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FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH IN THE MEDITERRANEAN ASSOCIATED COUNTRIES: CURRENT STATE OF AFFAIRS AND PROPOSALS FOR IMPROVEMENT

Adolfo Barajas and Seyed Reza Yousefi

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Financial Development and Economic Growth in the Mediterranean Associated Countries: Current State of Affairs and Proposals for Improvement

Adolfo Barajas and Seyed Reza Yousefi***

*Senior Economist, Asian Division, Institute for Capacity Development, International Monetary Fund.

**Department of Economics, University of Texas, Austin.

Abstract

Slow growth in the Mediterranean Associated Countries (MEDA) over the past three decades can be partly traced to underperformance by the financial sector. Several countries in the region lack financial depth, and the region as a whole has not fully benefited from the level of banking intermediation on offer, signaling a "quality gap." Policy should therefore aim to enhance banking competition by removing entry barriers and improving credit information, reduce the role of state banks, further the process of financial reform, and provide a financial infrastructure conducive to bank and financial market development. Moreover, quality of intermediation appears to be related to access, and MEDA countries have also underachieved in terms of providing access to financial services to large segments of the population, in particular, to small and medium-sized enterprises. Efforts to widen access should also lead to improvements in quality and, ultimately, higher long-run growth.

I. Introduction

A key challenge for the Mediterranean Associated Countries (MEDA)[1] is to generate higher rates of economic growth over the medium term. In order to raise living standards and to confront intensifying employment pressures over the coming years, the region will need to boost economic growth by several percentage points per year. For instance, analysis by Abdih and Garg (2011) reveals that for a group of six MEDA countries,[2] an estimated 18½ million additional jobs will need to be created by 2020 to absorb the current unemployed plus the projected new entrants to the labor force. At current growth rates, job creation will likely fall short by about 7½ million jobs.

Figure 1. Real GDP Per Capita Growth by Regions (Average 1980-2010, Percent)

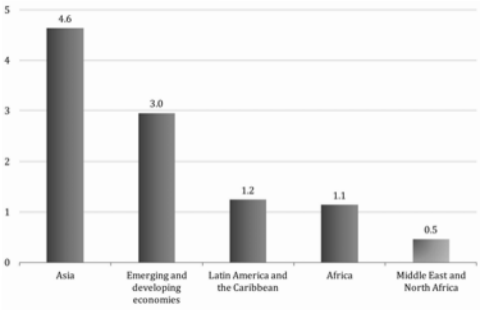
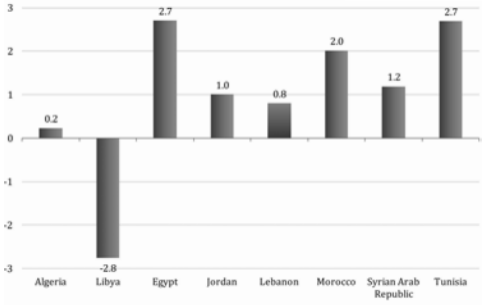


Figure 2. Real GDP Per Capita Growth in MEDA Countries (Average 1980-2010, Percent)



Source: IMF, World Economic Outlook.

Unfortunately, it is well documented that the wider Middle East and North Africa region has had disappointing growth performance over long periods of time relative to other emerging and developing countries (EDC). For example, during 1980-2010, real per capita GDP grew by an average 0.5 percent per year in the Middle East and North Africa, compared to 3 percent for EDCs on average, 4.6 percent in developing Asia, and 1.2 percent in Latin America and the Caribbean (Figure 1). Performance among the MEDA countries in particular has been mixed but unimpressive overall (Figure 2). While Egypt and Tunisia registered a 2.7 percent growth rate, approaching the EDC average, others have not done nearly as well: Morocco at 2 percent, Jordan and Lebanon at about 1 percent per year, Algeria at close to zero, and Libya with negative average growth.

Many researchers have sought to explain the growth underperformance across the Middle East and North Africa, and have pinpointed several possible contributing factors. Hakura (2004) and Guillaume and Rasmussen (2011) identified shortfalls in institutional quality and ease of doing business, excessive government consumption and, in the case of the oil importers in the region, to lack of trade openness. Bhattacharya and Wolde (2010) noted that the lack of access to credit was a key factor driving growth differentials relative to the rest of the world, along with a shortage of labor skills and of adequate supply of electricity.[3]

1. Throughout this paper, the MEDA group will refer to the following nine countries: Algeria, Egypt, Jordan, Lebanon, Libya, Morocco, Syria, Tunisia, and the West Bank and Gaza.

2. Egypt, Jordan, Lebanon, Morocco, Syria, and Tunisia, to whom the authors refer as the "MENA6".

3. All three variables are derived from the World Bank Enterprise Surveys, in which firms are asked whether different factors are considered a major constraint to their expansion: access to credit, and lack of appropriate labor skills or of electricity supply.

More recently, Barajas, Chami and Yousefi (2011a, 2011b) examined whether there might be a financial sector dimension to the Middle East and North Africa growth problem, either because financial systems there had not developed or deepened sufficiently, or because the deepening that did occur had not been as effective as in other regions in providing intermediation services that ultimately would enhance economic growth. The study found that, at least at the aggregate level, financial depth did not seem to be an issue for the region as a whole, although there was significant variation across countries in the region. Some countries–particularly the oil-rich Gulf Cooperation Council (GCC) countries–displayed levels of financial depth comparable to those in the most advanced EDCs, while others had very small banking systems with little intermediation activity and relatively inactive or non-existent stock markets. Moreover, even when a country exhibited a level of banking sector depth that was adequate by international standards, there seemed to be an unexploited potential for even greater intermediation. Finally, for a given level of banking depth, the Middle East and North Africa indeed was shown to deliver significantly smaller growth benefits than in other regions, thus signaling a "quality gap" in intermediation relative to the rest of the world.

In this paper we revisit this issue, focusing on the MEDA countries in particular and assessing to what extent they share the characteristics identified for the Middle East and North Africa region as a whole. There are two key reasons to suspect that MEDA countries do behave differently from the rest of the region, the first being that, with the exception of Algeria and Libya, they are not significant hydrocarbon exporters. Recent studies have shown that there is also a "resource curse" associated with the financial sector; in comparison to non-hydrocarbon exporting countries, the financial sector contribution to investment tends to be weaker (Nili and Rastad, 2007) and the direct impact of its banking sector on economic growth is smaller (Barajas, Chami, and Yousefi, 2011a).

A second key difference between MEDA and other Middle East and North Africa countries is that their income level is somewhat intermediate between that of the GCC countries (with a World Bank classification as High Income, Non-OECD), on the one hand, and that of Sudan and Yemen (Low-Income Countries). MEDA countries are classified as Lower Middle Income Countries. To the extent that the level of financial development as well as its impact on growth depends on income level, this would distinguish MEDA countries from the rest of the region.[4]

In the following sections of the paper, we separate into two parts the question of whether there is a financial sector component to the lackluster growth performance observed in the MEDA countries over the past several decades. First, in Section II we ask whether the level of financial depth itself appears to be an impediment for sustaining higher growth rates. Second, in Section III we investigate whether a given level of financial depth produces smaller impacts on growth

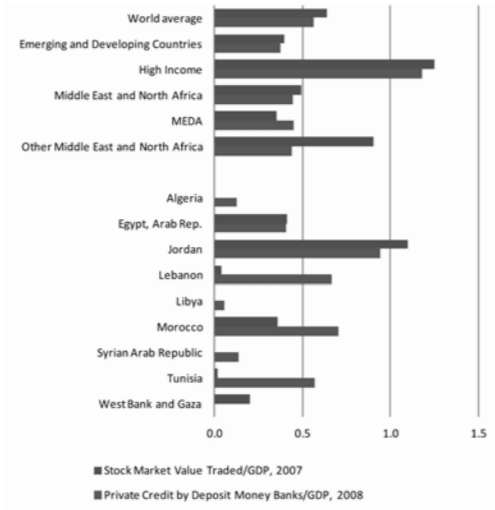
4. In a related study, Barajas, Chami and Yousefi (2012) also find that the growth benefits from banking depth increase with income level.

in the MEDA countries relative to the rest of the world. In Section IV we investigate possible causes for disparities between MEDA and other regions, based on the findings in the previous two sections. Finally, in Section V we conclude with a discussion of policy options for enhancing the financial sector's contribution to economic growth.

II. Is It Lack of Financial Depth?

A vast literature now exists which establishes that a vibrant, dynamic, and well-functioning financial sector leads to a host of improved economic outcomes. In particular, there is widespread evidence that *financial depth*—the extent to which an economy is making use of bank intermediation and financial market activity—is associated with higher rates of economic growth. On the basis of two common measures of financial depth—the ratio of private credit to GDP for bank intermediation, and the stock market turnover ratio[5] for market activity—on average countries in the Middle East and North Africa do not appear to be lacking relative to other regions. For example, in 2008 the average private credit-GDP ratio for this region was, at 45 percent, substantially higher than the emerging economy average of 38 percent, although well short of the 118 percent level typically observed in high-income countries. In 2007, stock market turnover in the region was close to 50 percent, a full ten percentage points higher than for the average emerging and developing economy (Figure 3).

Figure 3. Financial Depth in MEDA Countries in International Comparison



Source: World Bank Database on Financial Structure, 2010, and International Financial Statistics.

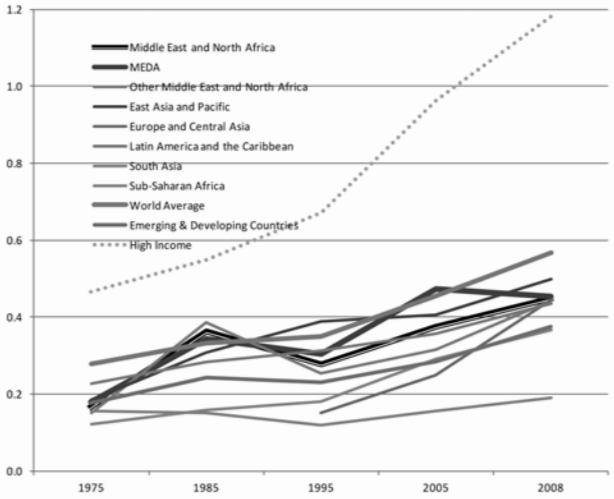
More specifically, MEDA financial systems on average do not appear to be particularly shallow. In 2008 the average private credit-GDP ratio for MEDA was, at 45 percent, virtually identical to that of the wider Middle East and North Africa. However, stock markets in MEDA countries were substantially less developed than in the wider region, with a turnover ratio of 36 percent in comparison to 91 percent for other countries in the Middle East and North Africa, although they compared favorably to the 30 percent average for the emerging countries as a whole, and even so with the 21 percent average for the East Asia and Pacific region.

However, several qualifications should be made. First, there is considerable heterogeneity within MEDA countries. In particular, Jordan, Lebanon, Morocco, and Tunisia exhibit markedly deeper

5. Defined as the ratio of the total value of shares traded to GDP.

banking systems, with depth well above 50 percent of GDP, while others, such as Algeria, Libya and Syria, register depth below 15 percent of GDP (Figure 3). With regard to equity markets, Jordan stands out as having particularly high activity–turnover of 110 percent–while Egypt and Morocco are at about the EDC average, and the rest of MEDA countries are well below.

Figure 4. International Comparison: Private Credit by Deposit Money Banks/GDP, 1975-2008



Source: World Bank Database on Financial Structure, 2010, and International Financial Statistics.

Second, trends in bank deepening over time are not encouraging for MEDA countries. Although they deepened substantially along with other regions from 1970 to 2005, this is the only region that failed to deepen further after 2005, with private credit to GDP falling by two percentage points up to 2008 (Figure 4). Although it is quite possible that many banking systems in other regions were engaging in unsustainably high rates of bank lending in the run-up to the global financial crisis, the observed pre-crisis credit stagnation in MEDA should be cause for some concern, at the very least to merit further study to identify its main causes.

Third, MEDA countries rank the lowest in terms of converting bank deposits into private sector credit. For the average MEDA banking system in 2008, credit represented 54 percent of bank deposits, as opposed to over 80 percent for other Middle East and North Africa countries, and almost 70 percent for the average EDC (Figure 5a). In this regard, it is Jordan, Lebanon, and Morocco who are situated at about the EDC average, with the rest of the MEDA countries falling well short. Furthermore, over three decades the ratio has fallen more rapidly in MEDA than anywhere else, and has continued to fall over the past decade, while beginning to recover in other regions (Figure 5b). Thus, in most MEDA countries there is substantial untapped potential in the form of deposits that could be channeled into productive activities.

Figure 5a. Bank Credit/Deposits in MEDA Countries, 2008

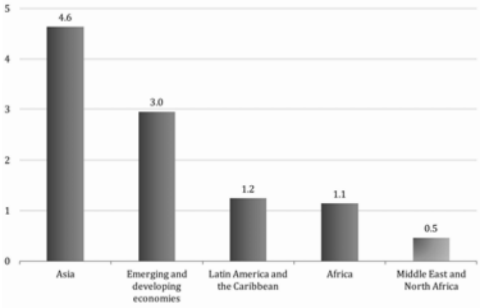
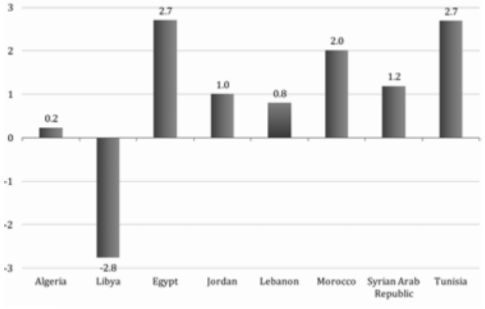


Figure 5b. International Comparison: Private Credit/Bank Deposits, 1975-2008



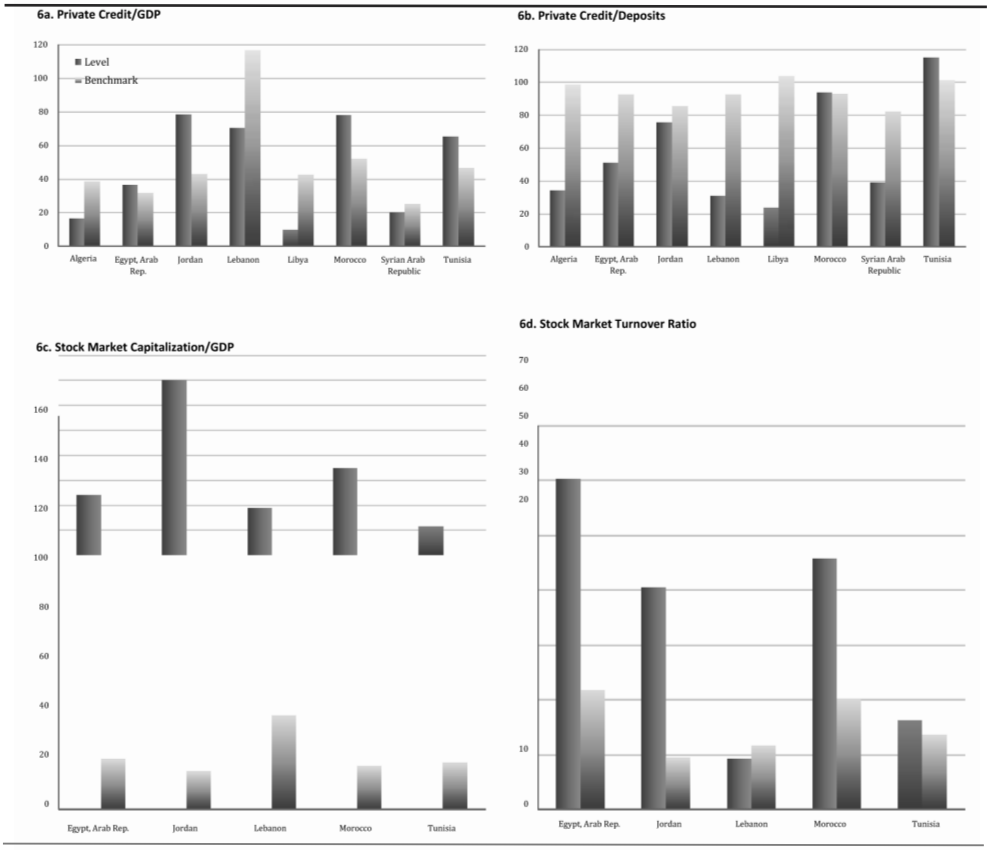
Source: World Bank Database on Financial Structure, 2010, and International Financial Statistics.

Finally, the level of financial depth achieved by a given country is undoubtedly related to structural factors, that is, characteristics of the economy that cannot be easily modified through policies in the short term. For instance, it is reasonable to expect that rich countries with a large and mainly urban population naturally would have higher levels of financial depth relative to poorer countries with smaller and more disperse populations. This is due to the fact that there would be greater demand for financial services in the former countries, and there would be more conducive conditions for the supply of these services as well.

Bearing this in mind, we also ask to what extent the observed financial depth in MEDA is attributable to the structural factors. Recent work by the World Bank (Al Hussainy et al., 2011) has in fact undertaken this exercise empirically for a large group of countries across all regions, by estimating a "benchmark" or expected level of financial depth given a country's structural characteristics: its income, population level and density, age dependency ratios, and whether it is a fuel exporter, an offshore financial center or a transition economy. In other words, the estimated benchmark permits a comparison between the level achieved by a given country and that of its structural peer group. This comparison in turn sheds light on the effectiveness of policy, as under or overperformance relative to the peer group indicates to what extent policy variables–the non-structural determinants–have been contributing to financial deepening in the country in question.

Based on the World Bank estimates, in 2009 four MEDA countries–Egypt, Jordan, Morocco, and Tunisia–exhibited ratios to GDP of both private sector credit and stock market capitalization above their benchmarks, and thus are overperforming relative to their peer groups. However, as implied earlier, performance on the ratio of credit to deposits was lacking throughout the MEDA countries; except for two–Lebanon situated at the benchmark level and Tunisia overperforming by some ten percentage points of GDP–MEDA countries fell short of the structural benchmarks. Finally, for the five countries where data is available, all but Lebanon experienced levels of stock market activity above the benchmark (Figure 6).

Figure 6. Financial Depth Performance of MEDA Countries in Comparison to their Estimated Structural Benchmarks, 2009



Source: World Bank, Finstats Database.

To sum up our reading of the data on financial depth, it appears that MEDA countries as a whole are not lagging behind the rest of the world. However, we also observed considerable heterogeneity within the region, and there is certainly a subset of countries that could stand to benefit from greater financial depth, particularly those that exhibit depth below the benchmark levels that one would expect given their structural characteristics. For banking intermediation in particular, four countries are markedly below the emerging and developing country averages, and another five are well below the world average. There is even greater room for improvement regarding financial markets, where the turnover ratio in at least ten of the countries lies below the emerging and developing country average, although the comparison with the benchmark levels reveals that structural characteristics play an important role in constraining further stock market development.[6] Finally, where MEDA countries are most clearly underperforming is in converting deposits to private sector credit; not only did we observe a persistent gap in the credit-deposit ratio with respect to all other regions, we also noted a gap with respect to the structural benchmark in all but one of the countries, Tunisia.

6. Note that, due to data limitations, not all MENA countries are included in this sample. Also, it is reasonable to assume that financial market activity is relatively small in the four countries for which the turnover ratio is not available.

III. Is There a “Quality Gap” as Well?

Thus, lack of financial depth would certainly appear to be a factor limiting growth in several MEDA countries. The next logical question is whether it is also the case that, for the same level of financial depth, MEDA countries might be obtaining a smaller positive impact on growth relative to other regions. That is, the *quality* of finance might also be lagging.

First, a brief description of the body of research relating financial depth to economic growth. Beginning with the seminal study by King and Levine (1993), researchers have related different measures of financial depth[7]—the extent to which an economy is making use of bank intermediation and financial market activity—to rates of economic growth for a large group of countries and over an extended period of time, at least three decades. The financial depth indicators have been introduced as explanatory variables into regression equations, either in a pure cross-section sample of countries, or in a panel data setting that combines both time and cross-country variation. The regressions usually have included several control variables that have proven to explain long-run economic growth, for instance, educational attainment, ratios of public consumption and foreign direct investment to GDP, terms of trade, and initial levels of per capita GDP. The main finding has been that financial depth—both in banking and in stock market activity—exerts a robust, positive, and economically important effect on economic growth.

Until recently, the empirical studies assumed that this effect was identical across countries; a single, homogeneous coefficient was obtained for the financial depth variables in these regressions. However, there has also been increasing interest in examining possible sources of cross-country heterogeneity in these relationships. For example, Khan and Senhadji (2000) and Khan, Senhadji and Smith (2001) found that, above a certain threshold, inflation begins to slow growth in developing and industrial countries, and above another threshold, inflation begins to impede financial deepening. Arcand, Berkes and Panizza (2011) found that the positive impact of banking depth on growth weakens progressively as depth increases to very high levels. Eventually, when private sector credit exceeds 110 percent of GDP, the marginal effect of additional deepening on economic activity becomes negative, both at the economy and industry level. Nili and Rastad (2007) focused on oil exporters, and found that they tend to exhibit lower financial depth and that the positive impact of their financial depth on aggregate investment is substantially weaker.

The results of our research reveal that MEDA countries appear to suffer from a "quality gap" in banking. In three recent studies, (Barajas, Chami and Yousefi, 2011a and 2011b, and Barajas, Chami and Yousefi, 2012), we explored whether the effect of financial depth on growth might vary across regions or between oil exporters and other countries.[8] We found evidence that the impact

7. Several indicators have been used to measure banking sector depth, such as the ratio of liquid liabilities to GDP, or M2 to GDP, or—as in this paper—of private sector credit to GDP. For stock market activity, the indicators noted here—market capitalization to GDP, the value of shares traded to GDP, and the value of shares traded to capitalization—the *turnover ratio* for market activity—have also been used frequently.

8. Regarding the analysis of oil exporters, we introduced several improvements and extensions over previous studies, such as Nili and Rastad (2007) and Beck (2011), by (1) employing *both* a cross-country regression and a dynamic panel method; (2) using a longer and more updated sample period and taking non-overlapping five-year averages of all variables, rather than annual observations; (3) building a more comprehensive country sample, with up to 144 countries included in some regressions; (4) in particular, an expanded sample of oil exporters; (5) running regressions for *non-oil* GDP in addition to total GDP growth; and (6) examining the impact of the stock market activity in addition to that of the banking system.

Table 1. The Impact of Banking Sector Depth on Growth, 1980-2005

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Explanatory variables	Dependent variable: Real per capita GDP growth							
Private Credit	0.013 ***	0.016 **	0.016 **	0.011 ***	0.012 ***	0.012 *	0.011 ***	0.012 ***
	(3.473)	(2.342)	(2.425)	(3.033)	(2.810)	(1.960)	(2.934)	(2.886)
Private Credit x Financial Crisis	-0.006 ***	-0.005 ***	-0.006 ***	-0.006 ***	-0.006 ***	-0.006 ***	-0.006 ***	-0.006 ***
	(-5.624)	(-2.670)	(-2.796)	(-5.204)	(-4.864)	(-4.012)	(-5.543)	(-4.678)
Heterogeneity: Differences in the growth impact by region								
Private Credit x Middle East and North Africa		-0.005 *	-0.004					
		(-1.765)	(-1.263)					
Private Credit x MEDA						-0.007 *		
						(-1.732)		
Private Credit x non-MEDA						-0.001		
						(-0.364)		
Private Credit x East Asia & Pacific		-0.002	-0.003			0.000		
		(-0.389)	(-0.575)			(-0.089)		
Private Credit x Europe & Central Asia		0.011 **	0.012 **			0.014 **		
		(2.043)	(2.052)			(2.425)		
Private Credit x Latin American & Caribbean		-0.006 *	-0.006			-0.004		
		(-1.783)	(-1.624)			(-1.181)		
Private Credit x South Asia		-0.008	-0.007			-0.004		
		(-1.420)	(-1.310)			(-0.734)		
Private Credit x Sub-Saharan Africa		-0.008	-0.008			-0.005		
		(-1.418)	(-1.414)			(-0.911)		
Heterogeneity: Differences in the growth between oil exporters and non-oil exporters								
Private Credit x Oilexp				-0.007 **			-0.008 **	
				(-2.255)			(-2.289)	
Private Credit x Oildep					-0.030 ***			-0.028 ***
					(-3.118)			(-2.816)
Private Credit x Oilexp x MEDA							0.003	
							(0.524)	
Private Credit x Oildep x MEDA								0.047 ***
								(3.530)
Observations	678	670	678	678	637	678	678	637
Number of countries	146	142	146	146	144	146	146	144
AR2	0.927	0.879	0.936	0.832	0.928	0.991	0.832	0.936

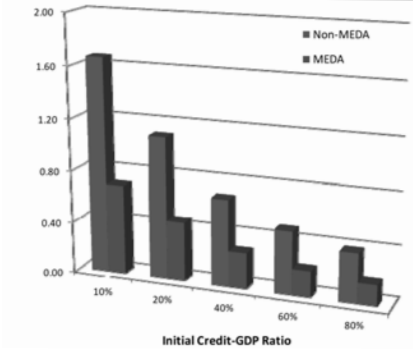
This table shows the results of dynamic panel regressions for growth of real total per capita GDP using a GMM procedure following Arellano and Bover(1995). The explanatory variables are: Oilexp, a dummy variable for oil exporting countries; Oildep, the share of oil GDP in total GDP; and Private credit, the ratio of bank credit to the private sector to GDP. Other control variables (not reported) are Education, the percentage of gross secondary school enrollment; Initial income, initial GDP per capita; and FDI expressed as a percentage of GDP. Some specifications also include interactions between private credit and regional dummy variables and/or either Oilexp or Oildep. Data are averaged over non-overlapping five year periods beginning in 1980. Robust t-statistics are shown in parentheses, and significance at the 1 percent (***), 5 percent (**), and 10 percent (*) levels are indicated.

of banking sector depth is weaker for both Middle East and North Africa countries and for oil exporters in general, although we were unable to detect similar differences regarding the impact of stock market activity. Moreover, when we applied the analytical approach to the MEDA countries more specifically, we confirmed the previous finding; in fact, the weaker impact of banking in the Middle East and North Africa appears to be driven to a large extent by the MEDA countries. Relative to other regions–advanced countries as well as most EDCs–the growth benefits of a given level of banking depth are estimated to be about 58 percent lower in MEDA, whereas non-Mediterranean countries in the Middle East and North Africa derive growth effects from banking similar to those in advance of other EDCs. In some regressions, the overall coefficient becomes non-significant for MEDA countries, thus implying that banks have had a negligible growth impact. However, in contrast to other regions, the more oil-dependent MEDA countries tend to fare slightly better.

Table 1 summarizes the results of our analysis of banking depth and growth estimated over the 1980-2005 period. For the average Middle East and North Africa country, the coefficient of real per capita GDP growth on the private credit-GDP ratio is about 0.011, as compared to 0.016 (Column (2)), meaning that, for the same level of overall bank intermediation, the growth impact will be a third lower. Looking within the region, the impact for MEDA countries is about 60 percent lower (Column (6)), a coefficient of 0.005, as compared to 0.012), while that of non-MEDA countries is virtually indistinguishable from that of advanced countries.[9] The analysis also shows that the lower growth impact–the quality gap–exists for oil exporters in general (Column (4)), and increases with the degree of oil dependence (Column (5)). However, MEDA oil-dependent countries appear to perform slightly better than countries with similar levels of oil dependence in other regions (Column (8)).

How large are the estimated effects on growth? On the basis of the regression results, we calculated the predicted impact of sizable increases in banking depth and stock market turnover on growth. For banking depth, we considered the impact of increasing private sector credit by 30 percentage points of GDP, roughly equivalent to the deepening achieved by high-income countries between 1995 and 2005, and slightly greater than the deepening that would be required for Libya to achieve the EDC average level of 38 percent. As Figure 7 shows, the growth impact can be sizable in many countries. For example, for Algeria, Libya or Syria, who start from credit-GDP ratios of around 10 percent, deepening by 30 percentage points, would increase annual per capita growth by about ¾ of a percentage point. However, non-MEDA countries starting at the same initial depth would derive considerably larger growth benefits; for example, similar deepening in Armenia or Mexico would raise growth by 1½ percentage points, reflecting the quality gap in banking in the MEDA countries. For countries further along in their financial development, the gains from further deepening are not as large.[10] For example, Egypt, a starting from a credit-GDP ratio just above 40 percent, would obtain an additional one-fifth of a percentage point in annual growth, whereas a similarly deep non-MEDA country, say, Macedonia, would obtain an additional one-half of a percentage point.

Figure 7. Estimated Impact on Real Per Capita Growth of 30 Percentage-Point Increase in Credit-GDP (Percentage Points)



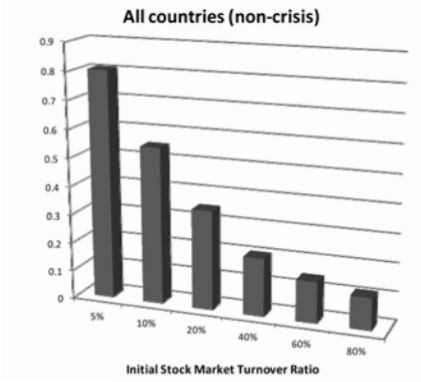
Source: Authors' calculations.

9. Note that the coefficients showing heterogeneity across regions refer to a comparison with respect to high-income or advanced countries. Thus, a coefficient that is not statistically significant from zero indicates that the given region obtains a growth impact equivalent to that of high-income countries.

10. This is a common result in this literature, a product of growth equations being estimated in logarithmic terms.

Regarding the level of stock market activity, we calculated the predicted impact from an increase in turnover by 20 percentage points of GDP, equivalent to the increase in the world average between 1995 and 2005, although somewhat higher than that obtained on average by the EDCs. Figure 8 illustrates the potential gains from increasing stock market activity. As in the case of banking sector depth, the additional increase in growth is greater the lower is the initial level of turnover. For example, Tunisia and Lebanon, with turnover ratios of close to 5 percent in 2007, would increase their growth rates by four-fifths of a percentage point, while Morocco or Egypt, at about 40 percent turnover, would increase growth by one-fifth of a percentage point. Furthermore, note that there is no measured quality gap in stock market activity; the estimated gains do not vary noticeably across regions.

Figure 8. Estimated Impact on Real Per Capita Growth of a 20 Percentage-Point Increase in Stock Market Turnover (Percentage Points)



Source: Authors' calculations.

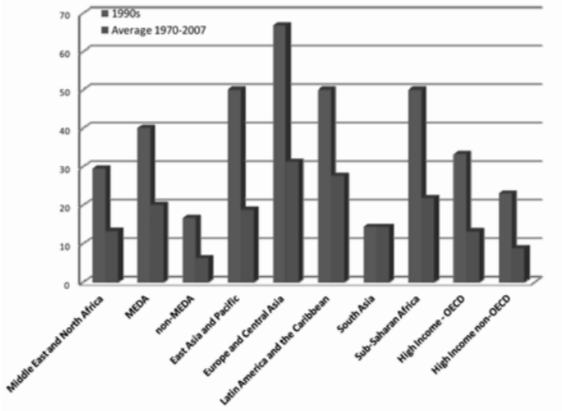
A final issue to consider in analyzing the benefits of financial deepening is the role played by banking crises. It has been recognized that these events, often associated with excessively high rates of credit growth, can set back the process of economic development quite considerably. Indeed, following the arguments of Rousseau and Wachtel (2011), we control for the occurrence of systemic banking crises in our regressions, and find that they tend to reduce the impact of deepening on growth by up to one-half (Table 1). This differentiation is particularly relevant after 1990, given that about 60 percent of all systemic crises that occurred during the 1970-2007 period did so in the 1990s. Thus, in our preceding discussion of different growth effects across regions and between oil exporters and non-oil exporters, it should be stressed that these comparisons refer to economies during normal, or non-crisis times.

How important is this distinction for MEDA countries? It is apparent that banking systems in the Middle East and North Africa have been relatively immune from systemic crises. Throughout the 1970-2007 period, this region had the lowest incidence of financial crisis among the emerging and developing world (Figure 9).[11] Within this region, MEDA countries were relatively more prone

11. In particular, the GCC has only witnessed one major banking crisis during this period, in 1982 in Kuwait.

to banking crises—one-fifth of country-decades were in crisis throughout this period, compared to 10 percent for the non-MEDA countries in the region, or 14 percent for South Asian countries. However, this is still appreciably lower than the frequency observed in other regions, such as Latin America, at 28 percent.

Figure 9. Frequency of Systemic Banking Crises
(Percentage of Countries Experiencing a Crisis)

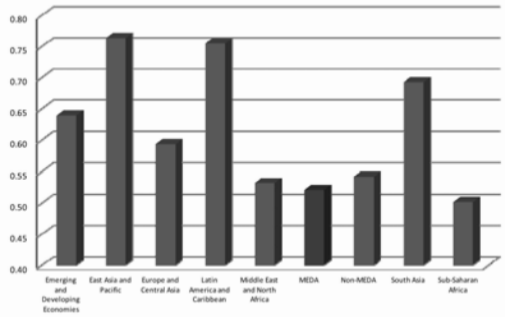


Source: Laeven and Valencia (2008) and authors' calculations.

IV. Possible Causes

What can explain the relative lack of financial depth in certain MEDA countries, on the one hand, and our estimated quality gap in banking intermediation, on the other? Here we consider a number of areas in which the literature has identified shortcomings in MEDA financial systems, which provide clues as to what may be driving the estimated underperformance described in the previous sections.

Figure 10. Banking Competition, Average H-Statistic Estimated Over 2002-2008
(Scale:1 = Perfect Competition; Positive but <1 = Monopolistic Competition)



Source: Anzoategui, Martínez Pería and Rocha (2010) and authors' calculations.

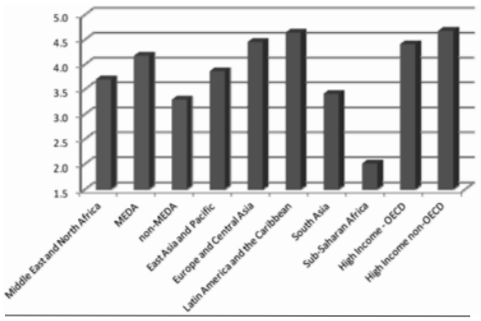
First is the comparative lack of competition in MEDA banking systems. A recent World Bank study analyzed bank pricing over the 1994-2008 period for a worldwide sample of countries, specifically the extent to which changes in input prices are transmitted to the output prices. It revealed that banking systems in the Middle East and North Africa, and particularly the MEDA countries, tend to behave as under monopolistic competition, and are significantly less competitive than in other regions, with the possible exception of Sub-Saharan Africa.[12] Furthermore, it identified two major factors contributing to the lack of competition: a deficient environment regarding credit information, and relatively strict obstacles to entry into the banking market. Figure 10 illustrates these findings, showing how the estimated degree of competition–the H-statistic–in MEDA countries is low by international standards, and Figure 11 shows their low quality of credit information relative to Latin America and the Caribbean and Europe and Central Asia, although they compare favorably with South Asia and Sub-Saharan Africa.

Second is bank ownership. Many countries in the region are characterized by a relatively high share of state banks and/or a relatively small share of foreign-owned banks (Figure 12), both of which are related to the obstacles to entry alluded to above. However, it is also important to point out stark differences that are visible across the MEDA countries. At one extreme, Algeria, Libya and Syria have a dominant role played by state banks–in 2008, the asset shares approached 100 percent in the first two, and about 70 percent in the latter–and essentially no entry of foreign banks. At the other extreme, Lebanon and Jordan have zero state bank participation, while having permitted substantial foreign bank penetration. The remaining countries lie somewhere in between, with state

12. The Anzoategui, Martínez Pería and Rocha (2010) study estimated banking competition indicators for a large sample of countries and tested for differences across regions. They found competition to be significantly lower in the Middle East and North Africa relative to all other regions except Sub-Saharan Africa.

bank participation that is high by international standards–between 37 and 57 percent market share in 2008–and with modest foreign bank participation, below international averages.

Figure 11. Credit Information Index Scale: 0 (Poor Access, Quality) to 6 (High Access, Quality)



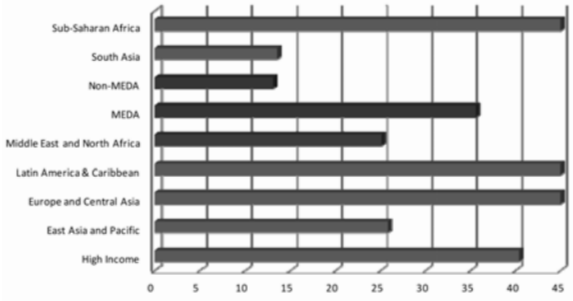
Source: World Bank Ease of Doing Business Database.

Figure 12. Share of Public and Foreign Banks throughout the World, 2002

Source: Micco, Panizza and Yañez (2007); Farazi, Feyen and Rocha (2011) and authors' calculations.

What are the consequences of having relatively high state bank participation and low foreign bank participation? Regarding state banks, their strong presence has often been cited as a factor limiting financial development, yet the question of whether they exert an independent negative impact on growth–for example, via a lower quality of bank intermediation–is not clear-cut. However, one recent study identified two factors that combine to produce significant negative growth effects from state ownership of banks: low levels of financial depth and low institutional quality.[13] Within the country sample analyzed, two MEDA countries–Egypt and Syria–fell in the group for which state ownership was likely to undermine growth. As to foreign banks, their entry and presence has often been linked to improvements in banking sector performance and competition, thus suggesting potential benefits in certain MEDA countries from greater opening to foreign banks, although on average these countries appear be further along than the rest of the Middle East and North Africa (Figure 13).

Figure 13. Foreign Bank Entry:
Percentage of Foreign Banks among Total Banks, By Country, 2008



Source: Claessens and Van Horen (2012).

13. Korner and Schnabel (2010) analyzed the impact of state banks of economic growth during 1970-2007. The institutional variables considered were: democracy, political rights, bureaucracy quality, and corruption control.

14. They conducted their analysis on a sample of nine countries: eight MEDA countries (all except the West Bank and Gaza) plus Yemen.

A recent study on bank ownership in MEDA countries (Farazi, Feyen and Rocha, 2011)[14] showed that state banks tend to have lower profitability, higher costs, and higher rates of nonperforming loans. They attributed this behavior to three interrelated mandates served by state banks in the region: (1) a government financing mandate, which directs a large portion of their lending to the public sector in general; (2) an employment mandate, which leads to higher labor costs at the unskilled levels; and (3) a development mandate, whereby their financing is directed toward favored sectors of the economy. Foreign banks were found to behave similarly to their domestic private counterparts, but their market penetration and influence might be limited due to weak credit reporting systems in the region.

Figure 14a. Normalized Index of Overall Financial Reform
Scale: 0 = Fully Repressed, 1 = Fully Liberalized

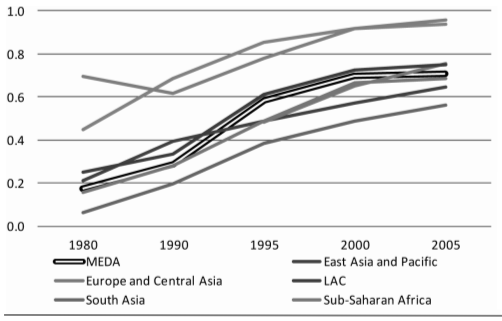
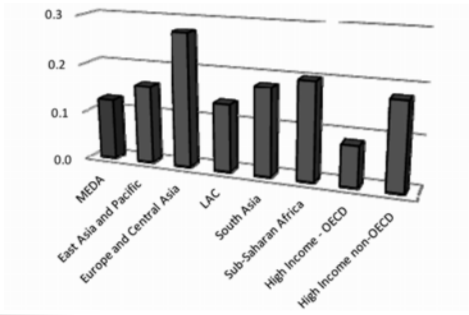


Figure 14b. Progress in Financial Reform
Change in Overall Index 1995-2005



Source: Abiad, Detragiache and Tressel (2008) and authors' calculations.

Third is the overall state of financial reform. Based on recent research examining progress in various aspects of financial liberalization and reform across countries, it is possible to gauge the status of financial sector policies in five of the nine MEDA countries[15] relative to the rest of the world. For these countries on average, a composite index of overall financial reform[16] in 2005 was somewhat intermediate, lying below the level of Latin America and the Caribbean and Europe and Central Asia, but above that of Sub-Saharan Africa and East Asia and Pacific (Figure 14). However, there were two areas in which MEDA countries clearly underperformed: capital account openness and privatization of the financial system. Furthermore, progress in financial reform appears to have stalled relative to other regions; among emerging and developing economies, MEDA countries registered the smallest increase in the composite index between 1995 and 2005, and an almost negligible increase between 2000 and 2005. In particular, previous gains were partially reversed in two areas in particular: credit controls and directed credit/high reserve requirements.

15. The MEDA countries included are Algeria, Egypt, Jordan, Morocco, and Tunisia.

16. As constructed by Abiad, Detragiache and Tressel (2008). The overall index summarizes seven aspects of financial reform: (1) credit controls and excessively high reserve requirements; (2) interest rate controls; (3) entry barriers; (4) privatization; (5) capital account restrictions; (6) prudential regulations and supervision; and (7) securities market policy. The index is coded so that higher values indicate a more liberalized/well supervised banking system.

V. Policy Discussion: How to Enhance Efficiency and Access

Clearly, our reading of the state of MEDA countries' financial systems relative to the rest of the world is that a portion of the observed underperformance in economic growth over the past four decades can be traced to financial sector issues, encompassing both the depth of financial activity and the ability of bank lending activities to spur greater rates of economic growth, which we have termed the *quality* of bank intermediation. Therefore, policies should be pursued that induce improvements on these two major fronts.

Of course, it must be recognized that the policy strategy cannot be "one size fits all", simply because of the varying starting points among the different MEDA countries. We have highlighted the fact that financial depth varies widely throughout the region, both in absolute terms and relative to each country's structural benchmarks. We have also indicated the sharply differing ownership structures, although the general tendency in MEDA countries is to rely more heavily on state banks and less on foreign banks than is the norm in other regions.

That said, actions should be undertaken to enhance depth, as several countries with relatively shallow financial systems can potentially exploit substantial gains in growth. Numerous studies have shown that improvements in financial infrastructure—the legal framework protecting creditor and small shareholder rights—are effective in increasing the incentives for banks to undertake risky but productive lending, and for private investors to direct part of their excess funds into local capital markets. Other institutional improvements—achieving more effective contract enforcement and stronger property rights in general—have also been shown to lead to greater depth.

For the most part, interest rates have been liberalized and direct credit controls have been removed among the MEDA countries, although some rollback of these reforms is evident. Therefore, these countries must take care not to re-impose these controls to a greater degree, and to phase out existing controls that are certainly playing a role in limiting financial deepening. With specific regard to development of securities markets, government actions to kick-start financial market development, by placing government debt domestically on open and voluntary markets and encouraging development of a secondary market would also be welcome.

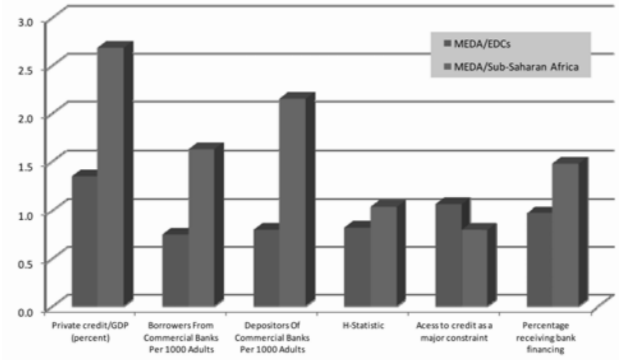
For both deep and shallow systems in the MEDA countries, efforts should be made to improve the quality of bank intermediation. One particular area is to provide the conditions for increasing banking competition. Here, removal of entry barriers, along with actions to improve the credit information environment—for example, improving public credit registries and promoting the creation of private credit bureaus—should be expected to play an important role.

Along these lines, a phasing-out of state dominance of MEDA banking systems is crucial, particularly in those countries where banking systems are shallow and institutions weak, and it is

therefore more likely that long-run growth has been compromised. More generally, the threefold mandate governing state bank behavior in the region has resulted in unnecessary cost inefficiencies and excessive credit risk, in addition to undermining the allocation of credit among the most worthy investment projects.

It seems quite plausible that deficiencies in banking quality are related to an inability to provide widespread access to financial services and products throughout the population. Although the coverage of data reflecting financial access is far from complete, there are indications that, for a given level of banking depth, MEDA banking systems are less effective than other regions at providing access. For example, although the average ratio of private credit to GDP is about a third higher in MEDA than in the average EDC, access to credit is about a third lower, and access to bank deposits is about one-fifth lower (Figure 15).[17] Furthermore, enterprise surveys reveal that businesses are 10 percent more likely to consider lack of credit to be a major constraint to their expansion in MEDA than in the average EDC. Similar conclusions can be drawn by comparing depth and financial access between MEDA countries in Sub-Saharan Africa; the disparity in depth–MEDA having notably larger banking systems–is much greater than that in various measures of access.

Figure 15. Financial Depth and Financial Access:
Comparing MEDA Countries to Sub-Saharan Africa and to the EDC Average (Ratios)



Source: IMF Financial Access Survey Database, World Bank Enterprise Surveys and authors' calculations.

Finally, there are indications that access issues are particularly acute for small and medium-sized enterprises (SMEs); relative to most other regions, MEDA banks reach a smaller proportion of these firms (Figure 16a), and there is a higher incidence of bank credit being cited as a key constraint to firm expansion (Figure 16b). Rocha et al. (2011) report the results of recent surveys of banks in the Middle East and North Africa, showing that in MEDA countries, loans to SMEs comprise only about a tenth of the total loan portfolio, less than a third of the target that banks would like to reach.[18] For Egypt, Syria, and West Bank and Gaza in particular, these loans comprise between 4 and 6 percent of the total.[19] The surveys also highlight the importance of information

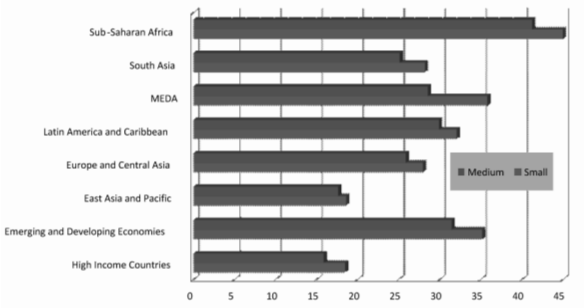
17. Access to credit is measured as the percentage of adults receiving bank loans, and access to deposits is the percentage of adults holding bank deposits, as reported by the IMF Financial Access Survey.

18. Calculated from Rocha et al. (2011), Figures 2a and 3a. The survey covers seven MEDA countries: Egypt, Jordan, Lebanon, Morocco, Syria, Tunisia, and West Bank and Gaza.

19. It should also be pointed out that the GCC banks perform even worse in this area; the share of SME lending in the total portfolio ranges from ½ percent (Qatar) to 4 percent (United Arab Emirates).

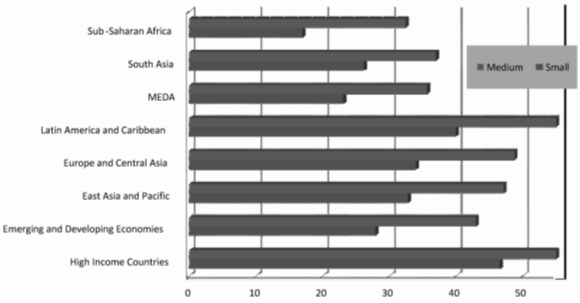
and regulatory deficiencies as obstacles to greater financing; over 80 percent of respondents considered transparency of SMEs, lack of reliable collateral, and weak credit information systems to be particularly relevant, and between 60 and 75 percent cited regulatory and legal shortcomings, in particular the lack of protection of creditor rights.

Figure 16a. Enterprise Survey:
Percentage of Small and Medium-Sized Firms Identifying Access to Credit as a Major Constraint



Source: World Bank Enterprise Surveys.

Figure 16a. Enterprise Survey:
Percentage of Small and Medium-Sized Firms Receiving a Line of Credit or Loanfrom a Bank



Source: World Bank Enterprise Surveys.

The Rocha et al. (2011) study argues that, along with actions to increase competitiveness in the banking sector, improvements in the financial infrastructure will be critical to expand SME access to credit. To this end, collateral and insolvency regimes need to be strengthened and, as we also argued above, the credit information environment must be improved. A complementary role can also be played by introducing and strengthening credit guarantee schemes, but the bulk of the improved access should come from an increased ability of banks to adequately gauge and manage the risks inherent in expanding their activities toward hitherto underserved yet potentially highly productive firms.

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