Challenges for the Financial Systems and the Monetary Policy Regimes in Southern Mediterranean Countries After the Crisis (ARI)

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Theme: This ARI reviews some aspects of the financial systems and the design and implementation of monetary policy regimes by central banks in the southern Mediterranean countries in order to assess the scope for changes in these areas. To adequately frame the discussion, the economic performance of the region over the last few years –marked by the global financial crisis and the 'Arab Spring'– is also reviewed.

Summary: Although the southern Mediterranean countries grew at considerably high rates over the past decade, on average they lagged behind other developing regions. At present the economic disruptions associated with the 'Arab Spring' and the negative external conditions in the EU are levying a heavy toll in terms of growth, and changes in economic regulations are needed. In the financial sector, measures to develop and facilitate the international integration of financial markets, promote competition between banks, and increase their transparency can help improving its intermediation role vis-à-vis the private sector. Most countries in the region have followed a managed or fixed exchange rate regime, with capital controls. A shift towards more flexible exchange rates and the eventual adoption of inflation targeting regimes, which in many cases has been successful in other developing countries, particularly in Latin America, could also be considered, although a gradual and prudent approach, depending on the situation of each country, will be required.

Analysis:

Overview of the Region's Economic Growth

The world economy registered a strongly expansionary period between 2000 and 2007 that also benefited the southern and eastern Mediterranean countries (including Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Syria, Tunisia and Turkey) which recorded average growth rates of between 4% and 5%. The average for the region, including Turkey, was 4.8%, which in absolute terms can be considered good. However, compared with the growth registered in other emerging and developing countries –which would appear to be an appropriate benchmark– the figure is less impressive. In fact, the Mediterranean countries grew by around two percentage points below the group average for emerging and developing countries and more than three and a half percentage points below Developing Asia (see Table 1). During the world financial and economic crisis years of 2008 and 2009, and due to the generally limited integration of the region in the global financial markets, the weakening of economic activity was moderate and no country

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entered into recession with the exception of Turkey and Libya. Also, the region enjoyed a relatively intense recovery in 2010.

At present, the economic disruptions associated with the political transitions in some of the region's countries are taking a heavy toll in terms of growth. External conditions are not favourable either –especially in the EU, the most important partner for the Mediterranean countries– and, as a result, a sharp deceleration of economic growth has was registered in 2011 and is also projected for 2012. According to IMF figures, only Morocco will achieve a growth rate (4.6%) in 2011-12 similar to the average growth over 2000-07. By contrast, Libya, Syria, Jordan, Egypt and Tunisia will grow more than three percentage points below their 2000-07 averages, while Algeria, Lebanon and Turkey will grow about one percentage point below their average for the expansionary period.

Table 1. GDP growth (% and percentage points-pp)

Countries	**2000-07 (1)**	**2009 (2)**	**2010 (3)**	**2011F (4)**	**2012F (4)**	**2011-12 vs 2010 (pp) (4)-(3)**	**2011-12 vs 2000-07 (pp) (4)-(1)**
Advanced	2,6	-3,7	3,1	1,6	1,9	-1,4	-0,8
Emerging & developing	6,6	2,8	7,3	6,4	6,1	-1,1	-0,3
Developing Asia	8,4	7,2	9,5	8,2	8,0	-1,4	-0,3
Latin America	3,6	-1,7	6,1	4,5	4,0	-1,8	-0,6
Mediterranean	**4,8**	**0,3**	**6,1**	**3,9**	**2,6**	**-2,9**	**-1,5**
Algeria	4,0	2,4	3,3	2,9	3,3	-0,2	-0,9
Egypt	4,7	4,7	5,1	1,2	1,8	-3,6	-3,2
Israel	3,9	0,8	4,8	4,8	3,6	-0,6	0,3
Jordan	6,6	5,5	2,3	2,5	2,9	0,4	-3,9
Lebanon	3,6	8,5	7,5	1,5	3,5	-5,0	-1,1
Libya	5,0	-2,3	4,2	NA	NA	NA	NA
Morocco	4,6	4,9	3,7	4,6	4,6	0,9	0,1
Syria	4,2	6,0	3,2	-2,0	1,5	-3,5	-4,4
Tunisia	4,8	3,1	3,1	0,0	3,9	-1,2	-2,8
Turkey	5,2	-4,8	8,9	6,6	2,2	-4,5	-0,8

F: forecast; NA: not available.
Source: IMF WEO, October 2011.

Hence, even if the negative effects of the 'Arab Spring' on economic activity are short lived, economic growth is expected to remain relatively slow, both in absolute terms and in comparison with a recent historical perspective. This will make it more difficult to manage successfully the transitions in the Arab Mediterranean countries. Indeed, given the high expectations of economic improvement that citizens have in the new setting, returning to pre-crisis growth rates would not be enough: the region needs higher rates of growth, comparable to those attained in other emerging and developing countries and at least enough to prevent further increases in their already high unemployment rates. Furthermore, the region also needs a more inclusive kind of growth, whose benefits can spread among the citizens and that allows for improved living conditions and more opportunities for work. An essential ingredient to achieve this higher and more inclusive growth is a new agenda of economic reforms, agreed between all the relevant actors in the Arab Mediterranean societies.

Of course, economic governance is an essential part of a reformist agenda aimed at reinforcing growth. Economic governance entails several aspects: first of all, the functioning of public institutions, which are direct providers of many goods and services; but, more importantly, economic governance also defines the framework in which the private sector operates –the business climate– and in this regard most countries in the region rank particularly low; and economic governance and the way in which rules and regulations are applied determine how the benefits of economic activity are distributed among the population. So there is no doubt about the importance of governance and the need of a wide-ranging set of reforms in that area in the Mediterranean countries. This ARI deals with a specific aspect of economic governance, which is the monetary policy regime. But before touching on these issues it would be convenient to review some of the key characteristics of the financial systems of the Arab Mediterranean countries, to provide some hints of possible improvements in that area, which is intimately related to monetary policy.

Key Characteristics of the Southern Mediterranean Financial Systems

The first key feature of the region's financial systems is their limited degree of connection to other financial systems. This can be seen in various aspects related to the banking sector: (1) the level of foreign bank lending is low, much lower than foreign bank lending in Latin America and Developing Europe in terms of GDP; (2) the overall reliance of the banking system on foreign funding –most of which comes from the EU, that accounts for more than 70% of foreign claims– is reduced; (3) correspondingly, the loan-to-deposit ratios are low and in no case are above 100%; and (4) the direct presence of foreign banks is not very significant and their share of total bank assets is low, with the exception of Lebanon, Egypt and Morocco, where it reaches 20%.

A second key feature of the region's financial systems is their limited development, particularly as regards the level of financing to the private sector. Capital markets play a marginal role, with corporate bond markets still at a nascent stage in most cases. In some countries, the stock markets registered buoyant activity in the pre-crisis years, but data on issuance of new shares, listing of new companies and market liquidity reveal that the stock markets' role in financing new investment is generally limited. Accordingly, banks play a predominant role in the region's financial sectors and are the main channel for funding these economies. However there are sharp differences between countries, with Lebanon having by far the biggest and most developed banking sector, and oil-exporting countries, like Algeria, Libya and Syria, still lagging behind. Nevertheless, banks' claims on the private sector as a percentage of GDP are generally low.

Banks appear to have a bias towards holding liquid assets and government debt rather than lending to the private sector. And, within the private sector, credit to households has shown a growing trend at the expense of credit to the corporate sector. Many private companies have to rely exclusively on retained earnings to finance investment and this can mean lost business opportunities and, on aggregate, lower growth. Furthermore, a risk of the present situation, in which public deficits have grown as a result of the economic slowdown and increases in public spending as a first response to the 'Arab Spring', is that the public sector's increased funding requirements might crowd out private credit.

There is also evidence of a high loan concentration. For instance, the exposure of banks to their 20 prime clients, in terms of capital, is higher than in any other region in the world. Interconnectedness with large and often family-owned conglomerates, in some cases, and the pre-eminence of public companies, in others, explain this high level of credit concentration. On the other hand, access to financial services among the population is low and surveys indicate that small- and medium-sized companies find it hard to obtain credit.

From a policy perspective, there are several ways to increase competition in the banking sector and improve its intermediation role to the private sector: easing the entry of new domestic and foreign players and improving the disclosure of information and the legal frameworks that protect minority shareholder rights can make it more difficult to concentrate credit in a reduced number of clients and contribute to extend access to finance both to households and small companies.

Policy should also pursue the development and strengthening of the corporate debt market to complement the options for financing productive activities. Of course, the development of local currency bond markets is a long-term task that involves a sequence of structural changes, with macroeconomic stability, including low and stable inflation, being a prerequisite. The establishment of a robust market infrastructure, including creditor rights and sound regulatory and supervisory systems are also needed. The development of local markets for public debt, that provide benchmarks, and strategies to broaden the domestic and foreign investor base can also help to consolidate a stable source of finance for local firms.

In any case, the Arab Mediterranean banks are generally well capitalised and have good profitability, which are two positive features that must be emphasised from a financial stability perspective. The banking sector's main problem in this regard is the legacy of a large stock of non-performing loans. Although some countries have managed to reduce the structurally high levels of non-performing loans, they still account for more than 15% of total loans in Algeria, Egypt, Libya and Tunisia, and in some cases the levels of provisions are low. Asset quality is a concern as the present economic slowdown can add pressure in this field. Efforts have been done in recent years to control this problem, speeding the procedures for realising real-estate collateral or injecting capital into state companies to enable them to repay their loans, but there is a need for further improvement by ensuring effective management and control of risks in the banks, improving the legal frameworks to protect creditors and through the creation and better functioning of credit information registries.

More generally speaking, there is scope for further progress in strengthening the capacities of bank supervisors, which in the case of the Arab Mediterranean countries are the central banks. In this regard, complete compliance with Basel Principles regarding governance, resources and operational independence of bank supervision is paramount. Equally important would be the adoption of the Basel capital framework on an accelerated schedule, depending on the specificities and capabilities of the countries.

Monetary Policy Frameworks in the Mediterranean Countries

It is well known that there are no conclusive theoretical or empirical arguments to choose one monetary and exchange rate regime as optimal over the others. The best framework for each country depends on its own peculiarities and it can evolve over time. In the eastern and southern Mediterranean countries for historical, political and economic reasons most countries follow a managed or fixed exchange rate regime, while floating exchange rates have been until very recently the exception –only Israel and Turkey, with inflation targeting frameworks– as shown in Table 2. For the same historical and political reasons, most of these exchange rate regimes are oriented towards the dollar, although the euro has been gaining importance, due to the trade links of some of these countries (such as Morocco or Tunisia). Also, in order to keep fixed exchange rates, most of these countries have maintained controls on capital movements and have intervened heavily in foreign exchange markets.

Table 2. Monetary policy frameworks and exchange rate arrangement

	Monetary policy frameworks			**Exchange rate regimes**		
	Inflation target	**Monetary target**	**Exchange rate target**	**Fixed peg**	**Managed float**	**Free float**
Algeria			V		*	
Egypt			V		*	
Israel	V					*
Jordan			V	* (USD)		
Lebanon			V	* (USD)		
Libya			V	* (SDR)		
Mauretania		V			* (USD)	
Morocco			V	* (basket) (a)		
Syria			V	* (SDR)		
Tunisia		V			*	
Turkey	V					*

Note: (a) weight 80% EUR, 20% USD.
Source: IMF (De Facto Classification of Exchange Rate Regimes and Monetary Policy Frameworks as of April 2008 and Article IV Reports).

This broad picture has been subject to slow changes in recent years. Some countries have introduced greater exchange rate flexibility and capital account liberalisation. Some of them (Tunisia and Mauritania) have moved from a pegged exchange rate to a managed floating one, while others (Egypt) have widened the fluctuations against the anchor currency. They have also modernised their monetary policy instruments and strengthened the independence and transparency of their central banks.

While fixed exchange rates have yielded substantial benefits in terms of monetary policy credibility, price stability and disciplinary effects on other policies, they have also faced important challenges in recent years as a result of increased inflationary pressures (mainly due to commodity prices, but also to buoyant demand growth) in a more global environment both in terms of trade and capital flows. In some respects, these countries have been confronted with what could be called the 'impossible trinity' (which states that you cannot have at the same time fixed exchange rates, free capital flows and an independent monetary policy). In this context, managing the fixed exchange rates and controlling inflation has been increasingly difficult. As a result, some of the Mediterranean countries, like Egypt, Morocco and Tunisia, are planning to adopt inflation targeting with flexible exchange rates in order to focus on domestic policy objectives.

This shift towards more flexible exchange rates and the eventual adoption of inflation targeting regimes is in line with the trend observed over the past decades, first in the advanced economies and later on in the emerging markets. In the case of the emerging countries, the currency crises of the mid-1990s led many of them to the practical abandonment of exchange rate targets in favour of more flexible currency regimes. More specifically, there was an abandonment of intermediate exchange rate regimes in favour of the so called 'corner' solutions: most countries decided to increase the flexibility of the exchange rate, but a few smaller countries moved in the opposite direction, to full dollarisation (Ecuador) or currency boards (Bulgaria). In this context, the search for a nominal anchor led to the adoption of inflation targeting, which had already been a successfully tried framework in some advanced economies, by a growing number of emerging market economies.

Latin American experiences are a case in point. Many countries in the region switched from exchange rate targets to inflation targeting between 1999 and 2001-02 (Brazil, Chile, Colombia, Mexico and Peru). Some of them abandoned the fixed exchange rate under speculative attacks (like Mexico) but others did it pre-emptively (like Chile and Colombia). In many ways, inflation targeting has been successful in Latin America, as reflected in the reduction of inflation to low single-digit rates in recent years, despite some challenging periods of exchange-rate depreciation. It is important to highlight that inflation targeting countries in Latin America and other emerging market economies have always given some attention to the exchange rate, and in contrast to advanced economies they have also significantly increased their international reserves and implemented other macro-prudential measures to stem financial excesses, including capital controls in some cases. These elements, conceived as temporary devices in the transition period to the new regime, have been very useful for preserving financial stability during the crisis, and have become more permanent elements of inflation targeting frameworks in Latin America, in what has come to be known as 'IT+'.

Table 3. Countries with inflation targets (dates of adoption)

Advanced economies		**Emerging market economies (cont.)**	
New Zealand	1990	South Africa	2000
Canada	1991	Thailand	2000
UK	1992	Mexico	2001
Sweden	1993	Hungary	2001
Australia	1993	Peru	2002
Iceland	2001	Philippines	2002
Norway	2001	Slovak Republic	2005
		Indonesia	2005
Emerging market economies		Rumania	2005
Israel	1997	Guatemala	2005
Czech Republic	1998	Turkey	2006
Poland	1998	Armenia	2006
Korea	1998	Ghana	2007
Brazil	1999	Uruguay	2007
Chile	1999	Albania	2009
Colombia	1999	Serbia	2009
		Moldova	2010

Source: IMF (2206) and Hammond (2011).

More generally, empirical studies have shown that the adoption of inflation targeting can bring considerable gains to emerging market economies, not only in terms of disinflation but also of anchoring expectations and ensuring central bank independence and accountability. However, it must be clear that adopting an inflation target is not a panacea and the soundness of other economic policies and rigorous financial supervision are essential to achieve economic and financial stability.

Indeed, one interesting result in the empirical literature is that inflation-targeting central banks in emerging market economies miss their targets by far more than in advanced economies. Among other reasons, this can be due to the impact of external shocks, often exacerbated by capital inflows. The experience of Turkey, in the Mediterranean region, is an example of the difficulties and limitations of the inflation targeting approach: the economy has been hit by a series of external shocks that have prevented inflation from staying within the announced targets. It is a useful reminder that in a challenging global atmosphere the conduct of monetary policy becomes more difficult and it must be supported by a broader set of sound economic policies.

Moreover, the adoption of inflation targeting is quite demanding in economic, institutional and technical aspects. Without entering into theoretical requirements or criteria, there are a number of critical elements that must be in place –to a sufficient extent– for a successful adoption of this type of monetary policy regime: central bank independence, fiscal soundness, deep and stable financial systems, a well functioning monetary policy transmission mechanism and technical capacities. Of course, some of these factors are not specific of inflation targeting, but are also very important ingredients of any sound monetary policy regime. And it is important to underline again that monetary policy needs to be enshrined in a coherent set of economic policies supporting the quest for price stability.

The development of financial systems and markets is crucial to support the transition to a monetary policy regime aimed at price stability. Deep and stable financial markets, as well as a sufficiently developed set of monetary policy instruments, are needed for the appropriate functioning of the transmission mechanism, which means that central banks' policy rates are effectively transmitted to the financing conditions of households and firms and affect their saving and investment decisions. A sound banking system is also essential, for if the banking system is weak it will dampen the ability of the central bank to increase interest rates, for financial stability reasons.

Countries in the Mediterranean region planning to adopt inflation targeting –or similar regimes– have made important advances in some of these areas, but a number of impediments remain. For instance, while in the past years these countries have enhanced their institutional and technical preconditions, they still place significant importance on exchange rate stabilisation, their financial development has progressed relatively slowly and there are still important limitations to the effectiveness (and even the understanding) of the monetary policy transmission mechanism. In these circumstances, it is advisable that in order to complete unfinished reforms the transition to a new monetary and exchange rate regime is made in a gradual way. Political and social stability considerations, in view of recent developments in these countries, should also be taken into account when deciding the path towards a new monetary regime, as the potential benefits of such changes must be balanced against the possibility of financial instability, large depreciations of the exchange rate and risks to price stability.

It is also very important to take into account that the inflation targeting framework is subject to reconsideration in the aftermath of the global financial crisis. On the one hand, the possibility to separate the financial stability and the price stability objectives, which is at the basis of strict application of IT, has been put into question. Central banks have been called to re-think their exclusive focus on inflation and the failure to account adequately for financial-sector risks. The financial crisis of 2008 has made it clear that financial stability is of vital importance and that supervision at the micro level of each individual bank has to be completed with a macro approach to detect and prevent the building up of systemic risks. There is no doubt that central banks have to be involved in this new macro-prudential approach, although the precise way in which this involvement should take place is still a matter of discussion. In the Mediterranean countries, as in the rest of the world, due consideration of financial stability matters and how to better integrate institutionally this new macro-prudential function will be essential.

The pre-crisis consensus view that monetary policy (that is, interest rates) should only react to asset price shocks if they affect inflation prospects has been reconsidered and now it is widely accepted that central banks should at least try to lean against the wind of asset-price bubbles, although other policy tools (macro-prudential) could be more suitable to address financial stability issues. It is possible that in the future central bankers will have to optimise the use of different policy tools to achieve multiple objectives: this argues for a more flexible and wider inflation targeting regime, which takes into consideration issues –like financial stability– that were absent before the crisis.

An important lesson from the crisis is that central banks should be aware of the possible spill-over effects of actions on countries, as well as of the repercussions of other central banks' actions on their economies. The so called 'currency war' of September 2010, that originated because non-conventional monetary policy in the US was supposed to be causing excessively too strong capital inflows into emerging market economies and commodity markets, threatening the achievement of their policy objectives, is an example. In fact, cross-border effects can be very important and complicate the management of monetary policy. This raises the need for international coordination of policies, and also means that central banks, especially those with systemic importance, should internalise the effects of their policies.

In the case of emerging markets, these issues are particularly important when dealing with capital inflows. The crisis has shown that retaining some margin of intervention in the foreign exchange market may be justified in order to smooth temporary exchange rate fluctuations. Even capital controls might be a useful tool if they help to prevent the build-up of imbalances in the domestic financial system, when other policies are not available, but their potential for creating permanent distortions and their spill-over effects on other countries have to be taken into account.

In sum, challenges in the transition to more advanced and independent monetary policy regimes are important, not only because the conditions to be successful are difficult to meet, but also because the international framework is changing and increasingly interconnected, and past experiences in other countries and regions, though a useful help, leave some new issues open.

Conclusion: As many other regions in the world, but for their own reasons, the southern Mediterranean countries are leaving a particularly challenging moment, linked to the 'Arab Spring' revolutions and the high social and economic expectations attached to them. Against this background, prospects for growth in the region do not seem particularly bright. The impact of the social uprisings will reduce growth in the short term –and maybe even in the medium term– and growth potential is low by emerging markets standards. The need for a growth enhancing reform agenda seems imperative.

Financial deepening is an essential part of such an agenda and, linked to it, the development of a monetary policy framework that allows for a more independent monetary policy. The Mediterranean countries have traditionally followed fixed exchange rate regimes which have contributed to enhancing their monetary policy credibility, fostering price stability and discipline in other policy areas. However, as in other emerging regions before, in recent years they have been confronted with growing challenges in terms of inflationary pressures and the need for further capital account liberalisation, which interfere with their focus on the exchange rate. As a consequence, some of these countries are considering the possibility of adopting more flexible monetary policy regimes using price stability as the nominal anchor.

While the experience with inflation-targeting regimes in emerging market economies has been generally positive, the Mediterranean countries must be aware of the challenges posed by the change and of the limitations of this strategy. In terms of challenges, while flexible exchange rates should in principle allow them to respond appropriately to external shocks, the exchange rate is also an important transmission channel of external volatility into the domestic economy, more so in a financial world that is increasingly interconnected. In the case of emerging economies, with still underdeveloped financial markets, this type of considerations warrants keeping a close eye on exchange rates. Additionally, the historical evidence shows that the higher volatility of macroeconomic and financial variables in emerging market economies makes it more difficult for them to reach their inflation targets, which calls for the cooperation of other economic policies in pursuing this objective. All these considerations in general call for gradual changes in monetary policy regimes.

On the other hand, the recent financial crisis has cast some doubts on the appropriateness of monetary policy strategies that are narrowly focused on inflation targets that do not take sufficiently into account financial stability issues and spill-over effects to and from other countries. An increasingly globalised and interconnected world requires more complex monetary policy regimes, although the exact features of the new generation of frameworks to address them are still to be defined.

A more general consideration for the Mediterranean countries is how political and social issues should also be taken into account when deciding the path towards a new monetary regime, especially in view of recent developments in the region. Any change in times of political instability is subject to the risk of being counterproductive and end up being detrimental to the most impoverished segments of the population of these countries.

Besides, the economic and political situation in the different Mediterranean countries is not evolving homogenously, and the political transitions that practically all the countries are experiencing can give rise to very different outcomes. There is also a high degree of uncertainty regarding the economic model that the new authorities will be following and the type of relationship that they will pursue with external players, such as multilateral financial institutions. Correspondingly the choices regarding the monetary policy and exchange regimes will also vary depending on the countries and the possibly different political and economic models finally emerging in each case.

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