International financial integration of Mediterranean economies : A bird's-eye view

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INTERNATIONAL FINANCIAL INTEGRATION OF SOUTH-MEDITERRANEAN ECONOMIES

A bird's-eye view

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Abstract

Should South-Mediterranean economies continue their financial integration in the world economy, considering their current stance and in view of the experiences of developed economies with the global financial crisis? The economies of the North-African rim, that is Morocco, Algeria, Tunisia, Libya and Egypt have become more exposed to the global economy during the decades 1990s and 2000s. The same holds to some extent for the Middle Eastern economies Palestine and Syria, while Jordan and Lebanon have become very open economies.

In light of the unprecedented developments in the financial sectors of developed economies in the years 2008-2009 and in view of the current political Arab upheaval, this paper reviews the pros and cons of financial integration. It analyses financial integration indicators, as well as financial stability, and compares the South-Mediterranean region with other regions worldwide.

In the global perspective of other regions worldwide, this group of South-Mediterranean economies is unique. From this study follows that most countries of this group have high cross-border bank assets in combination with limited bank liabilities, high inflows of FDI and remittances and relatively high outflows of remittances. Apart from their low degree of cross-border bank indebtedness, they are more financially integrated in the world economy in comparison with Asia, the CIS, Latin-America and the Sub-Sahara.

The relatively low degree of trade and financial integration in the region and world economy sheltered these economies to a large extent from the negative external shocks during the global financial crisis of 2008-09. At the same time, the South-Mediterranean region has foregone the economic dividend that developed regions worldwide reaped thanks to growing financial sectors.

At the moment of the writing of this paper, that is 2012, so after the global crisis and after or during the upheavals or revolutions in some countries, these South-Mediterranean economies are at a crossroad. This paper studies the status quo, the achievements of the last years and sheds light on the pros and cons of further financial integration, regionally or worldwide.

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1. INTRODUCTION

The South-Mediterranean countries form a special region, particularly from an economic perspective. Their growth potential is high in view of their population growth, but also in view of their state of development and opportunities for further integration in the wider region as well as globally. Although beyond the scope of our analyses here – which focus on international financial integration and development – a substantial part of near future developments will depend on the political changes emerging from the Arab revolution. This chapter lays down the objectives and structure of this paper.

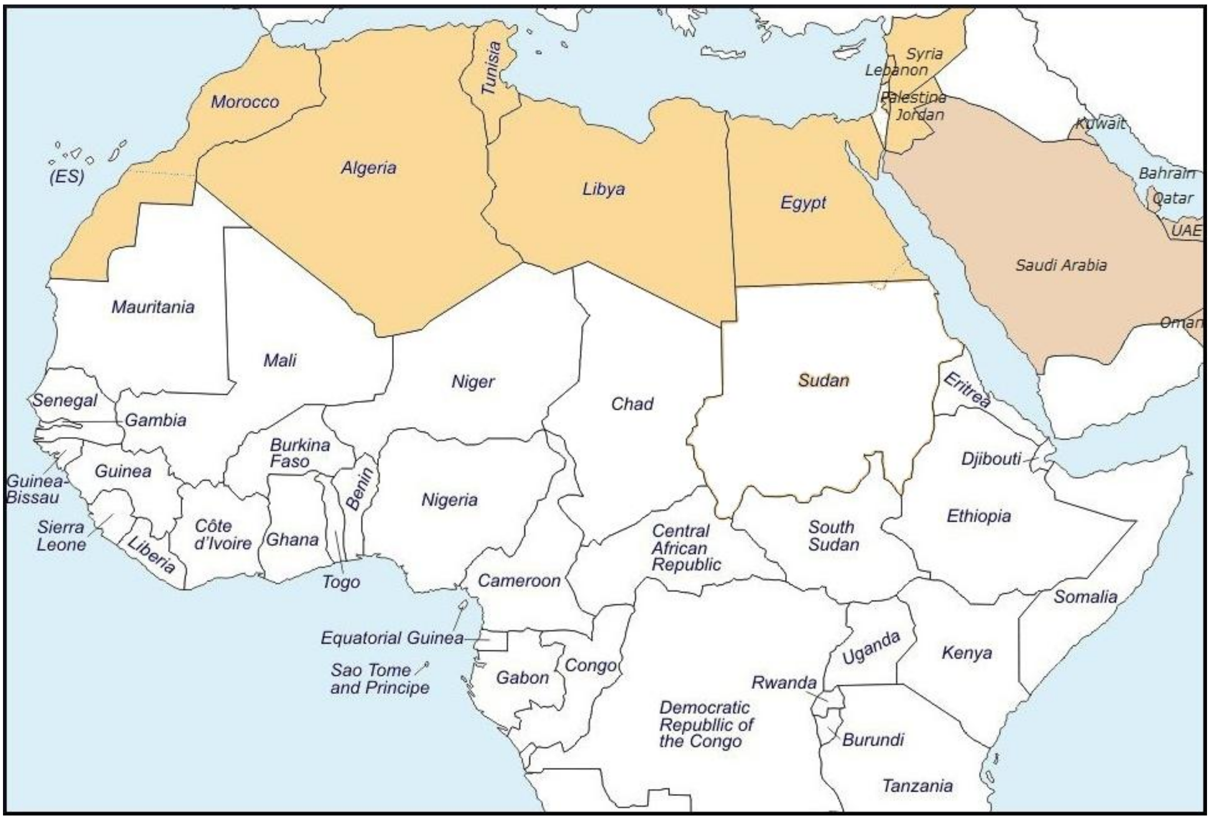
a. Coverage and aim

The main focus in this paper is on the North-African countries of the Southern rim of the Mediterranean, from west to east, being Morocco, Algeria, Tunisia, Libya and Egypt and the Middle-Eastern economies Jordan, Lebanon, Palestine and Syria (Graph 1). In this paper we refer to this group as *South-Mediterranean* economies. The study aims at listing, concisely describing and analysing as much information as is consistently available on the cross-border financial transactions of these South-Mediterranean countries, along with the economic factors that influence them, in order to provide a comprehensive picture of the cross-country differences and the South-Mediterranean's place in the world economy.

b. Content

The relationships between the South-Mediterranean economies and their legacy of interactions with Europe illustrate and explain the stance of their domestic welfare states, public finances and labour market performance values. We value in this study theoretical and empirical research as equally valuable and complementary. Theoretical studies may strike the balance between the benefits and costs of the existing degrees of international financial integration. Empirical research, on the other hand, in all its aspects, and with econometric analyses using advanced methods and techniques, sheds light on causal relations that underlie the international financial linkages.

Graph 1 South-Mediterranean region



Source: Marked by the authors from Google maps.
Note: South-Mediterranean countries are coloured beige here. The six darker countries are the Gulf Cooperation Council (GCC) countries.

c. Rationale

The main rationales for using international financial integration as a theme are the following:

i. The recent upheavals in Tunisia, Egypt, Libya and Syria ask for more factual and analytical information on the South-Mediterranean region, from different angles, for research and policy making purposes;

ii. Although growing gradually, the scientific literature on developments and prospects of the degree of regional and global financial integration of the southern South-Mediterranean region is scarce;

iii. As a reaction to the global crisis that first and foremost hit developed economies, some South-Mediterranean economies expressed the opinion that financial integration has been proven to be rather bad than good and therefore propagate for less financial integration. This paper wants to put economic developments of the South-Mediterranean and other regions in the world in a historical perspective, including the economic impact of the political shocks of falling regimes. It further discusses pros and cons of financial integration.

d. Major issues

The main subjects of this study are the past, present and possible future developments of cross-border stock and bond market activities, as well as cross-border banking, foreign direct investment (FDI), the role of remittances, interest rate differentials and exchange rates.

e. Authors' contribution to the literature

As to the broad literature on international financial integration, our contribution lies in the combinations of factors that influence financial integration in contrast to many one-dimensional approaches that only give a glimpse of the state of financial integration of the South-Mediterranean region. The bases for our analyses are official statistical sources and the literature as far as this concerns the theoretical foundations and empirical findings of other research on the South-Mediterranean region.

f. Distinctive features

This paper attempts to be comprehensive in all the empirically available domains of cross-border finance. In comparison with other studies that emerged on this region, it makes a *cross-country* comparison and is moreover statistically factual in a broad sense instead of descriptive. In comparison with studies that emerged from policy institutions (International Monetary Fund, World Bank, Organisation for Economic Cooperation and Development, the United Nations and the European Union) it points at facts according to statistical backing.

2. INTERNATIONAL FINANCIAL INTEGRATION

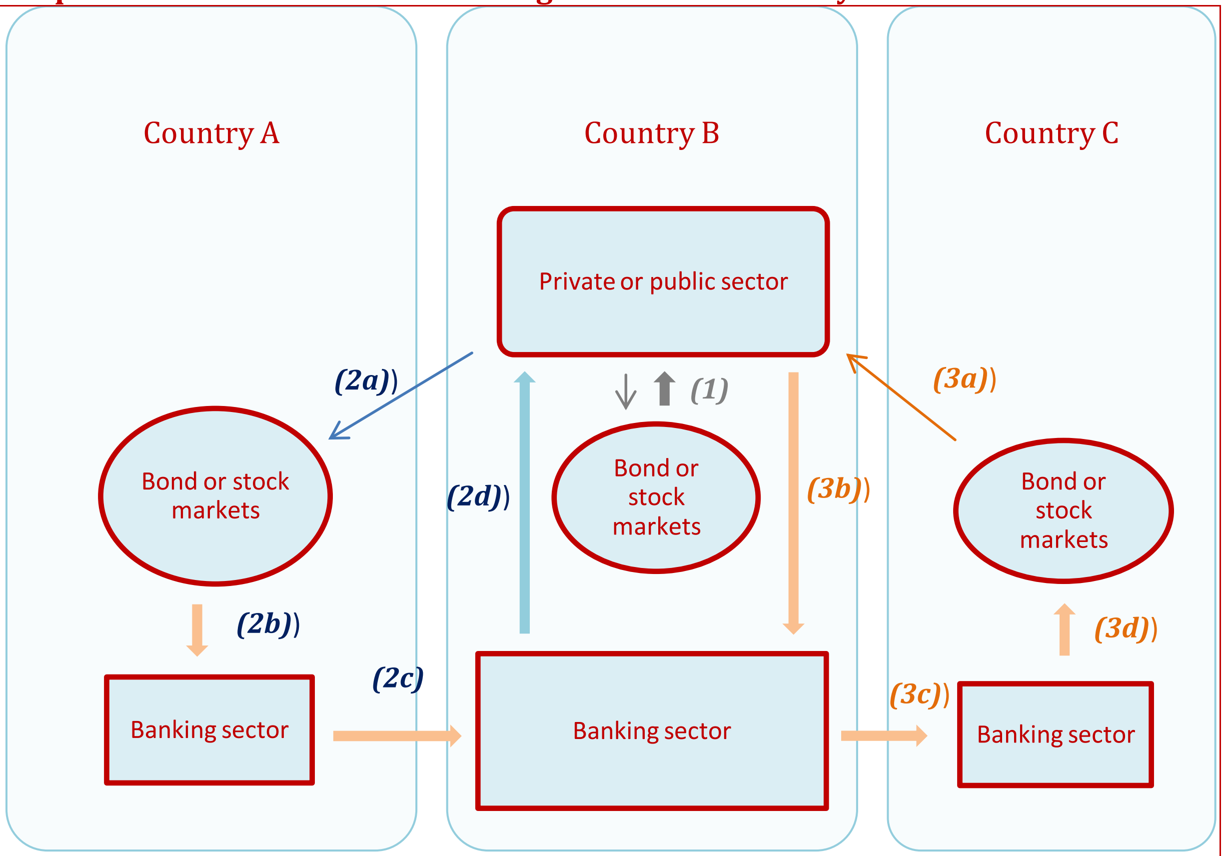
Financial integration and in particular *international* financial integration has become popular terminology only in recent decades, triggered by the globalisation glut across nations worldwide. Nowadays there is a vast scientific literature employing this term in many different ways. This section goes back to the meaning. It pins down the definition of *international financial integration*, as used in this paper. Thereafter, it discusses the merits and risks of this type of integration, distinguishes it from *financial stability* and lists formulas to quantify it. Last but not least, we motivate the application of international financial integration to South-Mediterranean countries.

a. What is international financial integration?

Financial integration is the traffic of financial transactions, through which a country's financial markets become more closely integrated. *International financial integration* points to the traffic of financial transaction across national boundaries. A country is more financially integrated than another country if it has more transactions, with more other countries, on more different financial markets, than this other country. The banking, equity, bond and other types of financial markets across national borders are then said to be closely interlinked. In this case national boundaries matter less.

Free-market thinking has been a main reason for the increase in international financial integration. The reduction or absence of rules, tariffs, and duties made more economies worldwide interconnected with their neighbouring economies and even with economies that are geographically further away. Financial outflows from countries in this position went to close or far neighbours, and vice versa, financial inflows from close or far neighbours returned to the country. These flows concern money in a broad sense, mainly transferred via the banking systems, being payments for shares, bonds, goods, services, and the buying even into bricks in case of direct investments. An increase in gross financial inflows often triggered an increase in gross financial outflows, as a country that receives money can also spend it more easily. The abolishment of trade barriers and the perception that economies can benefit from an open attitude has accelerated the opening up of economies by encouraging more exchange across borders.

Graph 2 International financial integration schematically



This graph illustrates the international financial integration of country B. Country B's private or public sector issues bonds or shares at the national bond market and receives money in return (see *(1)*). Also, this sector issues bonds or shares at a foreign bond or stock market *(2a)*, such as in country A, in which case the money returned flows via the banking sector of country A, see *(2b),* to the banking sector in country B *(2c)* to the issuers of the private or public sector in country B (see *(2d)*). At the same time, the public or private sector of country B buys bonds or shares from country C *(3a)* that it pays via the banking sector in countries B *(3b)* and C *(3c)* to the bond or share issuers at the bond and stock market of country C *(3d)*. The more of these types of financial connections an economy has with markets (bonds, equity, real estate) in other countries in the region or worldwide, the more interlinked this economy is.

The size of the transactions' value determines the impact that a shock in B can have on other economies. For instance, if the transactions between A and B are sizeable while those between B and C are small, a recession in B will affect A negatively while C may feel no pain. Among others, this depends on the financial linkages between A and C that are not illustrated here. In case A is strongly linked to C, a recession in B will hit C also negatively via the financial transmission channels that link A and C. It is this systemic risk that causes domino effects. A relatively small shock in a country can trigger a long series of shocks. An example is the US subprime mortgages that became toxic assets in 2007. Those turned out to be on bank balance sheets in many economies worldwide. Financial supervisors lack knowledge on these financial linkages. While they can know about the bilateral financial traffic of their institutions, they are agnostic about the comprehensive financial chain. Preventing system risk requires a worldwide supervisor.

Source: Authors.

Free-market thinking and the rapid developments in information and communication technology (ICT) have catalysed the creation of an increasingly integrated financial system that ignores national boundaries. Even without free-market thinking, the rapid progress in ICT had accelerated and augmented cross-border transactions, but the combination of free market thinking and ICT reinforced developments in international financial integration. The fact that computers process information at a high speed and transfer that information in an advanced and relatively securely manner makes people carrying out financial transactions speedily. Communication technology, via email and the internet among others, has become so widespread that sellers of products easily find clients where geographical distance no longer plays a role. Also, financial innovations have helped to expand the degrees of international financial integration. The fact that not only existing products such as shares, bonds and mortgages were tradable, but also all kind of derivatives that suited some investors at some moments in some countries better, contributed to the vastness of the financial transactions worldwide. It is expected that these are going to sum to 4 quadrillion US dollars soon.

b. What are the merits of international financial integration?

A main merit of international financial integration lies in the *enhancement of the growth of economic activity, or the growth potential of a country, and consequently jobs*. A higher degree of financial integration in general entails a higher degree of financial development. Financial development, in turn, can go hand in hand with economic growth. Broader and deeper financial markets, as well as a large banking sector, provide more financial means in the process of economic development. Financial institutions can actively encourage innovation by determining and funding productive investments. Productive investments lead by definition to a higher level of economic productivity, hence growth. Countries that are growing faster in general also develop their financial sectors more quickly as, for instance, in booming periods credit becomes more easily available and there is more demand for financial products, either to invest the additional savings directly or via intermediaries such as banks. For a further description of the benefits of financial integration, in terms of risk sharing e.g., see Stavárek *et al.* (2011).

So far, the empirical literature on the impact of financial development and economic growth for the South-Mediterranean countries shows a diverse picture. For instance, Kar *et al.* (2011) find no significant Granger causality running from narrow and quasi money, deposit money, private sector and domestic credit to income for Algeria and Egypt during the period 1980-2007. On the contrary, financial development induces growth in Jordan, Morocco and also Syria. Apart from other limitations in their analyses, such as data limitations, information on stock and bond markets is not employed in this analysis. In theory, it remains however unambiguous that economies with more developed financial systems contain more possibilities of channelling money to profitable opportunities and therefore, in potency, more growth.

Apart from the positive effect of financial integration on economic activity, where a free capital mobility across national borders allows capital to find the highest rate of return and therewith more availability of funds, there is also the advantage of risk or volatility reduction. The more an investor can diversify, the less risk is involved. Moreover, global mobility limits the ability of governments to pursue bad policies (see for instance Kirabaeva and Razin, 2011, or Herring and Litan, 1994). Perfect information, that is the absence of information frictions and complete risk sharing are key points in this respect.[2]

c. *What are the risks of international financial integration?*

As the global crisis of 2008-09 showed, a main risk of international financial integration is contagion in that negative shocks for one country or a financial market can transmit to other countries via (other) financial markets. A crisis in one country that affects the financial sector immediately affects the countries to which that country has a substantial degree of financial exposure. The global crisis originated in the financial sector of advanced economies and, as argued by some (see Aizenman and Pinto, 2011), meant that these countries "overshot" the optimal degree of financial deregulation.

[2] The fact that the international financial markets were late in discovering (in 2010) that the sovereign debt of Greece was quite risky, much riskier than the markets priced it, shows that even financial markets in developed economies are far from having perfect information.

Strong financial linkages or interconnectedness, for instance in equity stock markets or the banking sector, makes it hard to disentangle interwoven markets or institutions. A bankruptcy or even only fragile position of one bank can entail a domino effect, in that many other banks or other financial institutions exposed to this bank may get into a similar situation. For policy makers, it is difficult to establish policy for coping with this systemic risk.

This is an international issue. Policy makers should be able to disentangle the financial institutions in an integrated financial market or ring-fence them, which would isolate the original problem shooter and punish it solely – the more so, as distinctions between financial institutions have often become blurred, not so much between different types of institutions but between the same type of financial institutions across borders, such as banks for instance (see Van der Zwet, 2003). Due to moral hazard, financial institutions in an integrated financial market tend to grow as big as possible as this provides them a guarantee that the government will never deprive them of help because they are too-big-to-fail. For a detailed description of the costs and risks of financial integration, see e.g. Stavárek *et al.* (2011).

Graph 2 illustrates a case of bilaterally interwoven markets. As the accompanying note explains, the basic problem is not in the bilateral financial relations but in the financial relations of financial partners with which a country has linkages. Moreover, the partners of these relations are of importance. In the current global world only countries that fully close their borders, such as North Korea – like Albania before the fall of communism in the beginning of the 1990s – have a state of autarky that eliminates the risks of international financial integration. The other side of the coin is however their foregone welfare that is the great virtue of connected economies. Moreover, such an autarkic state often deprives its citizens of their most basic needs (food, health care).

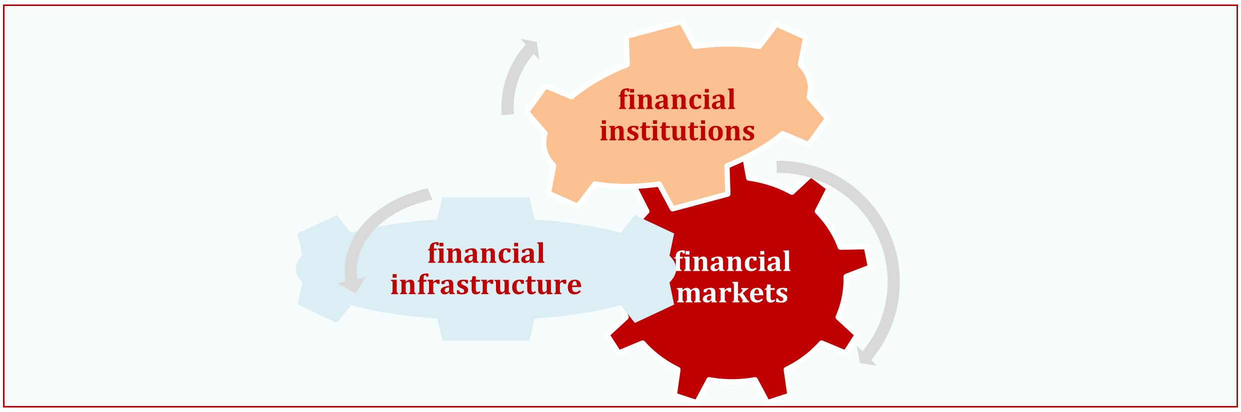
d. What is the relation between financial integration and financial stability?

This is hard to explain. While financial integration is a *degree* of financial markets being interconnected, financial stability is a *binary* state. An economy is either financially stable or it is unstable. In the latter case there are impediments or barriers that hamper financial transactions or, worse, the financial system collapses as a consequence of the domino effect (as happened after the fall of Lehman Brothers in September 2008).

According to Schinasi (2004), a financial system is in a range of stability whenever it is capable of facilitating, rather than impeding, the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events. Thus this is *one* definition of *financial stability*, pointing at a trinity of financial markets, financial institutions and the financial infrastructure.

A higher degree of interwoven financial markets and institutions, both in the number of markets and institutions as well as the relations of these markets and institutions, and the second degree relations, generally leads to a higher degree of stability.[3] However, we immediately add that one should not ignore the higher risk of contagion and even systemic risk implied in this situation. Ideally, one overall supervisor oversees the whole constellation. However, the real world is far from this utopia in practice. The main impediments are here the speed of financial transactions and the growth of the complexity of the financial products. Lack of a political will to give up sovereignty and disclose information at the international level adds to this.

Graph 3 Financial stability schematically



Source: Authors.

Note: The system becomes unstable when one or part of the radars breaks down.

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[3] One can compare this with a large firm or, for instance, a ministry. This is generally more stable than a small firm or ministry as many labourers in a good infrastructure (offices, materials, machines, phones) can share a lot of information and thus be prepared for various external shocks (cyber-attacks, electricity cuts, reactions from competitors).

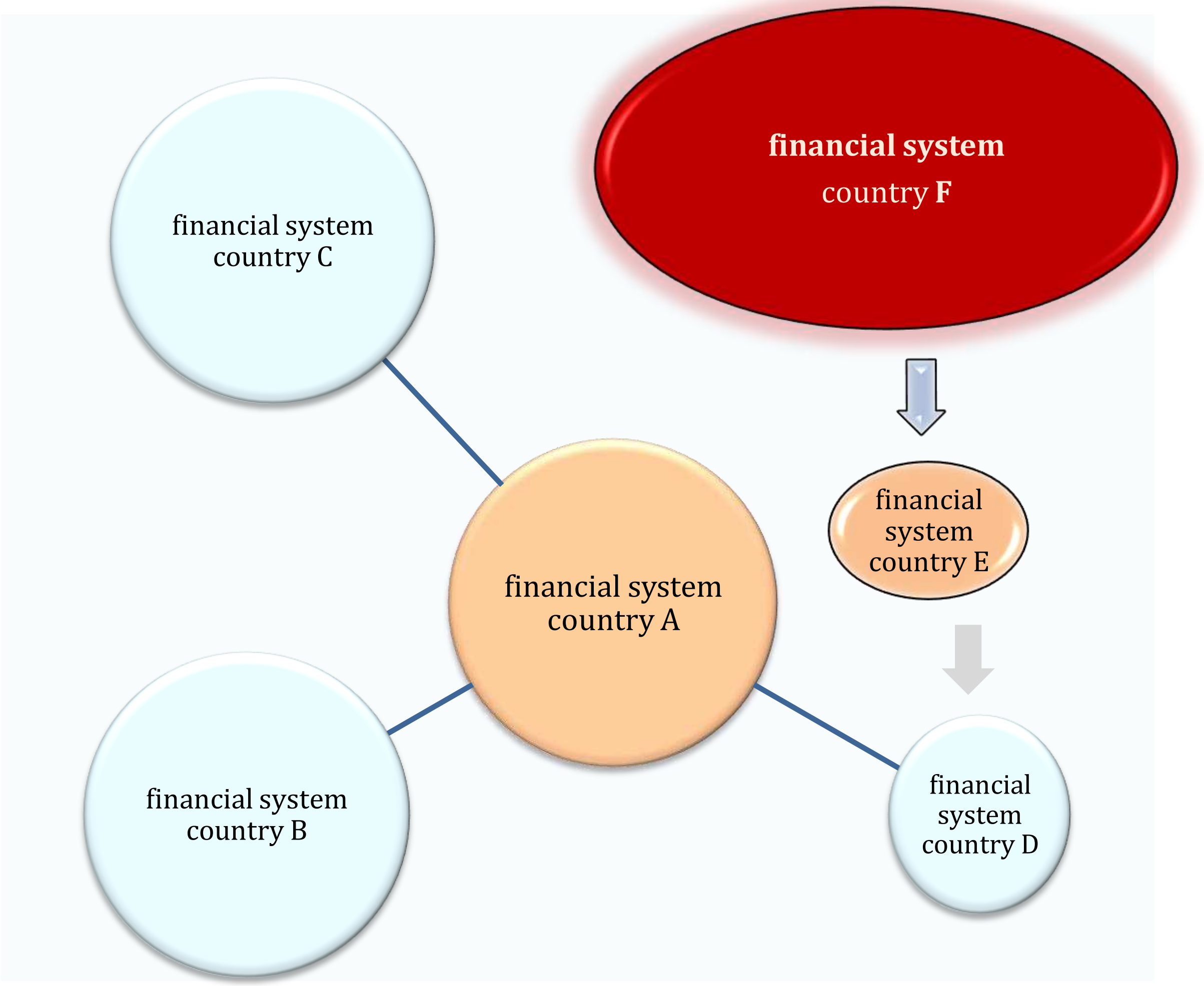
e. How to measure international financial integration?

Financial integration is not easy to grasp with one set of statistics. The issue is multi-dimensional and, as the accompanying text with graph 2 explains, it not only concerns the bilateral transactions but also transactions in markets of economies with which an economy has financial transactions. In a similar vein, the exposure of financial institutions which are debtors or creditors of the institutions of an economy matters, but also the exposure of institutions that are debtors or creditors to these institutions.

The more an economy is (internationally) financially integrated, the more there is a need for vigilance as to financial stability. For this reason, international institutions such as the International Monetary Fund and the Bank for International Settlements, as well as Central Banks of developed and developing economies now publish regular financial stability reports. These reports aim at highlighting the vulnerabilities, market pressures and risks in the financial system in a timely manner. In order to do so, they present a broad scoreboard of indicators on financial integration. Vulnerabilities are almost always multi-present, as each system has weak spots somewhere. In an economy that is booming, an example of vulnerability is the overheating of the real estate market. If the economy is in a recession, an obvious vulnerability is the high debt level of the growing government. Although these reports are always (too) late in identifying the real risks, such assessments in written reports are crucial as a monitoring tool. See also Čihák *et al.* (2012) for a more critical assessment of financial stability reports.

Standard statistics to monitor the status quo are the in- and outflows of bank loans and deposits, foreign direct investment, credit to the private sector, public debt and portfolio investments. For developing economies remittances are also highly relevant as a main flow of capital income that, if stopped suddenly, they disturb the financial system. This scoreboard of statistics should not be able to conceal vulnerabilities and show the resilience to a potential crisis. If not, the economy has a severe problem.

Graph 4 Financial flows that should be monitored



Note: This graph illustrates the complications of assessing financial linkages and consequently the risks of financial instability. Here, country A has financial connections in the first degree with the three partner countries B, C and D. Although the link with country D may seem harmless, this country has a strong link with country F via country E. A break down in the system of country F, that has no first-degree link with country A, may affect country A via country E and D.

Supervisors of the financial system can observe the first degree relations of country A, as well as the relations of country D, and country E, but are unaware of the linkage and size of the linkage of country A with country F. Supervisors should be able to monitor the second, third and further degrees of financial linkages of country A in order to assess the risks for country A in a comprehensive way. As they are often limited legally, there is always an unobserved risk.

In fact, supervisors of the financial system do not even know what they do not know.

Source: Authors.

f. Are South-Mediterranean economies financially integrated?

Evidently, South-Mediterranean economies have financial linkages. However, the size of financial flows in South-Mediterranean economies is lower and the exposure of their domestic markets to other markets, in and outside their economies, is far less than the flows and exposure of markets of developed economies. For this reason the issue of financial stability is less important than for developed economies. As the financial institutions, markets and infrastructure of most South-Mediterranean economies are less connected with the financial institutions, markets and infrastructure of other countries there is less risk of contagion. Negative spillovers from external shocks dampen or peter out immediately. Although there is less risk than in developed economies, the risk is not negligible. Subsequent sections in this study show in which countries and in which markets risk is most prominent.

3. FINANCIAL INTEGRATION OF THE SOUTH-MEDITERRANEAN ECONOMIES

Despite the fact that the multi-dimensional problem of measuring the degree of international integration is not easy, we make a first attempt in this section of our study. Statistical facts on the main channels of cross-border capital flows, such as banking, foreign direct investment but also remittances as such are illustrated for the group of South-Mediterranean economies in the first instance and for each of the countries in this group thereafter. We cannot prevent double-counting some flows, as for instance remittances may flow via the banking system while we measure them also separately, so both these linkages. More relevant than precise measures in this study are the trends that we observe. Some economies augment their degree of integration, not only in nominal terms but also in relative terms, such as in percentages of their nominal GDP, while other countries may diminish it. Apart from the economic contraction in the global recession years 2008-09, the degree of openness of Jordan and Lebanon is interesting to study, as well as the capital outflows of oil-exporters Libya and Algeria. Let alone the increasing importance of Egypt, Morocco and Tunisia (and Syria) on the global markets.

a. *Cross-border banking flows and the role of foreign banks*

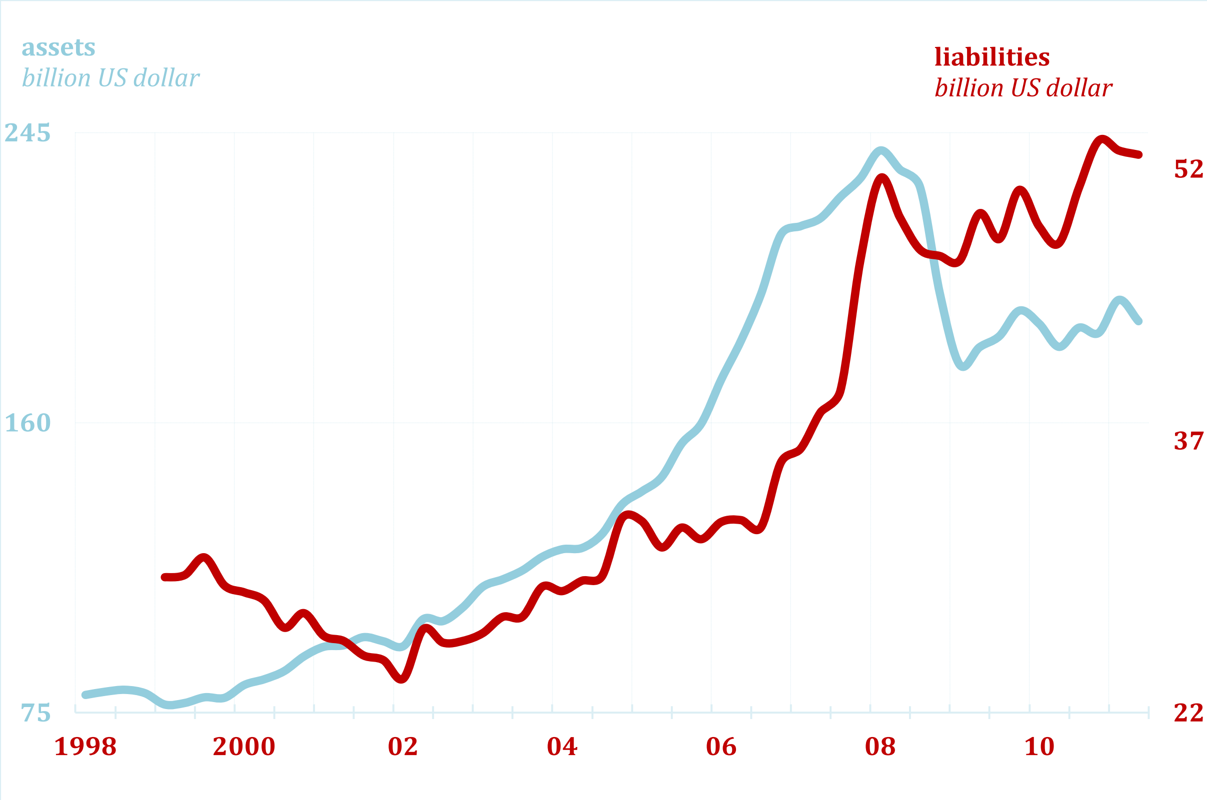
As with most other economies, cross border financial linkages of South-Mediterranean economies are largest in magnitude in terms of banking. Even though the domestic banking sectors lack competitiveness and the world ranking of the ease of doing business is relatively low (see De Lima *et al.*, 2011), cross border banking is significant. Moreover, the degree of international financial integrations has grown substantially during the last years, at least up to the global financial crisis in 2007-08.

Graph 5 shows the total liabilities that banks in the South-Mediterranean region have with multinational banks reporting to the Bank for International Settlements (BIS) in Basel. This includes all banks of developed economies but also many banks of developing economies. This gives us therefore a quite complete picture. It follows that South-Mediterranean banks were indebted to BIS banks, more than doubling from around 22 billion US dollar in 2002 up to 52 billion US dollar in 2011 (as indicated on the right axis). The rise in liabilities was highest in the years just before 2007. A falling demand for liquidities at the global international markets and for other financial needs put a stop to the positive trend in this year where the global crisis started.

An even sharper drop is observed in the counterpart of the liabilities, being the assets of these South-Mediterranean banks at the BIS reporting banks. Assets had more than tripled at that time, from 75 billion US dollars to 240 billion US dollars. To be more precise, which is possible as these are quarterly data, it follows that assets peaked in the first quarter of 2008. One year later, in the first quarter of 2009, bank assets were more than 60 billion US dollars lower. South-Mediterranean banks repatriated their own funds abroad towards their domestic markets, as there was a high domestic need for liquidity. In the quarters thereafter these cross-border bank assets stabilised but they had not returned to the high level of 2007 in the first half of 2011, so four years afterwards.

These cross-border liabilities and assets were quite unevenly distributed across the nine South-Mediterranean economies that we have under investigation here.

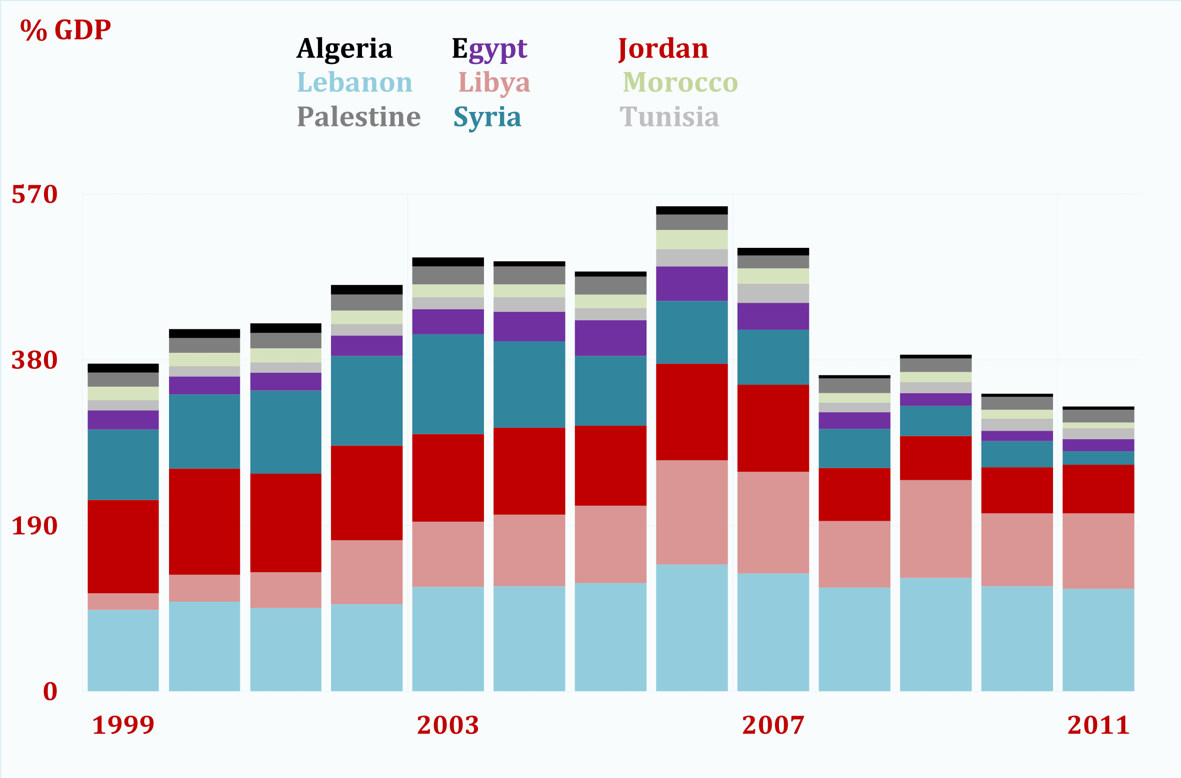
Graph 5 Cross-border South-Mediterranean bank assets and liabilities



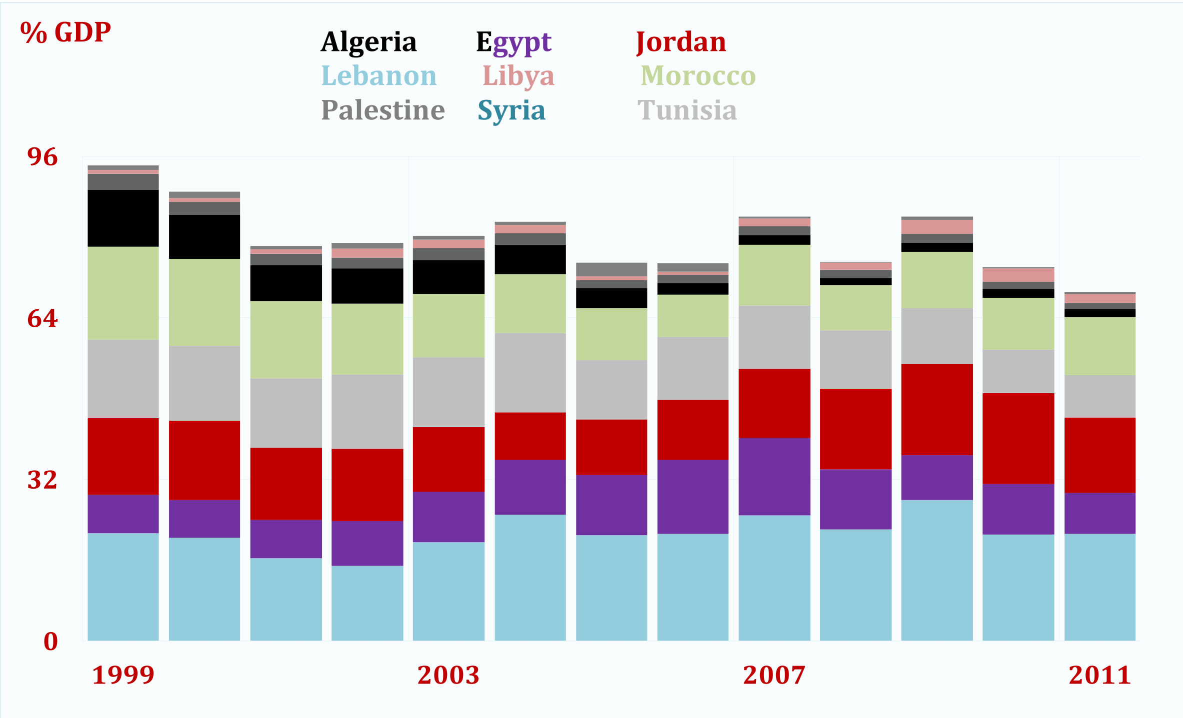
Source: Authors on the basis of the database of the Bank for International Settlements .

This evidently follows from Graphs 6a and 6b. They present the liabilities and assets, respectively, as percentage of GDP to make them dimensionless and thus comparable across the economies. The graphs stack these percentages for all nine countries in each year. It then follows that cross-border assets for Lebanon, Libya, Jordan and Syria were relatively high. Generally, these high creditors also are highly indebted. However, neither does this hold for oil-exporter Libya, nor for Syria, which was an oil-exporter (but is running out of oil). We can thus conclude that Lebanon and Jordan are most deeply financially integrated in the global economy, according to these cross-border banking statistics. On the other hand, foreigners are indebted to Libyans and Syrians via Libyan and Syrian banks but the latter are in return *not* indebted. Interestingly, Egyptian, Tunisian and Moroccan banks show the reverse picture. They owe money via banks abroad to foreigners as Graph 6b shows, but they are not creditors (see Graph 6a). In absolute terms, Egyptian banks owed most in 2007, notably 20 billion US dollars, so almost half of the total liabilities of South-Mediterranean countries (Graph 6d).

Graph 6a Cross-border bank assets of South-Mediterranean countries

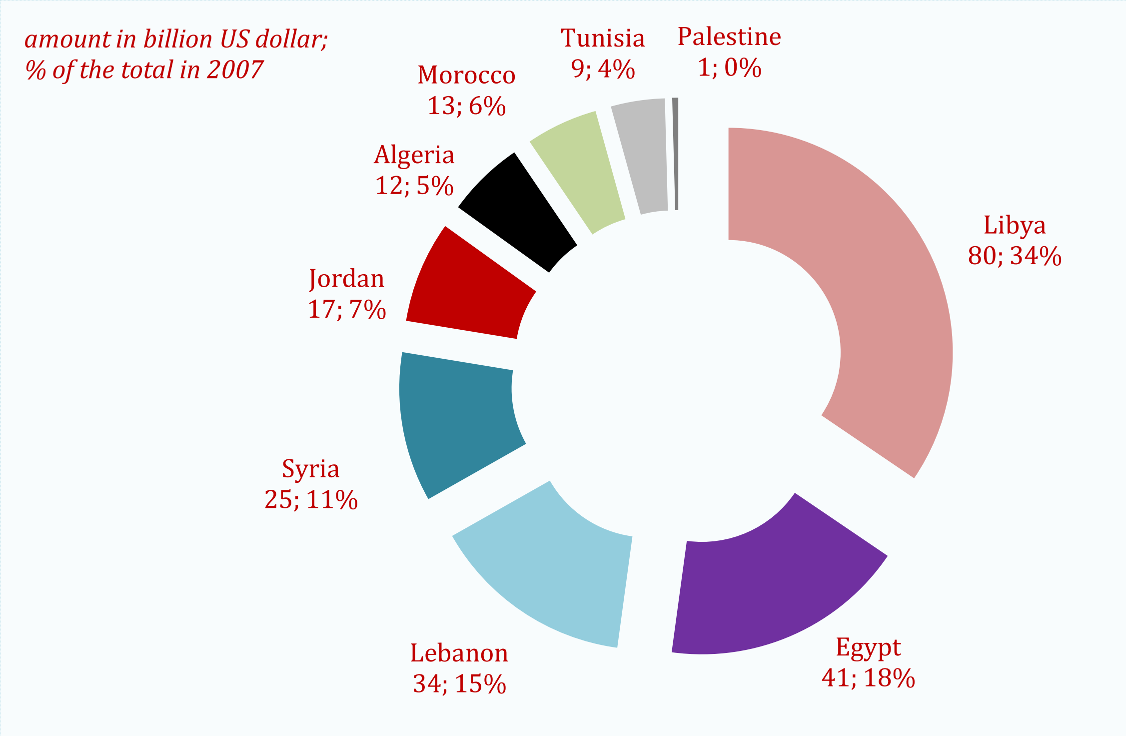


Graph 6b Cross-border bank liabilities of South-Mediterranean countries

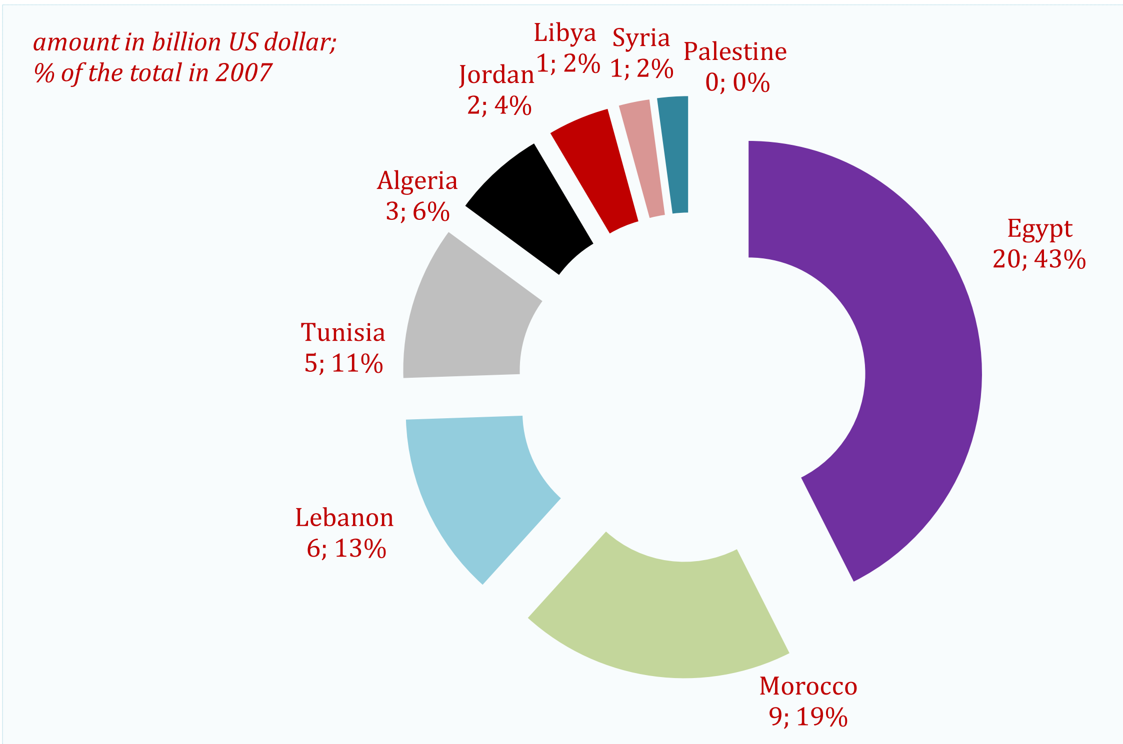


Source: Authors on the basis of the database of the Bank for International Settlements, the IMF World Economic Outlook and the Central Bureau of Statistics of Palestine.

Graph 6c Cross-border bank assets of South-Mediterranean countries in 2007



Graph 6d Cross-border bank liabilities of South-Mediterranean countries in 2007



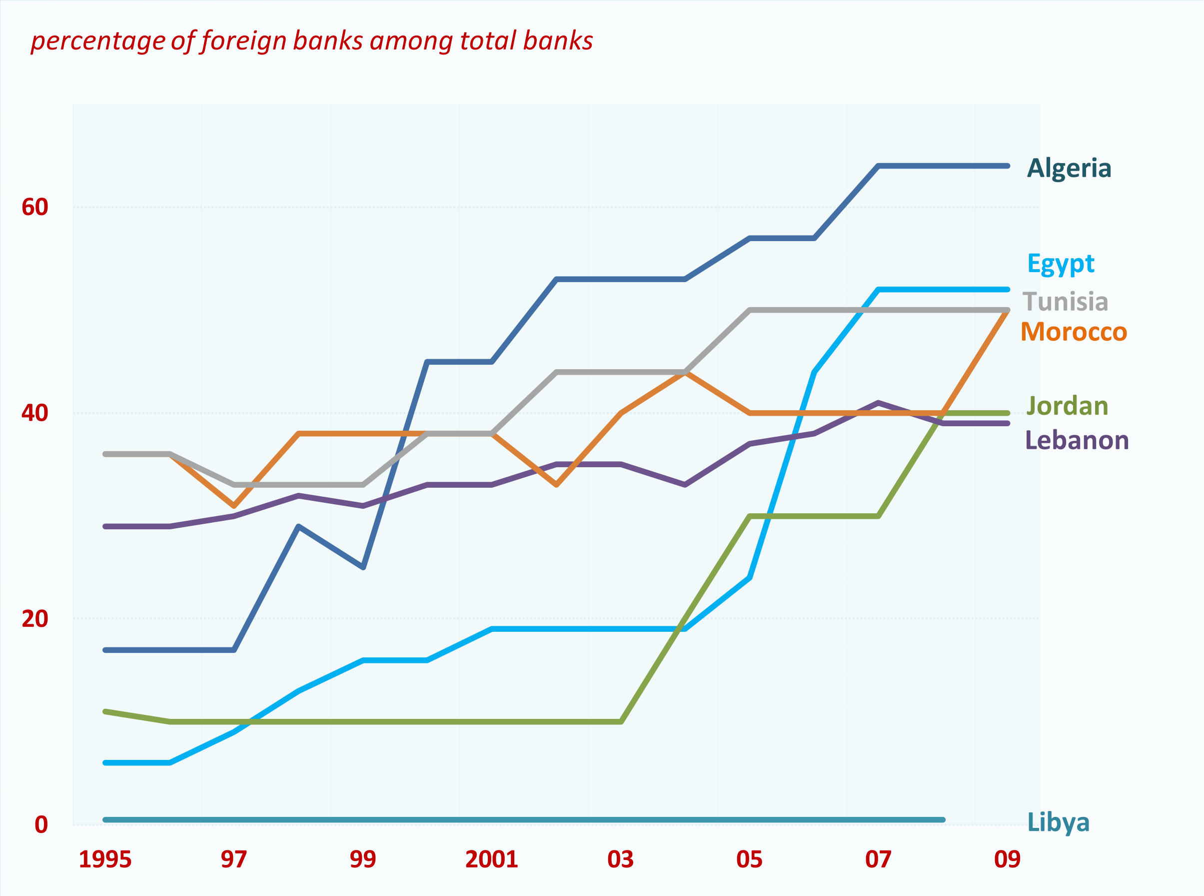
Source: Authors on the basis of the database of the Bank for International Settlements.

The role of foreign banks in a country is another relevant issue. Some studies in the literature show that the advantages of the presence of foreign banks outweigh the disadvantages. One advantage is that foreign banks compete with domestic banks to the benefit of households and businesses. Another advantage is that they provide additional access to financial services. Moreover, financial stability can increase. One of the disadvantages is the augmented foreign influence on the domestic economy. As the financial global crisis of 2008-09 has shown, there are significant risks to foreign bank and cross-border banking as a problem in the home country of a foreign bank is almost automatically spilled over to the domestic economy.

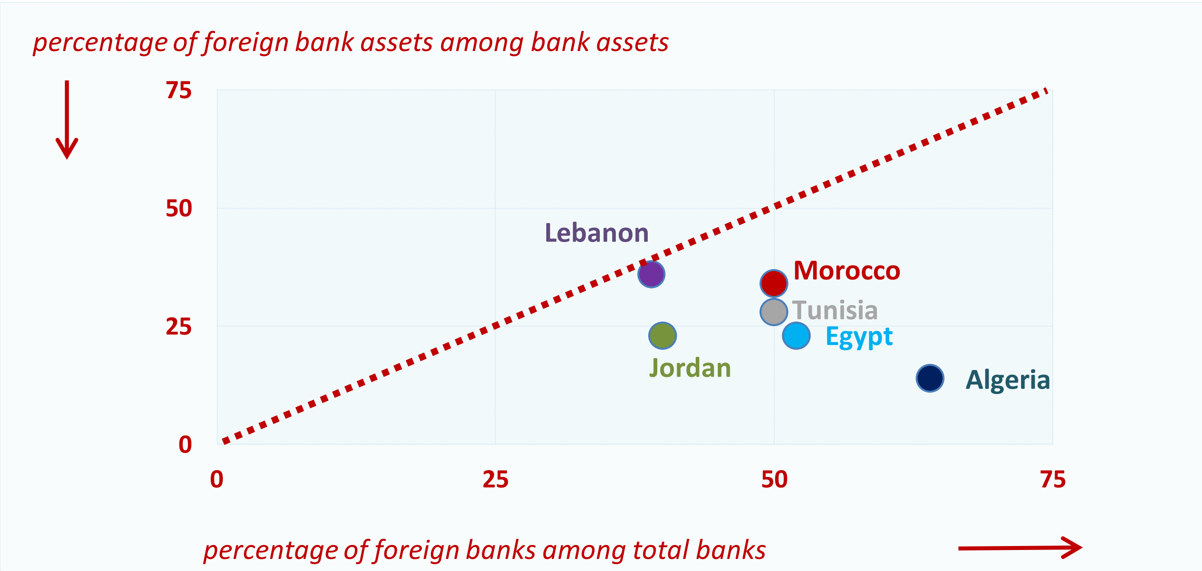
In most South-Mediterranean economies the number of foreign banks in the domestic market has significantly grown. While less than 20% of the banks were foreign in Algeria in 1995, this was more than 60% in 2009 as follows from Graph 7. The increasing trend during this period is even steeper in Egypt, the share of foreign banks rising from 6 to 52%. Only Libya shows no change. From 1995 to 2009 there were no foreign banks. Barriers and limited development in some countries still hinder the presence and also effectiveness of foreign banks (see Claessens and Van Horen, 2011).

Apart from the number of foreign banks, their relative size also matters. The access to financial services for small and medium-sized enterprises is better guaranteed in case of large foreign banks. As Graph 8 shows for 2009, a high share of foreign banks does not guarantee a high share of foreign bank assets. In Algeria the high majority of 64% of foreign bank assets only had 14% of the total bank assets. In Egypt, Morocco and Tunisia the share of foreign bank assets was around a quarter, while these banks form half the banking sector in numbers. Therefore, although there are many foreign banks their impact on the domestic economy is still limited. Only in Jordan and Lebanon the share of foreign banks in assets and numbers is about the same, implying that they play a substantial role at the domestic banking market.

Graph 7 The presence of foreign banks in the South-Mediterranean



Graph 8 Relative importance of foreign banks in the domestic market in 2009



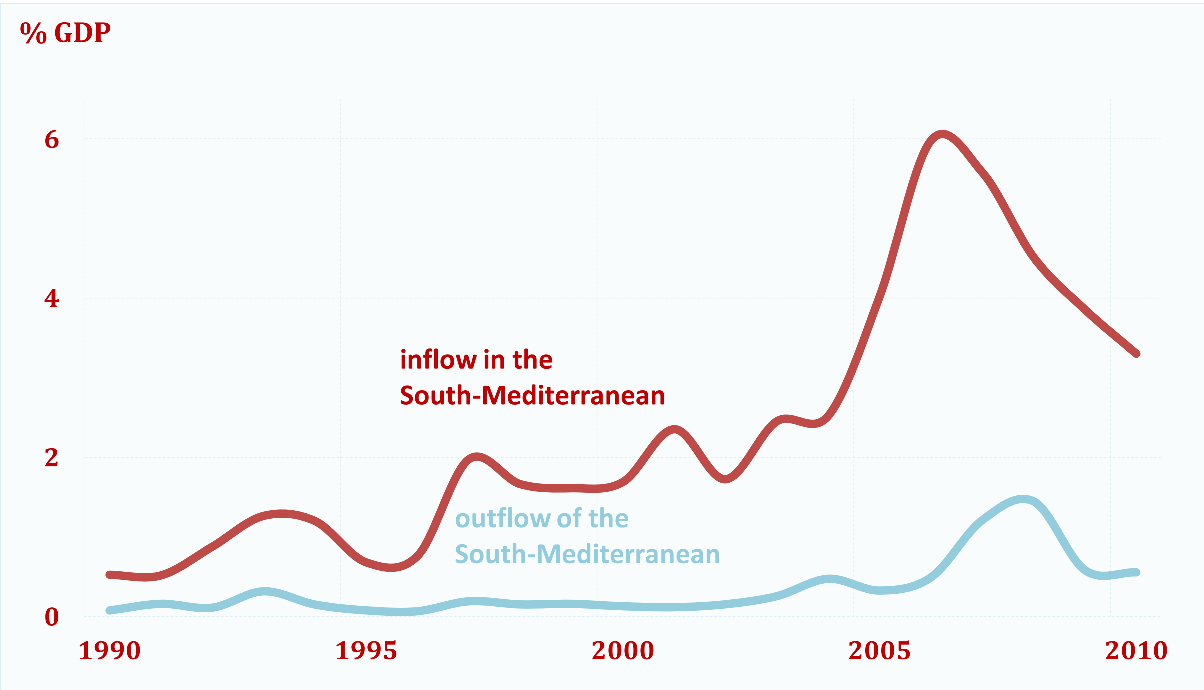
Source: Claessens and Van Horen on the basis of Bankscope (2011).

Note: For Tunisia data on bank assets in 2008 instead of 2009 are presented in Graph 8. No data is available for Syria, which signals that this economy is rather closed.

b. Foreign direct investment

Inward foreign direct investment in the South-Mediterranean region is playing a catalysing role for economic activity. These flows have risen up to 6% of GDP for the region as a whole as Graph 9 illustrates. Like the shifts that are visible in the cross-border banking flows, here we observe a significant drop as a consequence of the lack of liquidity worldwide and the sharp decline in global demand worldwide. The drop in inward FDI even halved in the period from 2006 to 2010. Apart from Syria and Algeria, the countries benefit from high inflows. Graph 10a and 10b show the in- and outward FDI per country. It follows that apart from Lebanon and Libya, beneficiaries suffered from the economic downturn and the lingering on of the financial crisis during 2006-10 (see Graph 10a). As Graphs 10a and 10b shows, the level of outward FDI is quite low compared with the inflows, whereas Lebanon and Libya are ahead of the other South-Mediterranean economies. Unlike Algeria that is also oil-rich, Libya re-invests its revenues from these resources abroad, even up to 6% of GDP in 2007 and 2008.

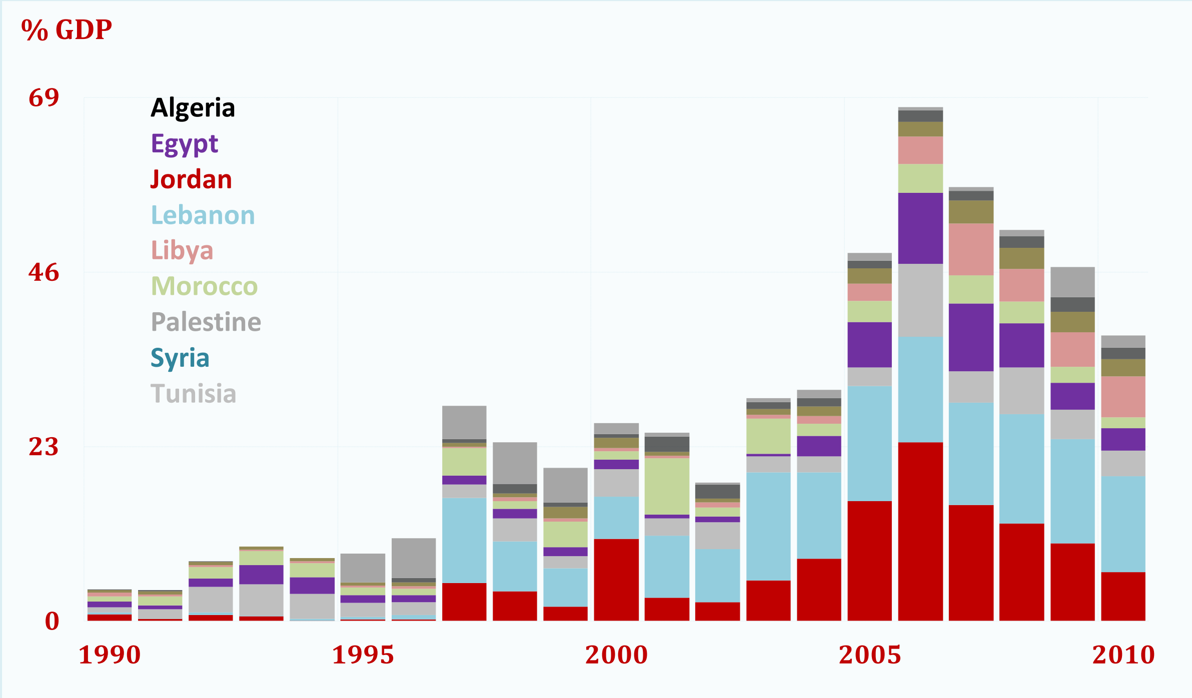
Graph 9 Foreign direct investment in and out of the South-Mediterranean region



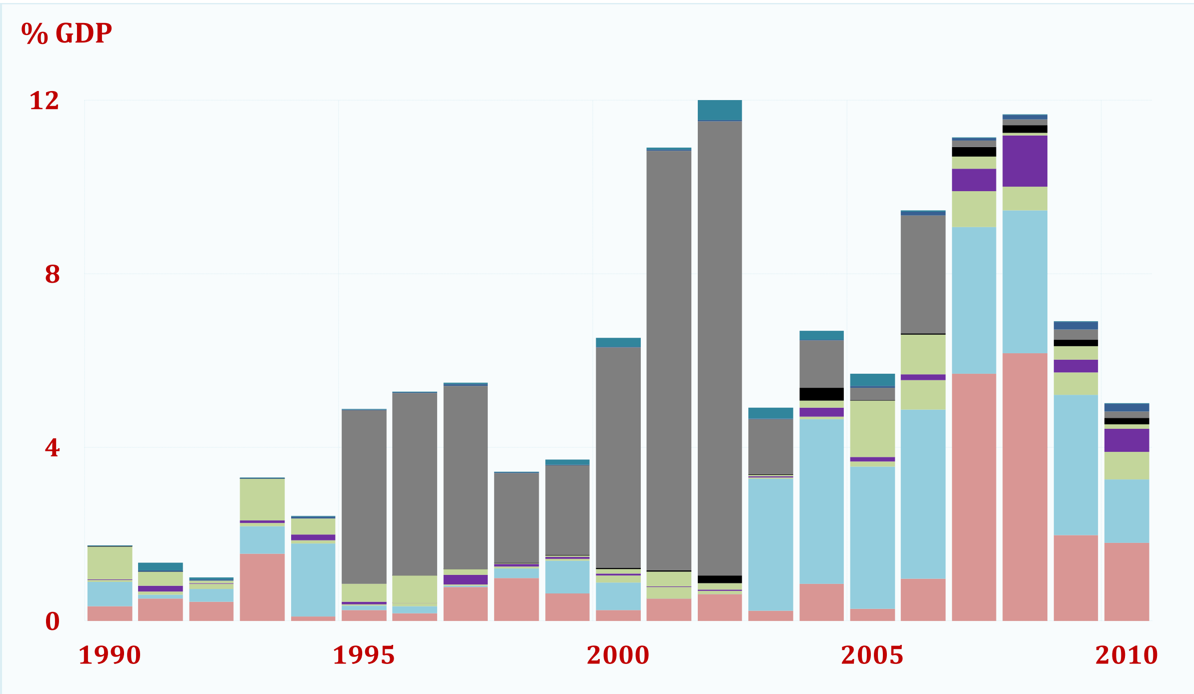
Source: Authors on the basis of the United Nations UNCTAD database and the IMF World Economic Outlook and the Central Bureau of Statistics of Palestine.

Note: The sum of the FDI of the individual countries is divided by the sum of the nominal GDP of the individual countries.

Graph 10a Inward FDI for each of the South-Mediterranean countries



Graph 10b Outward FDI for each of the South-Mediterranean countries



Source: Authors on the basis of the United Nations UNCTAD database and the IMF World Economic Outlook and the Central Bureau of Statistics of Palestine.

Note: FDI as a percentage of GDP per individual countries stacked per year.

c. Remittances

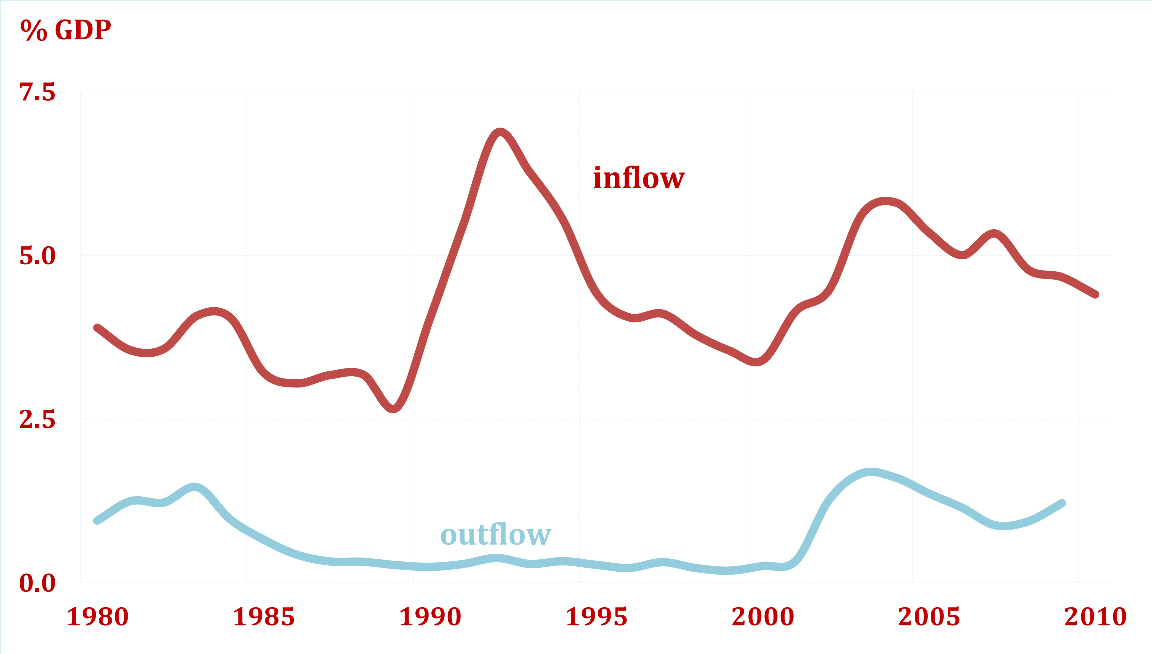
At the same time where a significant inward flow of funds in the form of FDIs was spent in the South-Mediterranean economies, a great number of people worked abroad. This follows from the information that we obtained from the inward remittances, as shown in Graph 11a. Even during the crisis of 2008-09 around 5% of GDP was received by South-Mediterranean employees that were working outside their native country.

Jordan and Lebanon earned most, as follows from Graph 11b that shows the remittances stacked per year as a percentage of the country's domestic GDP. This seems in contradiction with the FDI information, as the high degree of FDI in these economies suggests that this boosted economic activity and therefore economic growth and jobs. Nonetheless, as we know from other sources, many employees work in the Gulf Cooperation Council countries (Saudi Arabia, the United Arab Emirates, Bahrain, Kuwait, Oman, Qatar, see Peeters, 2011b), the European Union or in the United States. Libya and Syria, and even Algeria although to a lesser extent, gain far less from labourers abroad. Egypt and Tunisia, and even more so Moroccan workers abroad, account for a substantial proportion of remittances in terms of their GDP. This money earned abroad will in most cases be transferred to their home country, either in cash or via the banking system.

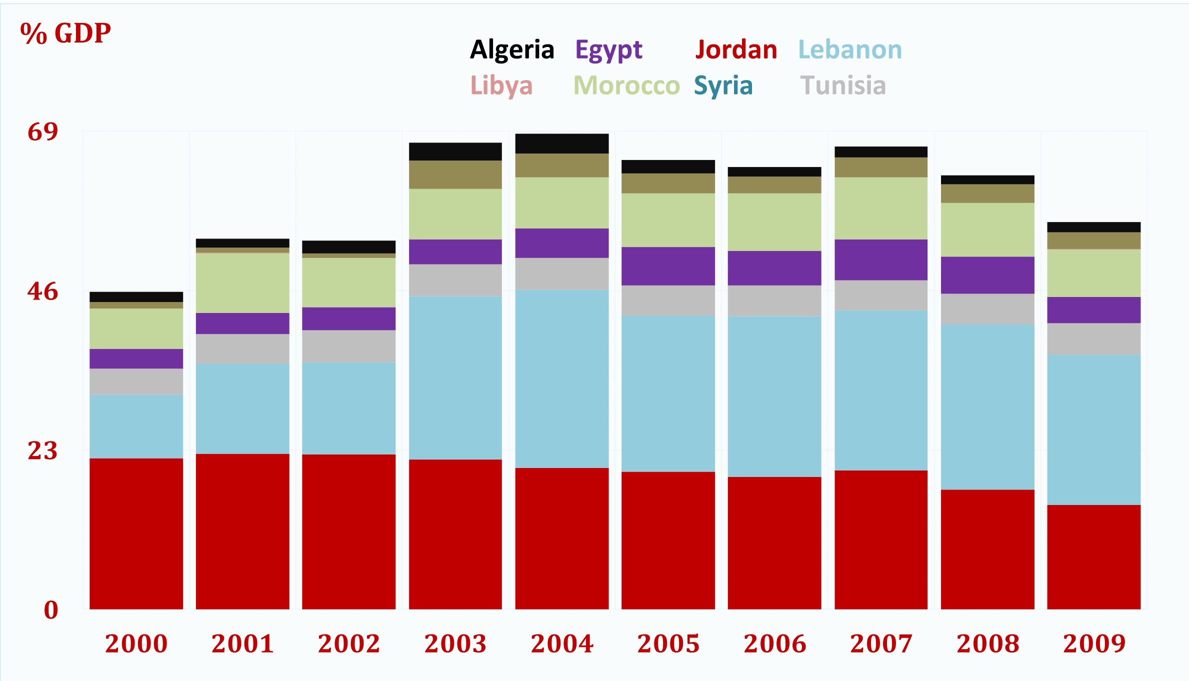
d. Cross-border portfolio investments and other factors

Buying and selling of shares and bonds, derivatives and other financial products by citizens of institutions in the South-Mediterranean in other countries, or vice versa, by foreigners in these South-Mediterranean economies, also constitutes non-negligible flows of capital across these South-Mediterranean borders. These flows are more substantial between each of the South-Mediterranean countries and non-Mediterranean countries than within the region. That is, the intra-regional portfolio investments tend to be small (see also Sabri 2002a, 2002b, 2008 and 2011 on these issues).

Graph 11a Remittances in the South-Mediterranean countries



Graph 11b Inflows of remittances in each of the South-Mediterranean countries



Source: Authors based on the of the World Bank and the IMF World Economic Outlook.

Note: Aggregate remittances in Graph 11a are calculated as the sum of the inflows and outflows of remittances for each country divided by the sum of the nominal gross domestic product. The decomposition in Graph 11b gives the remittances as a percentage of GDP, in each year stacked for all the South-Mediterranean economies. Palestine is not included due to the lack of data.

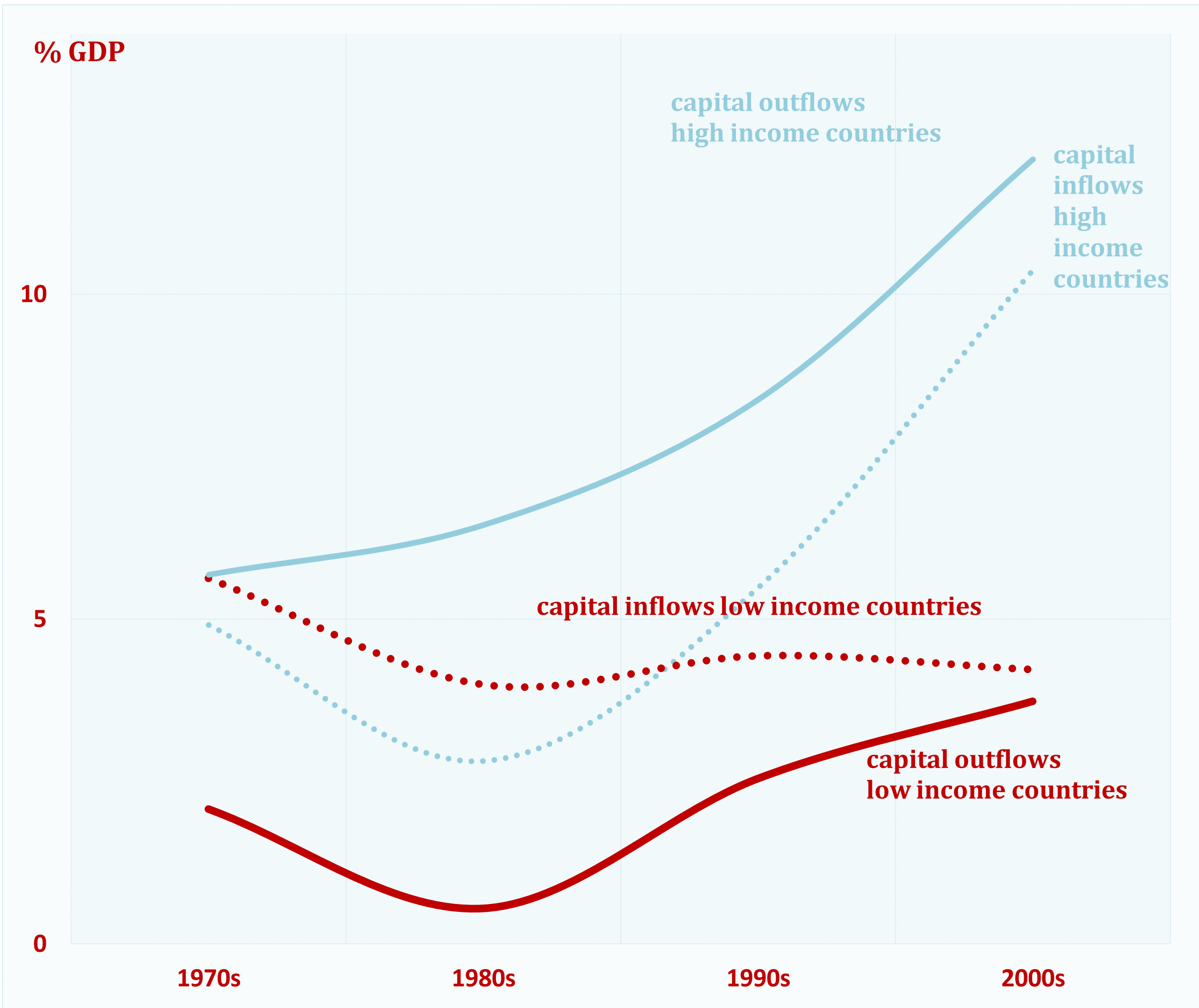
4. THE SOUTH-MEDITERRANEAN REGION'S INTEGRATION IN THE WORLD ECONOMY

The South-Mediterranean region is unique in that it combines high levels of bank assets abroad, high inward FDI and high inflows of remittances with low bank liabilities abroad and low outward FDI compared to other regions worldwide. Even though the region is quite heterogeneous, with main oil-exporters Libya and Algeria, and otherwise a great number of commodity resource dependent economies, on balance its net financial positions and net capital flows were positive in recent years. This follows from the analyses in this section that makes a comparison with Asia, the Commonwealth of Independent States (the CIS-countries), Latin-America, the OECD countries and the Sub-Sahara.

a. *Gross capital flows and international investment positions*

In- and outflows of gross capital are large and volatile and highly correlated. The fact that foreigners invest in a country often triggers or goes hand-in-hand with domestic agents investing abroad. The flows are pro-cyclical and in crisis periods there is retrenchment, depending on the origin of the shock either foreign or domestic agents' investments drop (see Broner *et al.*, 2011) and, with a short time lag, often the other gross capital flows drop. Stylised facts show us that this holds for high income countries, as shown in Graph 12, as capital in- and outflows move together, strongly upwardly from the 1970s to the 2000s. However, this positive correlation is far less visible for the low-income countries, as the graph shows. As the South-Mediterranean countries under investigation in this study are low-income countries measured as GDP per capita, apart from Libya, they are part of this group. It follows from graph 12 that gross capital inflows of low-income countries stabilised around 4% of GDP, while the gross outflows of these countries increased since the 1980s from 0.5% of GDP to almost 4% of GDP. The gap in capital in- and outflows, that is net capital inflows, has thus remained positive but gradually narrowed since the 1980s.

Graph 12 Gross capital inflows and outflows of high and low income countries



Source: Authors, based on Table 1 in Broner et al. (2011) with original data from the International Financial Statistics of the International Monetary Fund.

Note: These are capital flows by both foreign and domestic agents for 1970 until 2009, reporting the median value of country averages over trend GDP. The original median and high-income countries are averaged and presented here as only high-income countries. The group of low-income economies contains the South-Mediterranean countries as defined in this study, apart from Lebanon, Libya and the Palestine. Lebanon and the Palestine are not included in Broner's study. Libya is part of the medium income group.

b. Cross-border banking flows and the role of foreign banks

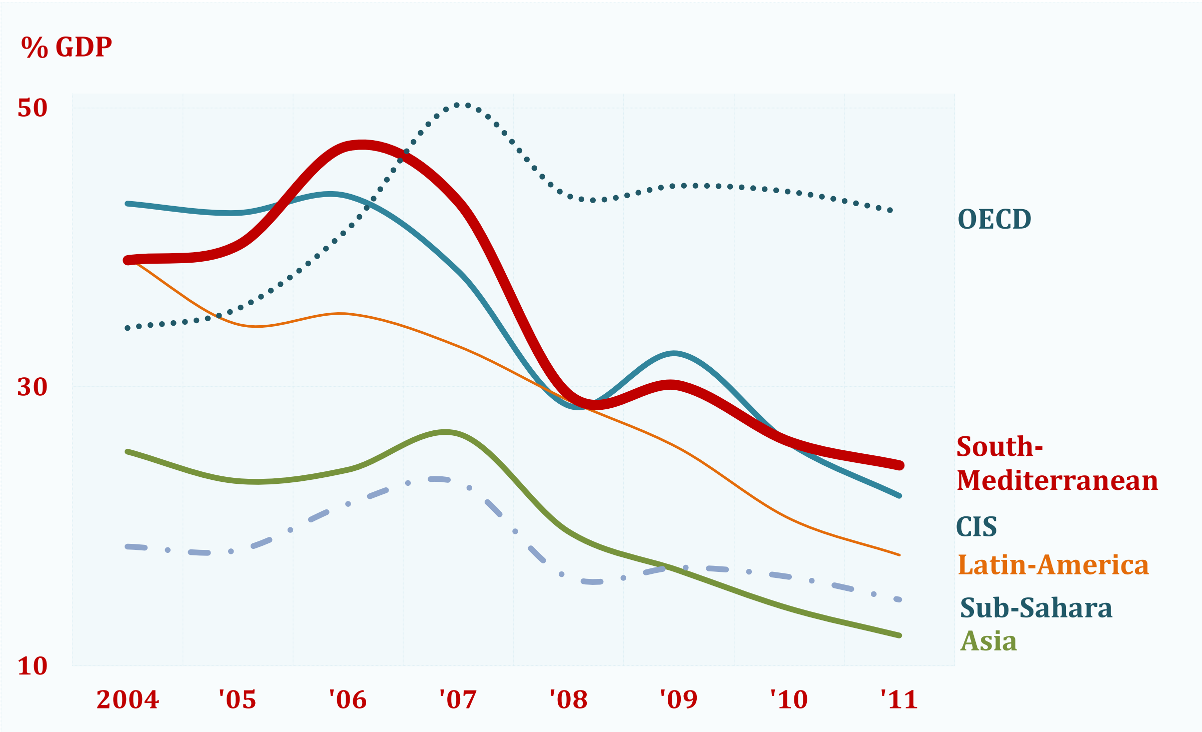
Now let us look again at cross-border banking, as we did with Graphs 5 and 6, but considering the region as a whole compared to other regions worldwide instead of the individual countries. We split the economies worldwide in six regions and distinguish between South-Mediterranean, Asia, the CIS, Latin-America, the OECD-countries and the Sub-Saharan economies.[4] Both in terms of assets as in terms of liabilities the group of OECD ranks high, as follows from Graph 13a and 13b, respectively. Up until 2007, assets moved speedily up to 50% of GDP while liabilities reached 17%-point higher, but this upward trend was evidently broken by the crisis. In the aftermath of the crisis, the OECD ranks still far above the five other groups. In terms of liabilities, the OECD has been far above any of the other groups for the whole period 2004-2011.

In sharp contrast, the South-Mediterranean has a shallow level of cross-border bank liabilities. Not only are the CIS, Asia and Latin-America relatively more indebted, but also the Sub-Sahara is more liable. In this respect, the high level of cross-border assets of South-Mediterranean banks is peculiar. Around 2004-06, the South-Mediterranean possesses as many foreign bank assets as the CIS and even the OECD, in terms of GDP. As we observed in Graph 6a that shows the assets as a percentage of GDP stacked in each year, and 6c that illustrated the absolute amounts, not only Libya, Lebanon, Jordan but also Egypt and Syria contributed here a great deal. Apparently, huge sums of money were repatriated to the South-Mediterranean or evaporated because of the bursting asset bubbles in the period from 2006 until 2008. In total, the assets came down 20%-points of GDP in only two years.

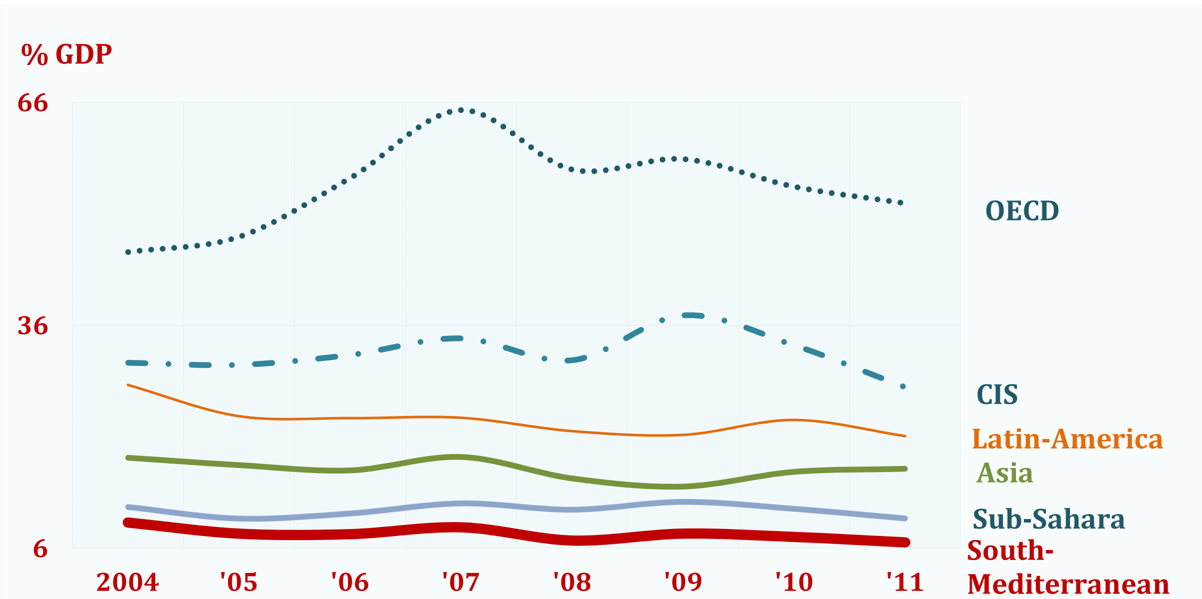
The CIS, Asia and Latin-America show a similar downward trend in cross-border bank assets in this period. Despite the fact that it was mainly the developed economies contained in the OECD-group that ran into most trouble after the global financial crisis (think of the European Union), the gap with the developing economies (South-Mediterranean, CIS, Latin-America) widened instead of narrowed. The higher exposure of the former to the other developed economies probably plays a role here.

[4] The CIS comprises all former Soviet economies, the Baltic countries and the non-OECD Eastern European economies.

Graph 13a Assets of the region's banks abroad



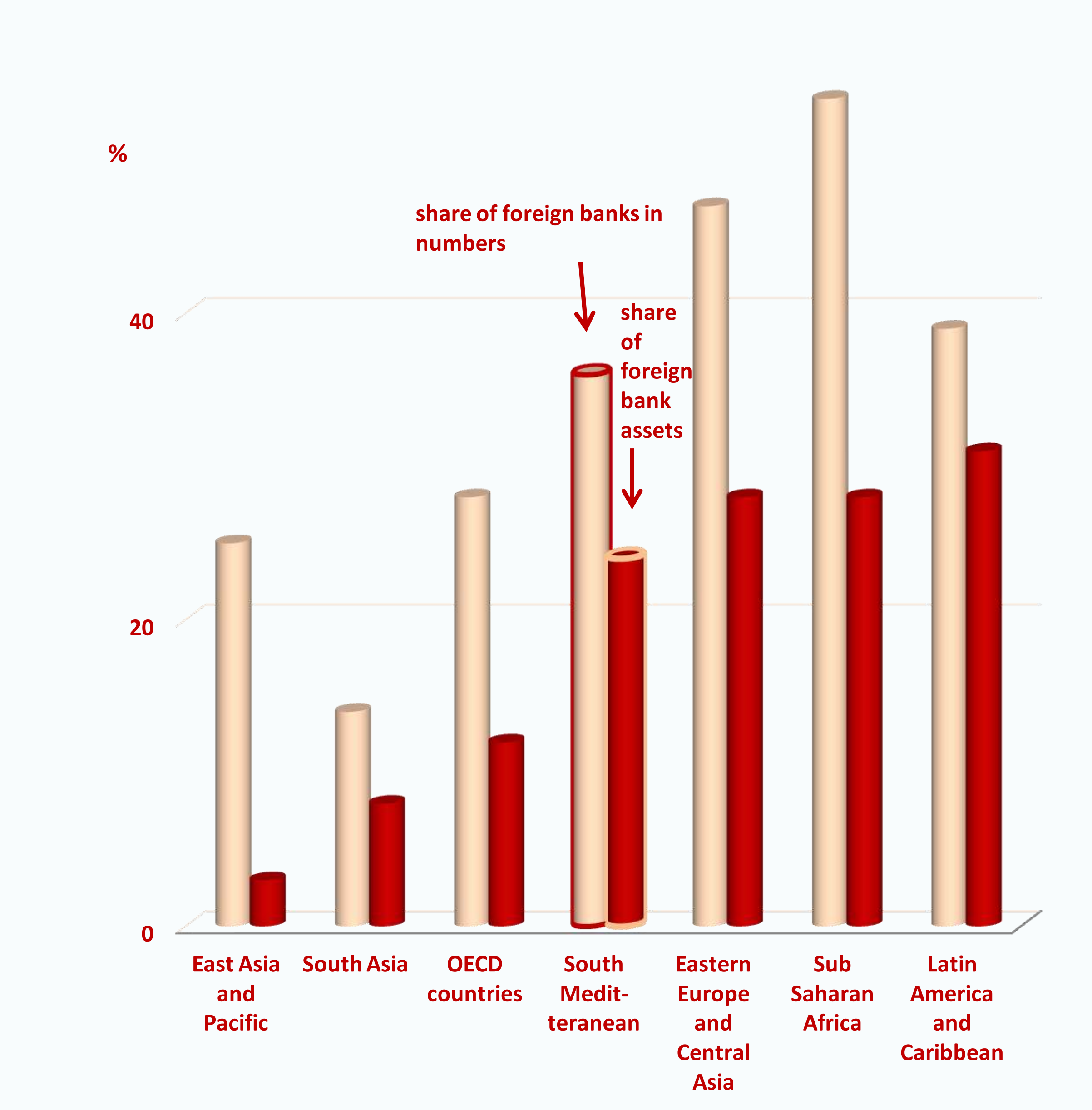
Graph 13b Liabilities of the region's banks abroad



Source: Authors on the basis of information from the Bank for International Settlements and the IMF World Economic Outlook.

Note: These series reflect the sum of a region's bank assets or bank liabilities as a percentage of the sum of the region's nominal GDP in each year. They include not only intra- but also interregional bank assets and liabilities of BIS reporting banks. Data for 2011 are only up and including the second quarter.

Graph 14 Foreign banks in the South-Mediterranean and other regions



Source: Claessens and Van Horen on the basis of Bankscope (2011).

Note: These are data for the year 2009. Due to lack of information Syria and Palestine are not included in the South-Mediterranean countries.

Foreign banks penetrated gradually into the South-Mediterranean markets, as Graph 13 shows. Their role in this region does not differ a lot from the role of these types of banks in the region of Eastern Europe and Central Asia, Sub-Saharan Africa, or Latin-America and the Caribbean. On average, the share in terms of foreign bank assets in total bank assets (domestic and foreign) was 24% in 2009, while 28-31% in these other regions. This follows from Graph 14. In comparison with East-Asia and Pacific and South Asia, but also the OECD countries with a share of only 12%, the influence in the South-Mediterranean was substantially higher.[5] As the group of OECD countries consists of high-income economies where domestic banks are numerous and with highly leveraged balance sheets, the low share of foreign bank assets is more due to the dominance of these domestic bank assets than to the low level of foreign bank assets. Foreign banks in OECD countries are often only niche players. In sharp contrast, in the South-Mediterranean region foreign banks matter more due to the weakly developed domestic banking sector that is so important for the financial intermediation and via this channel the further functioning of the real economy.

Some studies find that foreign bank presence in a country contributes to the financial stability of the domestic economy. In times of economic crisis, just like domestic banks, foreign banks reduce their domestic credit. This is shown by Claessens and Van Horen (2011) for the global recession year 2009. However, credit provided by foreign banks declined less than credit provided by domestic banks in countries with a majority of foreign banks while the reverse was true for countries with only a small share of foreign banks. This may be somehow artificial, for this specific recession year, as this crisis hit the developed economies via their own banks more than developing economies. Nonetheless, this finding is interesting for regions such as the South-Mediterranean. If it is true, foreign banks are conducive to the economy in terms of financial stability. If domestic banks contract in times of a domestic crisis, while foreign banks compensate for this behaviour by facilitating credit lines, the latter stabilise the banking sector and further financial system. Foreign banks can in this way also positively contribute to domestic economic growth.

[5] The OECD includes 27 countries, of which the US, Japan, most EU countries and other high-income economies.

c. Foreign direct investment

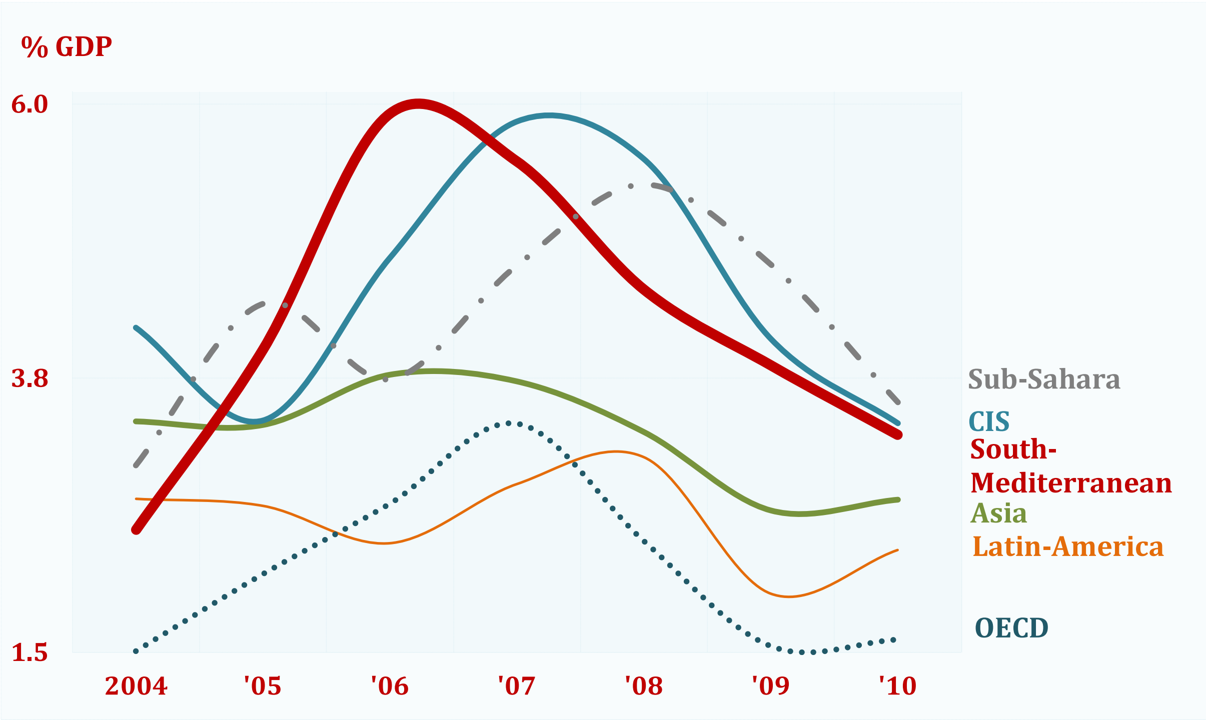
The South-Mediterranean region has succeeded quite well in attracting FDI, as follows from Graph 15a. However, the Arab Spring that started at the end of 2010 in Tunisia and spilled over to Egypt and Libya, and even to Syria, is troubling the situation. Other regions across the globe, such as the CIS and the Sub-Sahara, had almost comparable shares of FDI in recent years although they also suffered somehow in the aftermath of the global crisis.

The picture of the outward FDI, see Graph 15b, indicates that the South-Mediterranean is hardly a global player. Most other regions, even the majorly low-income Sub-Sahara, supersede it. Apparently the South-Mediterranean is not interested in investing abroad, or lacking the funds or knowledge to do so.

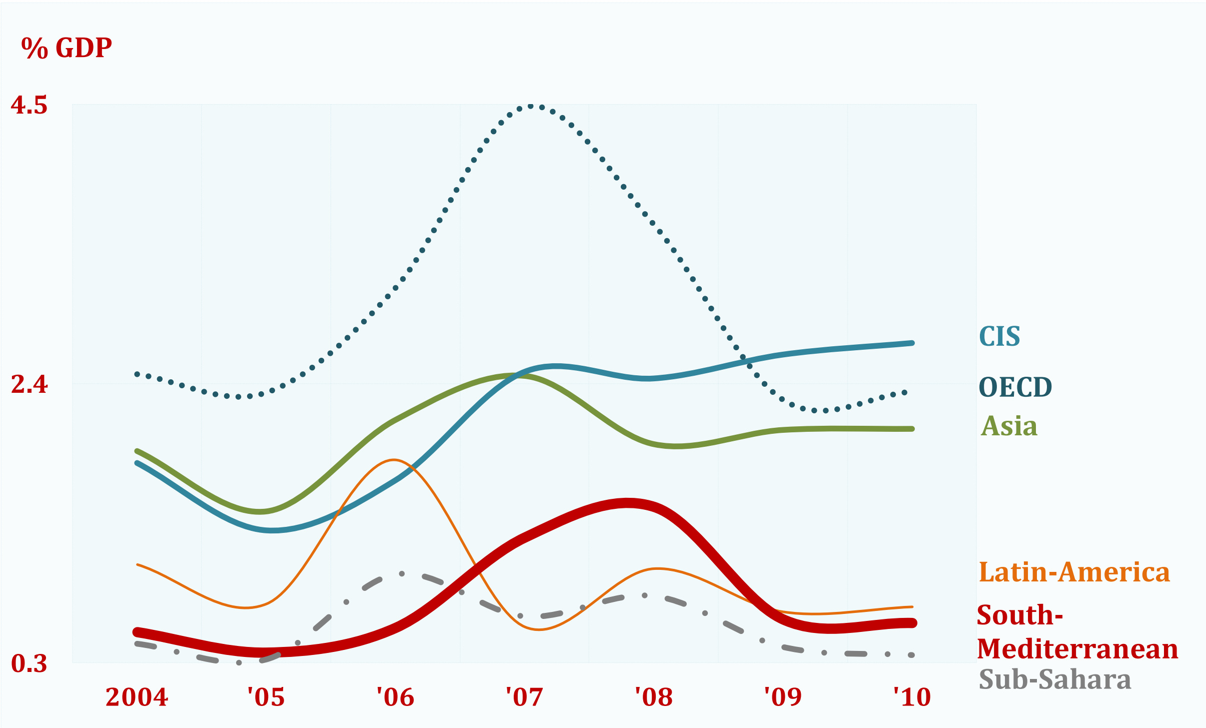
d. Remittances

The flows of remittances are more balanced (see Graph 16a and 16b). That is, the South-Mediterranean ranks highest in terms of inflows of remittances and at the same time quite high in terms of outflows. While, amongst other factors, the demographic pressure is pushing the South-Mediterraneans to seek work abroad (see Peeters, 2011a), there are relatively many foreigners working in these countries. This exchange of knowledge and information seems of high relevance if there is a wish to become a global player.

Graph 15a Inward FDI of the world regions



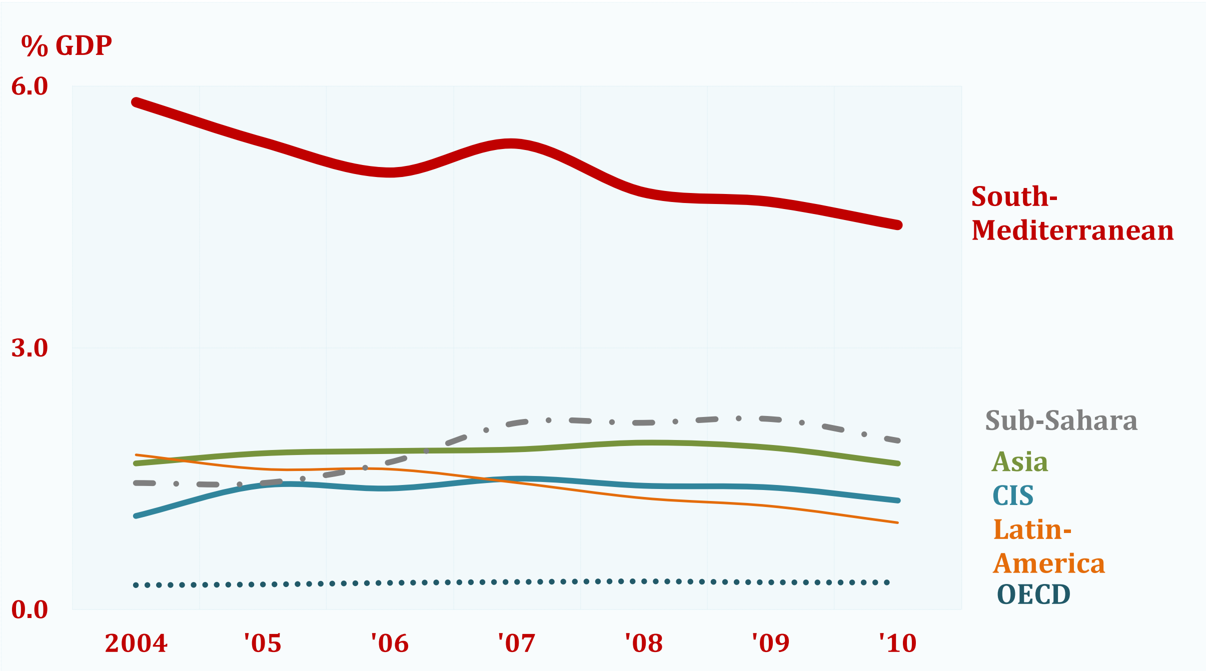
Graph 15b Outward FDI of the world regions



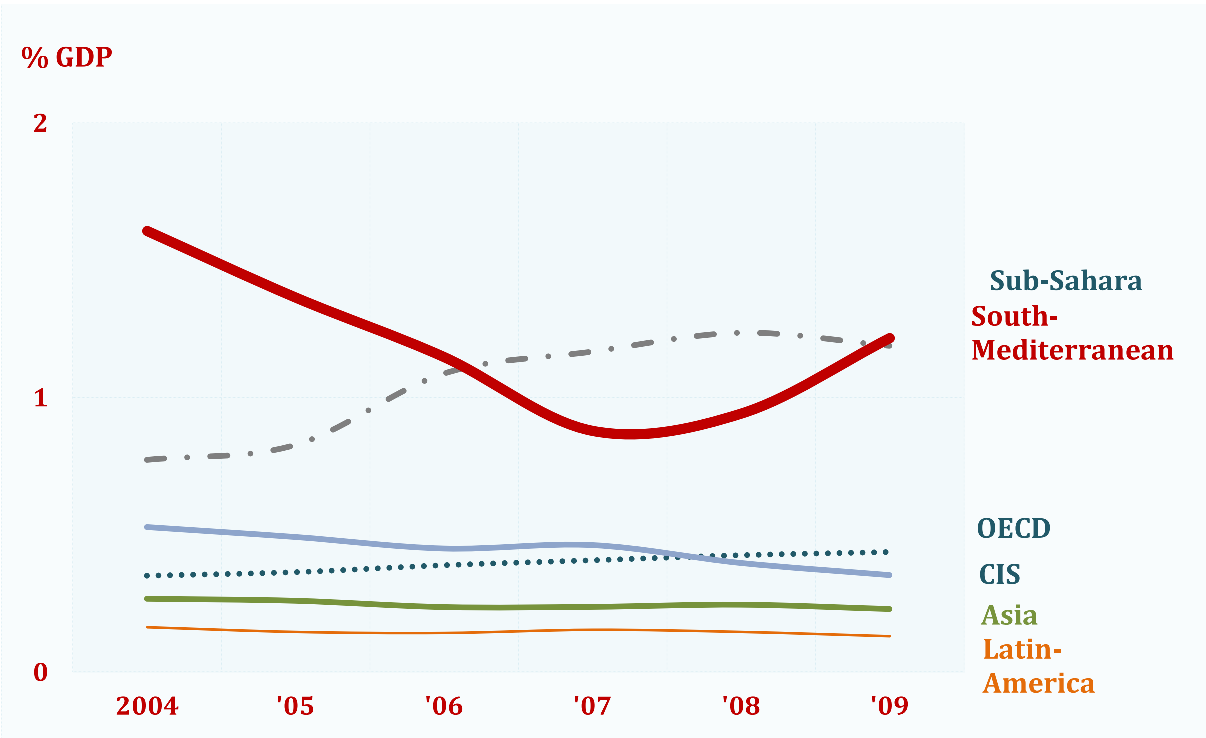
Source: Authors, on the basis of the United Nations UNCTAD database.

Note: These series reflect the sum of a region's bank inward or outward FDI as a percentage of the sum of the region's nominal GDP in each year. They include not only inter- but also intraregional bank assets and liabilities.

Graph 16a Inflows of remittances per world region



Graph 16b Outflows of remittances per world region



Source: Authors based on the remittances database of the World Bank and the IMF World Economic Outlook.

Note: These series reflect the sum of a region's bank in- and outflows of remittances as a percentage of the sum of the region's nominal GDP in each year. They include not only inter- but also intraregional bank assets and liabilities.

e. Monetary policy and exchange rate regimes

Monetary and exchange-rate policy evidently play a role in international transactions. This holds true in particular for the South-Mediterranean region. Some countries peg to the US dollar (Jordan and Lebanon) while others have a conventional peg to a basket of the euro and the US dollar or other currencies (Egypt, Morocco, Syria, Tunisia). This follows from Table 1. Palestine is a special case on integration, as it uses three foreign currencies. Although monetary policy transmission has become more effective over time, monetary policy is still very much geared towards exchange-rate targeting in most of these economies since the global crisis. Monetary policy and exchange rates do not necessarily hamper developments in international financial integration. However, the choice of countries with which the South-Mediterranean economies' financial markets integrate is often limited to those countries with which these countries have a relatively stable exchange rate. Jordan and Lebanon, for instance, integrate more with the United States and economies that have a fixed peg to the US dollar such as most of the GCC countries while Morocco and Tunisia are more interlinked with the euro area. In case of financial transactions with economies that have other currencies, financial transaction costs are high and expected benefits should be higher to compensate for these costs. The monetary policy and exchange rate regimes impact in this respect the financial integration, with neighbouring countries in the region itself, but also with other countries worldwide (see also Sabri *et al.*, 2012).

Table 1 Monetary and exchange rate arrangements

	Monetary policy	*Exchange rate policy*
Algeria	monetary targeting	managed float
Egypt	exchange rate targeting	managed float
Jordan	exchange rate targeting	conventional peg to the US dollar
Lebanon	exchange rate targeting	conventional peg to the US dollar
Libya	exchange rate targeting	conventional peg to the SDR*
Morocco	exchange rate targeting	conventional peg to the euro and the US dollar
Palestine	exchange rate targeting	no own currency, using the Israeli Shekel, Jordanese dinar and the Egyptian pound
Syria	exchange rate targeting	broad peg to the SDR*
Tunisia	exchange rate targeting	conventional peg to the euro and US dollar

Source: International Monetary Fund, national authorities and European Commission (2011).

* Special drawing rights (SDR) is a an international monetary reserve currency summing the values in US dollars, based on market exchange rates, of a basket of the euro, the Japanese yen, the pound sterling and the US dollar.

5. SUMMARY, POLICY REFLECTIONS AND CONCLUSIONS

This paper illustrates the financial integration of South-Mediterranean region, such as the trends in cross-border banking, foreign direct investment, remittances and other in- and outflows of capital across borders. It is carried out against the background of the scientific literature in which, many times deepening and broadening of financial integration is considered a virtue for economic growth and prosperity while, meanwhile, a global hurricane has shown the flipside of the coin called globalisation that had its eye of the storm in the financial sector of developed economies.

Our analyses concentrate on the economies of the Northern rim of Africa, that is Morocco, Algeria, Tunisia, Libya and Egypt, and in the Middle-East, that is Jordan, Lebanon, Syria and Palestine (where data permit us). The diversity in this region is broad. Jordan and Lebanon are most internationally financially integrated because of high inflows as well as outflows. The oil-endowed Libya and Algeria and to a lesser extent Syria had much money to spent, but only Libya spent significantly on FDI abroad. Apart from cross-border foreign bank assets, these economies are relatively closed. Intermediate cases are Morocco, Tunisia and Egypt. These resource-dependent economies are opening up their borders progressively, although the situation has become more uncertain for Egypt in view of the political upheavals.

In comparison with other regions worldwide, this group of South-Mediterranean economies is unique. Most countries of this group have high cross-border bank assets in combination with only little cross-border bank liabilities, high inflows of FDI and remittances and relatively high outflows of remittances. Apart from their low degree of cross-border bank indebtedness, they are more financially integrated in the world economy in comparison with Asia, the CIS, Latin-America and the Sub-Sahara.

We do not yet have a clear-cut answer to the question to what degree the South-Mediterranean region should integrate further in the world economy. There is a need for more insights gained from econometric research on the impact of cross-border flows on welfare and policy-related issues such as supervision frameworks and institutional settings.

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