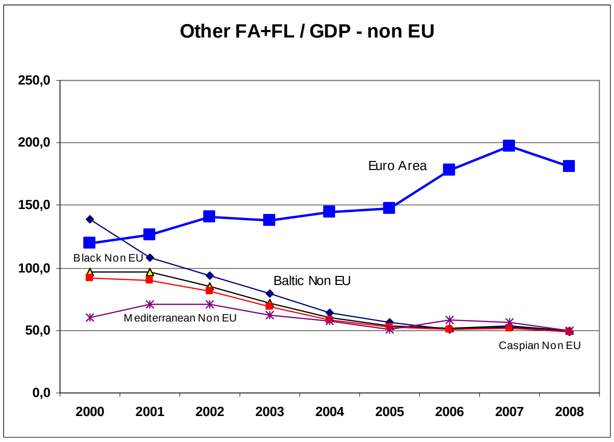


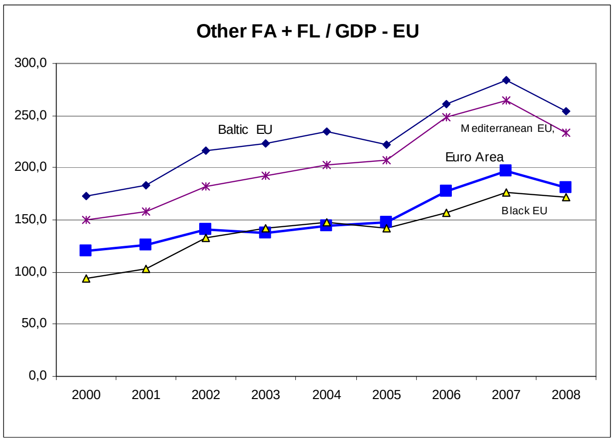
b) Gross Portfolio Equity and Foreign Direct Investment





c) Gross Other Investment (Portfolio Securities Debt and Other Investment)





Clearly, factors such as the increase in trade linkages, the reduction in capital controls, the foreign exchange regime, advances in telecommunications, and the increased availability of information are important in driving the acceleration of international financial integration in the four regions, but the trends (in particular those referring to other investments) underscore the deep difference that separates the European economy and that of neighbouring countries.

However, the structure and the quality of capital stocks has improved, in the sense that FDI has become the most dynamic source of net capital flows in all regions. The “Russian factor” is relevant here. In fact, the non-EU Baltic countries double their advantage on the Mediterranean region, while considering the relative size to GDP, and they are also more integrated than the EU Black Sea countries. During the decade FDI seems the most desirable type of flows, in that it tends to be more long-term and less easily reversible, as well as often incorporating new technology and other knowhow. Additionally we can notice that the announcement of the ENP project in 2004 has contributed positively in accelerating the FDI inflows in all regions.

But there is another fundamental trend concerning the convergence effect of a deeper integration. The *EU imbalances have increased* during the decade after the accession of the Eastern and Nordi countries, while for the non EU partners the convergence was the main effect of the European integration project until the disruption caused by the financial crisis in 2008. The Euro Area consolidated its position of net exporter of capital, with a net negative position near to 20% of GDP. Non EU Mediterranean decreased their net debt position from 35% to 21% of GDP, while the non EU Baltic region (Russia, for clarity) shifted from a net positive position to a negative one since 2004.

These trends confirm that the evolution of the neighbouring countries may be different from the other emerging market economies, which on the contrary, suffered the contraction of external capital flows during the same period. In this perspective the favourable expectations of the international lenders to the Baltic region, and Russia in particular, differ from the relative contraction of external financing (in particular bank loans) affecting the Southern Mediterranean region. These convergence patterns were interrupted by the financial crisis of the summer 2008. In fact, the net creditor position in 2008 in the three regions (Baltic, Caspian and Black sea) is essentially due to the contraction of portfolio liabilities of Russia.

Instead, for the EU economies the imbalances increased, with a positive net position for the Baltic region (net position of Germany) and a deterioration of the Black Sea region (Greece) and Mediterranean Region (Spain).

Which are the largest creditors and debtors, relative to their GDP levels? Even though richer countries tend to be creditors (Germany, with a net position of 25% of GDP in 2007 - 7% in 2001 and France, with a net creditor position of 10% of GDP), the correlation is less evident. Russia has been net creditor before 2004 and becomes net creditor again in 2008. Syria, Iran and Libya are creditor with net foreign credits higher than 30% of GDP (230% for Libya). In the Caspian region the foreign assets accumulated by the governments during the decade of high oil and gas prices now exceed the total foreign debt and inward FDI in countries like Azerbaijan, Turkmenistan and Uzbekistan, with an average net external position higher than 30%. Iran too, has a net positive position.

Several neighbouring countries have successfully build up foreign assets and funds that help mitigate the impact of the economic setback in the industrial countries, but the longer-term goal of economic diversification remain elusive. This is partly because these countries in the Mediterranean and Caspian basin are dependent on wealth from natural resources and they lack of the sound institutional framework that would support the creation of a more diversified economy.

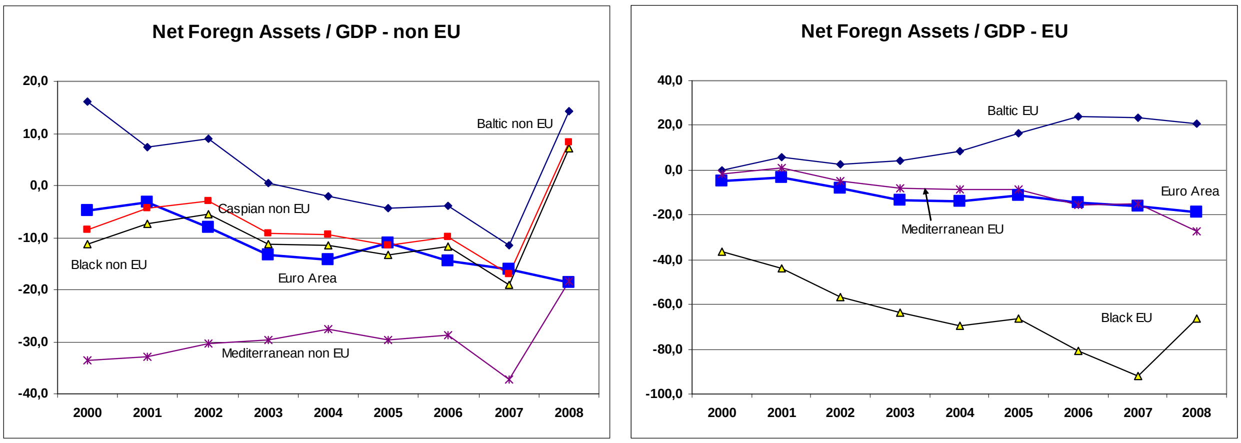
France become net debtor in 2008, with a remarkable contraction of the value of FDI. The EU largest net debtors are Spain, with a NEP index higher than 80% (from a 24% in 2000), Greece (more than 100%) and Italy (21%). Indeed, in addition to the level of development (measured by the GNI), several other factors—including demographics, the size of public debt and FDI, and natural resources—influence significantly the net external position of the four basin.

From the perspective of <u>private capital flows</u> the asymmetries between EU and non EU have increased, with a negative net external position higher than 35% of GDP in all regions and with only five capital exporting EU countries (Denmark, Germany and Sweden) in the Baltic Sea, Italy and France in the Mediterranean Sea. Among the neighbouring countries only Libya is a net investor (Portfolio Investments). For the non-EU Mediterranean countries and Baltic region, the downward trend in their external position was reversed in 2008, primary because of a deterioration of Russian Federation (contraction of inward FDI) and the stability of the Caspian ad Black sea. For the Baltic the improvement in 2008 is due to the contraction of foreign investments in the same year.

The comparative look for the net debt position (debt assets less debt liabilities) shows the common convergence to lower level of external exposure, around 10% of GDP, while in 2000 the non EU Mediterranean countries were exposed by more than 30% of their GDP. Here, the shift from indebtedness to FDI has been made possible by the instruments of the first pillar of the euromediterranean partnership within the Barcelona Process. Instead, the financial integration within the EU has encouraged a credit boom and over-borrowing which have increased the unbalances in the Black sea basin (Greece in particular and Romania), the Mediterranean (again Greece and Spain), in contrast with the Baltic Sea basin that is near the balance or in net creditor position.

Figure 3: Net External Position Index

a) Gross capital flows



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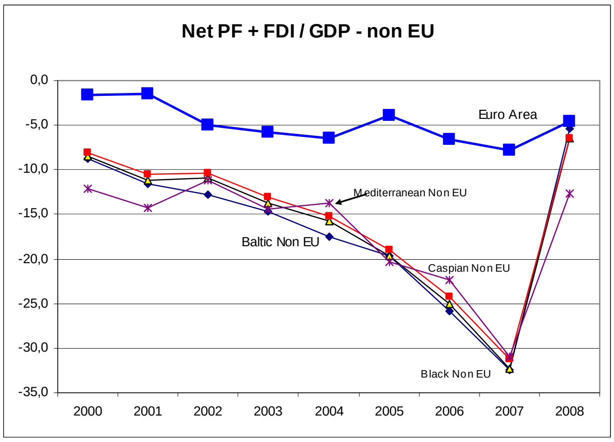

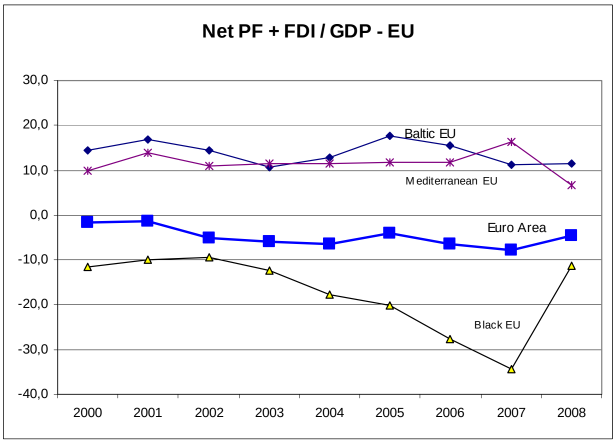

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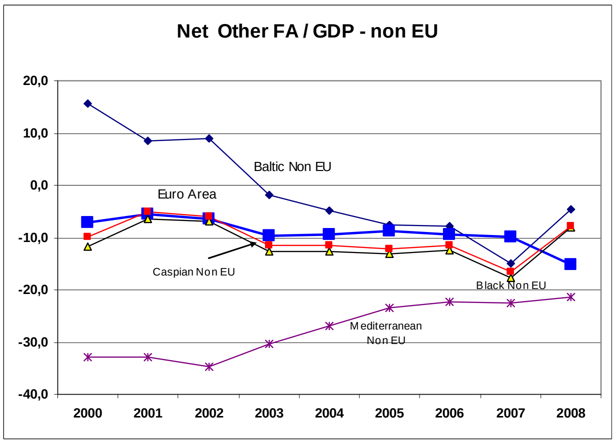
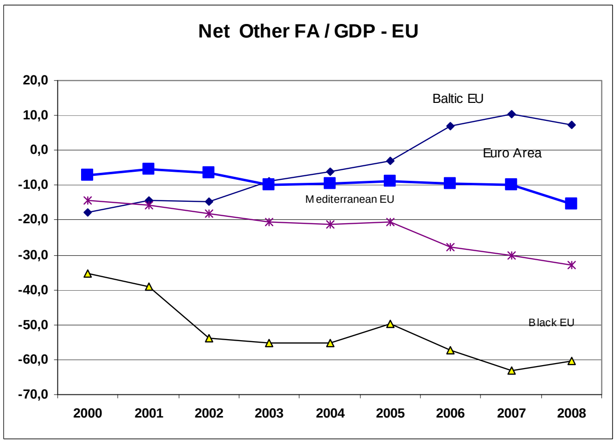




3.5 Opportunities and risks for neighbouring countries

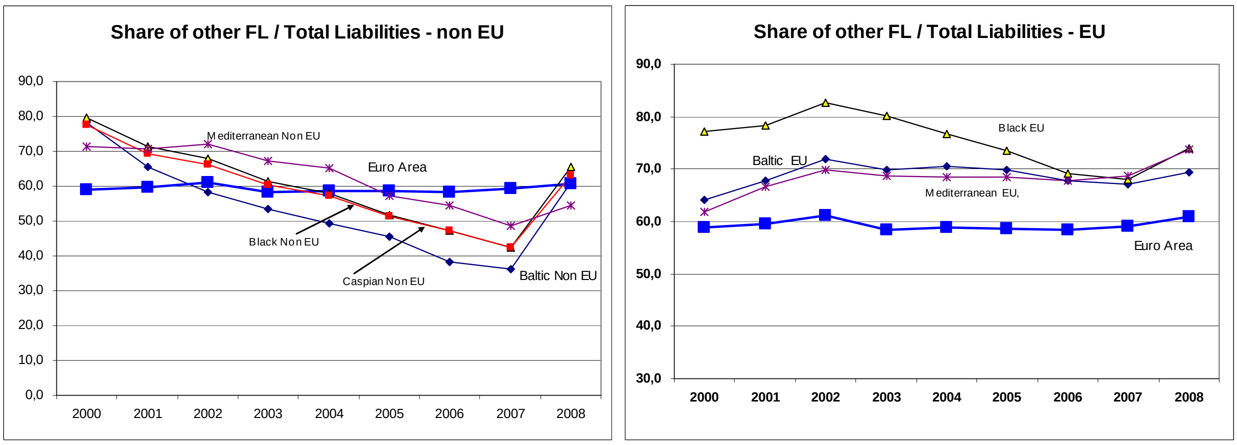
The large increase in cross-border equity and direct investment holdings and the shifting patterns in international borrowing and lending in the non EU partners can be viewed positively, as factors reducing the vulnerability of the neighbouring markets to external shocks. Equity liabilities (including FDI) now account for about 40% of total external liabilities as a whole, compared to 20% of EU countries. Only the non EU Mediterranean countries, while showing a gradual growth of private capital inflows, remained below 33%, offsetting the difference with a greater share of financial loans.

Financial integration also relates to the foreign assets and here we see an important systemic innovation, the growth of the outward FDI, which were enhanced by the removal of legal restrictions and the increased integration of the economies. The basins concerned are those of the Baltic and Black Sea, which are interconnected by the foreign investment activities of the Russian firms. The critical aspect in these financial relations is the lack of dynamism of the Mediterranean countries, with a share of direct investment of less than 10% of their foreign assets

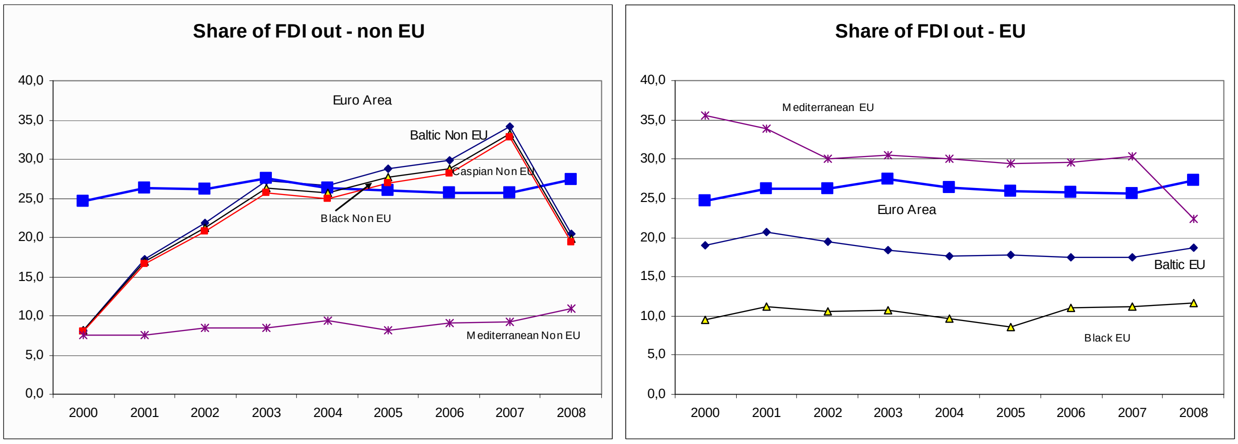
Consequently, all neighbouring economies have dramatically reduced the share of debt to their external liabilities to level well below the EU average, thus clearly reducing the risks of financial crises by linking more closely the return on external liabilities to domestic economic performance. However, as can be seen in figures 4, the financial crisis of 2008 as reversed the good performance of the previous years.

Figure 4: Share of FDI and Indebtedness

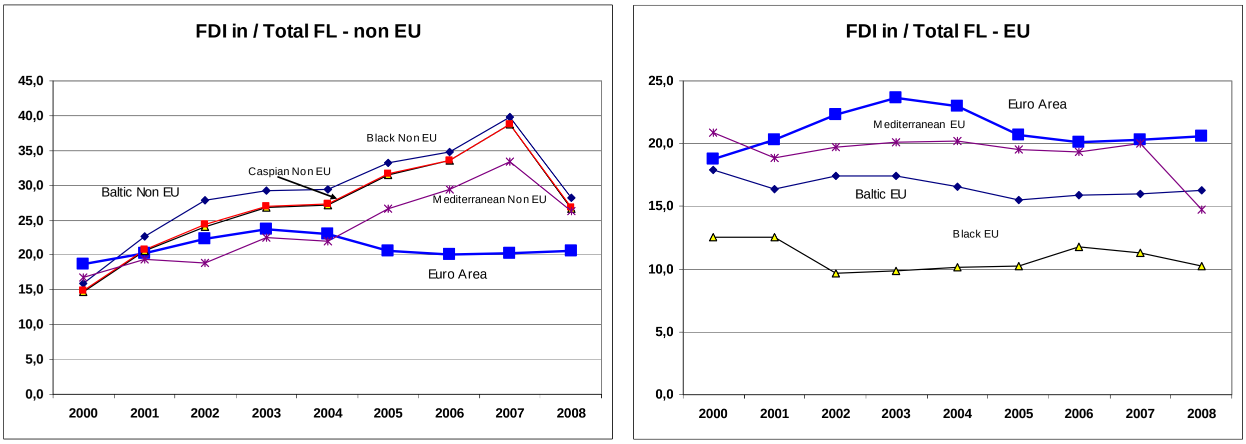
a) Share of Other Foreign Investment over total Foreign liabilities



b) Share of outward FDI over total Foreign Assets



c) Share of inward FDI over total Foreign Liabilities

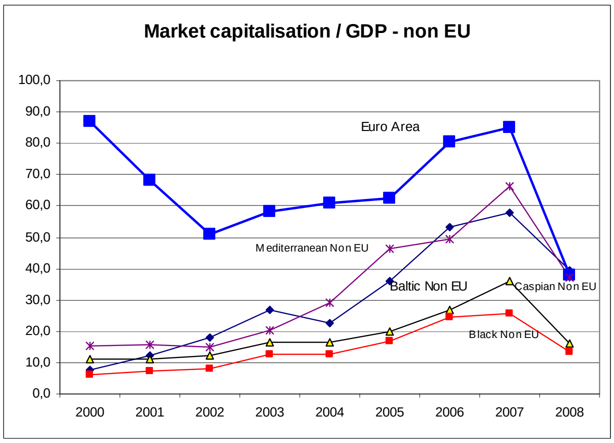


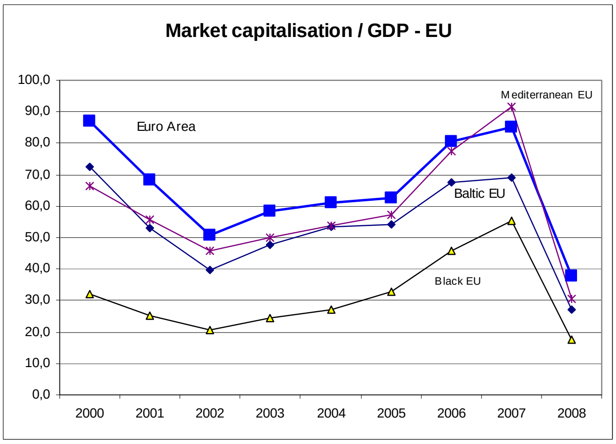
3.6 Stock market capitalization

In terms of their stock market capitalization, The Mediterranean and Baltic Sea Regions are in a better position. Particularly, Egypt, Jordan, Morocco, Croatia, in the Mediterranean basin and Russian Federation in the North show a clear upward trend between 2003 and 2007 (Figure 5).

Nevertheless, the stock market capitalization still remains considerably below the relevant quotients of developed economies in Tunisia, Algeria, Turkey, Syria, Belarus and in the Caspian basin. Because the stock market is of relevance in financing enterprises, further efforts especially to attract foreign investors can be very important.

Figure 5: Stock Market Capitalization in the 4 Seas 2000-2008, in percent of GDP





3.7 Reserves

Finally, international reserves that are the liquid external assets under the control of the central bank. Here we notice a great asymmetry between the EU and the non EU regions. Not only the reserves-GDP ratios are ten time larger in non EU countries but the ratios increased substantially during the decade, 30% of GDP in the Mediterranean basis and 35% in the Baltic region (Russia in particular).

In a period of greater flexibility of the exchange rates it is debatable this huge accumulation of reserves in line with the predictions of the buffer stock model (Adjustment costs, volatility of foreign trade, exposure volatile short-term inflows of capital)[16].

These reserves have a cost, a “social cost”, that Rodrik (2006)[17] estimated trough the spread between the private sector’s cost of short-term borrowing abroad and the yield that the Central Bank earns on its liquid foreign assets. The estimated spread is 3 to 7 percent, a spread undoubtly very high especially for capital scarce economies. Therefore, it can be suggested that the central bank either curtail the size of reserves accumulation or invest the excess reserves for more profitable returns in term of employment (Mediterranean basin) and growth (Baltic basin).

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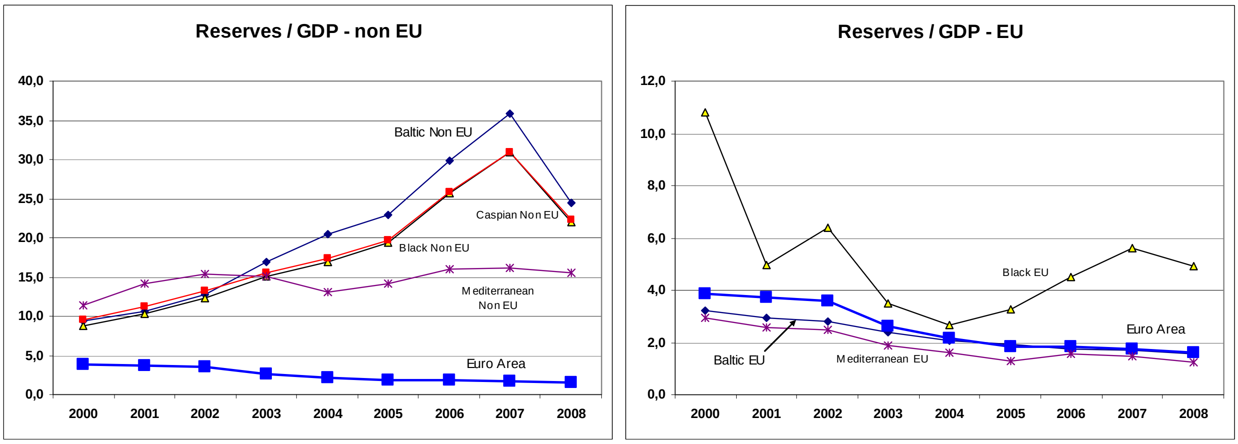
[16] CALVO, G. (1998); EDWARDS, S. (2004).

[17] RODRIK, Dani, (2006).

Figure : Stock of International Reserves in the 4 Seas 2000-2008, in percent of GDP



4. Conclusions

The experience of the South Mediterranean countries suggest that, despite the improvements in the FDI inflows and in deeper financial integration to some countries (Morocco, Tunisia, Egypt, Jordan) its sectoral destination does not always correspond to the real needs of the recipient economies. Excluding privatizations and investments in oil and gas concessions, foreign promoters invested only 1% of GPD, and the results were disappointing when confronted with the "ritual" declarations to stimulate local production capacity and to create additional employment and revenue.

Therefore the essential policy issue is not simply to deepen the financial integration of the neighbouring counties into the global market, but how to build competitive and dynamic sectors and to improve the composition of the exports along the competitive advantages that require continuous investment, especially in skills and information.

Despite these weaknesses, foreign investors could increase the chances of domestic enterprises to realize trade and investment opportunities through partnership, networking and exchange of information on best practices.

For understanding the factors behind the financial integration and the necessary policy measures, one needs to look at the role of the various institutions in the financial markets, not only in the markets for goods and services, which are the main interest of the FTA project.

Financial cooperation, rather than financial integration, is still seen as a tool for targeted assistance to partner countries and the financial resources allocated the EU supported financial Institutions are still marginal compared to the financial flows of interest to the partner countries. In three basins the financial cooperation is assisted and promoted by regional Financial Institutions supported by EU member states: FEMIP in the Mediterranean, the IEB, the Black Sea Trade and Development Bank, the Nordic Investment Bank. It is obvious that the institutionalization of financial cooperation is in itself an incentive, but at the same time is not the sole condition for the success of economic integration with the neighbouring countries.

Financial integration need the presence of foreign banks which are expected to strengthen the economic relationships among the EU and the partner countries or among the partner countries. Financial integration need also a more open attitude from the central authorities, which include also the reconsideration of the exchange rate regime, since recent experience shows that countries that anchored their currencies to the Euro at the end they get better results in term of growth and stability.

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Biographical note

Sergio Alessandrini joined the University of Modena and Reggio Emilia (Faculty of Law) in 1991 and is currently Full Professor of Economics. He is member of the Steering Committee of FEMISE (*Forum Euro-méditerranéen des Instituts économiques*), Marseille. He Graduated in Economics from Bocconi University (Milan, Italy) in 1972. He did post graduate studies in economics at Chicago University (Dept of Economics) and Cambridge University (UK).

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Also, he has served as President of the Economic programme Committee of the Lombardy Region during 2000-2005, and is consultant of the European Commission and international organisations for the Mediterranean and Centro Asian regions.