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POLICY AGENDA FOR AN INCLUSIVE, JOB-CREATING FINANCIAL DEVELOPMENT IN THE SOUTHERN AND EASTERN MEDITERRANEAN

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ABSTRACT

Recent empirical evidence shows that financial development in the Southern and Eastern Mediterranean Countries (SEMCs) is lagging behind. The exclusion of a substantial part of households and micro, small and medium-sized enterprises (MSMEs) from financial services, hampers economic development and job creation in the region. Moreover, financial development suffers from the absence of institutional diversity, high inefficiency and prohibitive lending costs.

In view of EMNES research, our findings provide justification for the following policy recommendations:

Achieve macro and financial stability by

- ensuring sustainable government finances;
- ensuring monetary stability by targeting low inflation;
- tackling the high level of non-performing bank loans.

Increase financial system diversity and enhance lending efficiency via

- financial market development (private bonds issuance, private placements, equity and IPO markets, etc.);
- developing legislative regimes for alternative financial structures and facilitating the adoption of new financial technologies (technology neutral approach, sandboxes, etc.).

Widen the access to affordable financial services for households and MSMEs by

- developing credit registries and guarantee schemes for MSMEs;
- developing and promoting digital financial services and increasing the role of postal offices for provision of basic financial services for households;
- requiring banks and insurers to provide basic financial services for households;
- investing in enhanced financial literacy for the low skilled.

The EU can contribute to this policy agenda for inclusive and job-driven financial development through funding, assistance and expertise in SEMCs:

- It can fund the development of a guarantee fund to cover losses of defaulted loans and promotion of financial inclusion initiatives;
- It can assist in the development of an action plan for financial market integration;
- It can provide expertise to develop alternative EU financial instruments within the EU for SEMCs.

The objective of this policy paper is to review the most salient trends in financial development, to identify the main challenges and to provide policy recommendations to achieve financial development that is inclusive and that contributes to economic growth and job creation in SEMCs.

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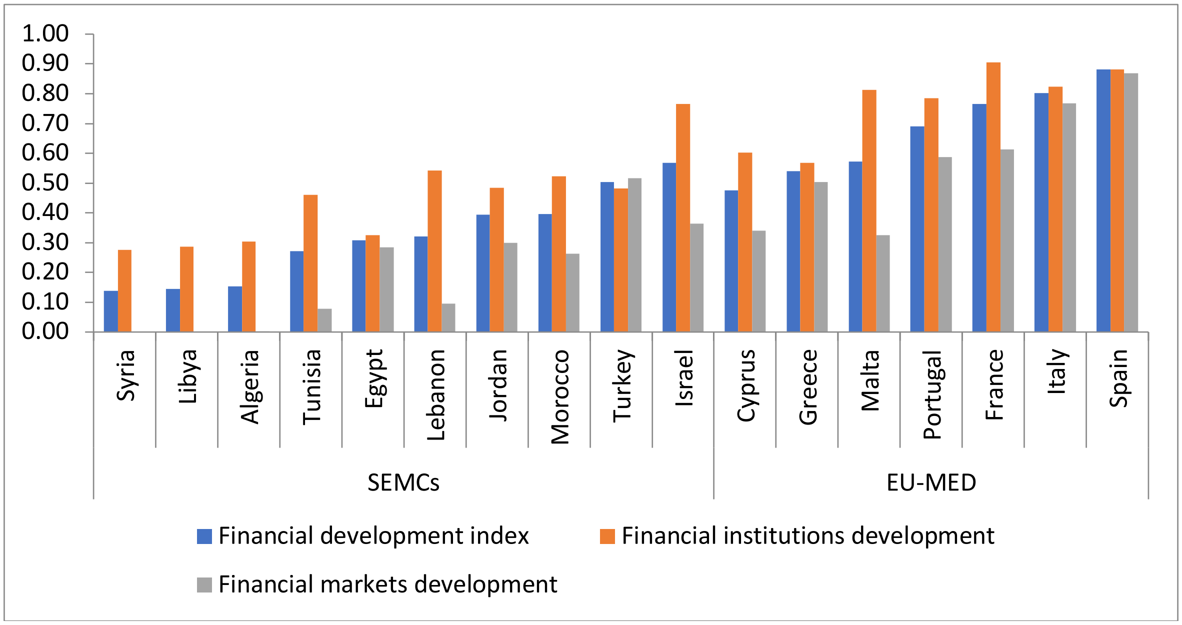
FINANCIAL DEVELOPMENT IN SEMCS

Financial development[1] in the Southern and Eastern Mediterranean Countries (SEMCs) continues to lag behind the EU Mediterranean countries. Looking at the financial development index (see Figure 1), SEMCs are substantially less developed than EU-MED countries, with financial intermediation dominated by the banking sector and the non-existent role of the financial markets. This diagnosis hides large disparities in the level of financial development between SEMCs. Whilst Turkey and Israel stand out in both their quality of financial institutions and financial market development, Morocco, Jordan and Lebanon are lagging behind in terms of financial market development whereas in Syria, Libya and Algeria the levels of financial development are abysmal.

Figure 1: Financial development as of 2016



Source: *EMNES elaboration based on Svirydzenka (2016).*

[1] Financial development is traditionally defined as the improvement of functions in the financial system such as: pooling of savings, the allocation and monitoring of capital for productive investments, risk diversification, and exchange of goods and services. Each of these financial functions can influence savings and investment decisions as well as the efficiency with which funds are allocated. (Levine, 2005)

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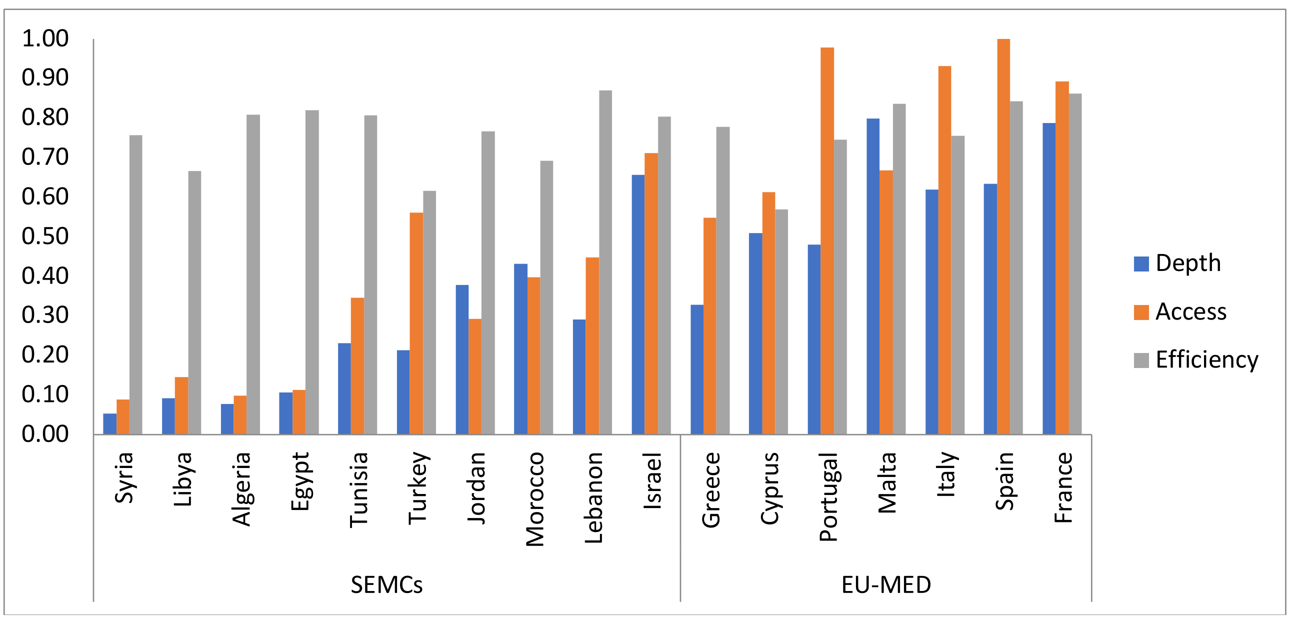
When looking at the attributes of financial institution development, as defined by Čihák, Demirgüç-Kunt, Feyen, & Levine (2012) and indices prepared by Svirydzenka (2016), SEMCs are efficient financial institutions in terms of their economic profitability (efficiency of financial intermediaries and markets in intermediating resources and facilitating financial transactions). However, in terms of access (degree to which individuals can and do use financial services) and depth (the size of financial institutions and markets), there is a need for improvement. Financial access needs to be urgently developed in the case of Jordan and Morocco, since they have high levels of financial deepening. And according to Barajas, Chami & Yousefi (2016) financial access needs to be promoted before financial deepening in order to benefit from the positive impact of financial development on the economy. In SEMCs, financial intermediation is almost exclusively based on banking intermediation that allocates a large share of funding for government and liquid assets, leading to households and micro, small and medium-sized enterprises (MSMEs) having poor access to financial services. (Ayadi et al., 2018).

Figure 2: Financial institutions development attributes (2016)



***Source**: EMNES elaboration based on Svirydzenka (2016)*

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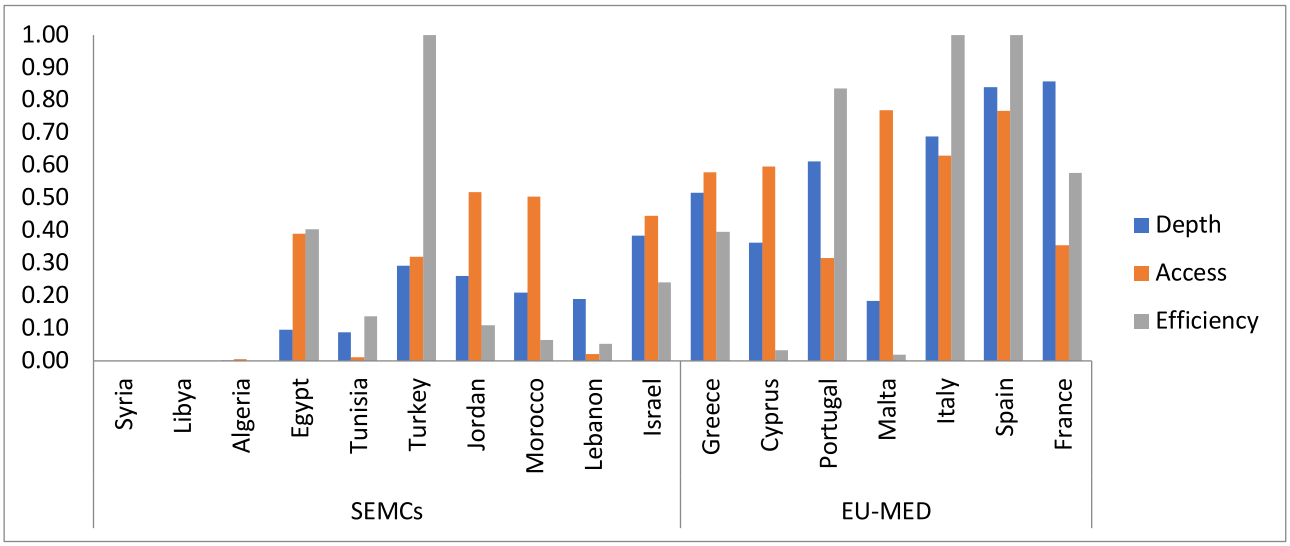
Financial markets in the SEMCs are underdeveloped in terms of depth, access and efficiency (see Figure 3). For SEMCs, all these attributes are low, with the exception of Turkey that has a high level of financial market efficiency. For Syria, Libya and Algeria, the financial markets are non-existent. Therefore, there is a huge opportunity amongst SEMCs for radical reform towards more developed financial markets.

Figure 3: Financial markets development attributes (2016)



***Source**: EMNES elaboration based on Svirydzenka (2016).*

WHY FINANCIAL DEVELOPMENT IS IMPORTANT?

There is a consensus in the literature that financial institution and market development contributes to economic growth if certain economic and regulatory preconditions are met (Ayadi, Arbak, Ben Naceur, & Casu, 2011). SEMCs do not meet these pre-conditions which include regulatory, legal and political certainty, access to capital and macroeconomic stability (Ayadi, 2013). This leads to an ambiguous relationship between financial development, economic growth and employment creation.

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Recent evidence shows that, on one hand, an increase in bank market power can positively impact economic growth in SEMCs (Issa, Girardone, & Snaith, 2018) whilst, on the other hand efficient financial intermediation and high levels of financial inclusion contribute to employment creation, in particular when the quality of institutions is high (Ayadi, Naceur, & Goaied, 2019).

Nonetheless, an excess of financial development leading to credit booms and sometimes the pre-empting of financial crises does not seem to be driven by income inequality that remains high in the region. In SEMCs, since financial development on average remains very low, especially in terms of financial inclusion, income inequality does not drive credit growth (Ayadi, Ben Naceur, & Challita, 2019).

The finance growth nexus weakens when financial development is not associated with financial inclusion. Financial inclusion has proven its contribution to both financial stability and economic growth (Arcand, Berkes, & Panizza, 2015; Barajas et al., 2016). Also, financial inclusion contributes to job creation in its early stages (Ayadi, Naceur, et al., 2019); the optimal level of financial inclusion must be achieved to ensure economic sustainability, whilst preserving financial stability. A recent EMNES Study (Ayadi & al, 2019) shows that financial inclusion could contribute to reducing income inequality and unemployment rates, although it has an effect on poverty reduction in low income countries. Enhancing financial inclusion requires improvements in banking market competition and the freeing up of financial regulations, institutional quality covering key social factors such as advancing education, reducing gender inequality, and utilising technology (Sha'ban, Girardone, & Sarkisyan, 2019).

Therefore, sustainable financial development must be associated with inclusion, economic growth and job creation, all of which are needed in SEMCs. However, several policy challenges still persist and are addressed here, with recommendations that engage different actors, including the EU.

WHAT ARE THE POLICY CHALLENGES FOR SEMCS?

Despite the modest improvement in financial development in recent years, SEMCs are still lagging behind their EU-MED counterparts. Besides not tackling the pre-requisites for a functioning financial system, the region faces three key policy challenges:

(i) the high cost of lending;
(ii) limited access to affordable financial services for households and MSMEs;
(iii) the absence of a diverse financial sector and low level of lending efficiency;

The **high cost of lending** can be explained by high bank funding costs, due primarily to the countries' risk factors (see Table 1). Additionally, the high level of non-performing loans, due to MSME failures and lack of accountability and financial transparency, add a further burden to bank balance sheets (see Figure 4)[2].

Table 1: Country sovereign rating 2019 (Fitch)

	Country	Credit rating: Fitch	Detail
EU-MED	Cyprus	Bba2	Lower medium grade
	France	Aa2	High grade
	Greece	B1	Highly speculative
	Italy	Baa3	Lower medium grade
	Malta	A3	Upper medium grade
	Portugal	Baa3	Lower medium grade
	Spain	Baa1	Lower medium grade
SEMCs	Egypt	B2	Highly speculative
	Israel	A1	Upper medium grade
	Jordan	B1	Highly speculative
	Lebanon	Caa1	Substantial risks
	Morocco	Ba1	Non-investment grade
	Tunisia	B2	Highly speculative
	Turkey	Bba3	Speculative

Source: *EMNES elaboration based on Fitch rating 2019*

[2] The data is not available for Algeria, Egypt, Jordan, Libya, Morocco, Syria and Tunisia but, in our research, the level of non-performing loans was underlined as a factor increasing the cost of lending. We also notice the high level of NPLs in Greece, Cyprus, Portugal and Italy due to the EU debt crisis.

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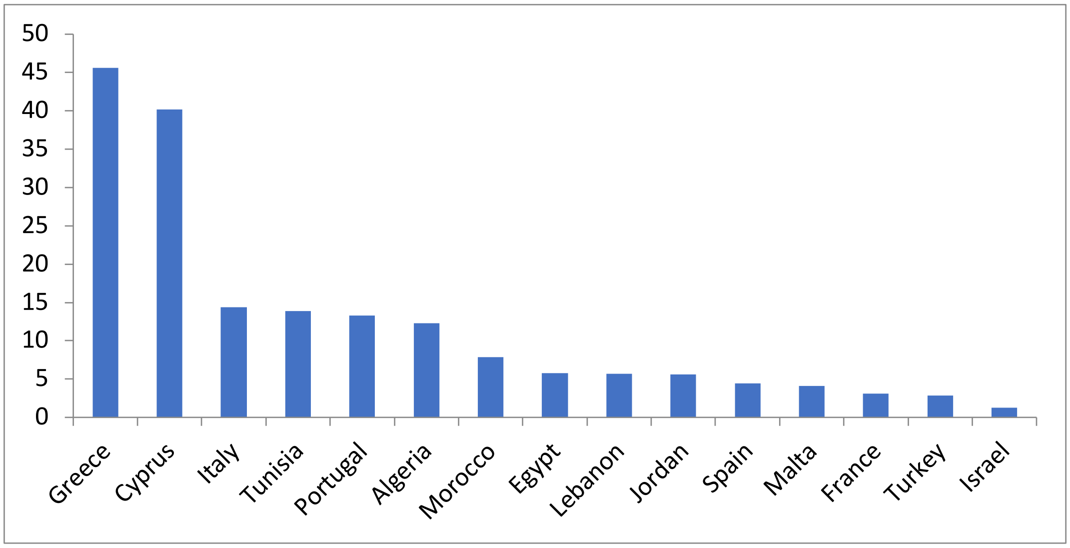
Figure 4: Non-performing loans to total bank loans (in %, 2017)[3]



Source*: EMNES elaboration based on World Bank database and IMF country reports*

Affordable access to finance can be considered one of the major obstacles faced by MSMEs (Ayadi & De Groen, 2013; Ayadi, Mouelhi, Sessa, & Zaki, 2019) and households in SEMCs (see Table 2). Banks generally require high collateral (real estate assets and cash), because of poor asset registrations and weak judicial systems. Moreover, the high level of information asymmetry, the strong reliance on cash due to high levels of informality and lack of transparency amongst small companies lead to higher risks, translated into higher costs of lending.

Turning to **households, financial inclusion** is elementary for enhancing the quality of life. Financial inclusion for households includes having access to affordable basic financial services, such as a bank account to make transfers and save money, but also basic insurance products (health insurance, disability insurance, life insurance, etc.).

In SEMCs, there is often limited access to basic financial services due to shortage of funds, high costs and a lack of trust in financial institutions (see Table 2). Moreover, there is also a lack of

[3] Data for Syria and Libya is not available.

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financial literacy within the population preventing them from understanding and efficiently using financial services.

Table 2: Reasons for not having bank account (% without account, 2017)

	Egypt	Lebanon	Morocco	Tunisia
Financial institutions are too far away	7.0	0.8	3.5	53.5
Financial services are too expensive	17.7	20.3	11.2	70.9
Insufficient funds	83.2	54.0	72.3	79.8
Lack of necessary documentation	12.7	0.4	7.6	15.1
Lack of trust in financial institutions	5.2	13.2	7.3	55.2
No need for financial services ONLY	3.7	5.2	11.5	-
Because of religious reasons	4.7	2.9	4.1	15.3
Someone in the family has an account	9.4	32.6	3.8	5.5

***Source**: EMNES elaboration based on World Bank (2017)*

MSMEs suffer from restricted access to financing supply, due to the large dependence **on bank-based financial intermediation** and to the **large market share of government owned banks** which tend to be less efficient and riskier than privately owned banks (Ayadi et al., 2018). There are hardly any alternatives for bank credit in SEMCs (the existence of a low number of microfinance institutions and credit unions). Most SEMCs, therefore, rely on arbitrary family finance and informal networks. Also, the banks have **large liquidity reserves and lend primarily to the public sector**, crowding out lending to household and MSMEs. Therefore, private banks are economically profitable because they lend to their own governments, with a low level of lending to the private sector and MSMEs and, consequently, no significant contribution to growth, considered to be lending inefficiency.

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POLICY AGENDA TO PROMOTE FINANCIAL DEVELOPMENT AND INCLUSION

In view of these trends, the most recent economic evidence and persistent obstacles, targeted policies are required to promote financial development and inclusion, so that they contribute to economic growth and employment creation in the region. These policies must engage the efforts of key actors, including regulators and supervisors and liquidity providers, as well as lenders and borrowers (Chami, Fullenkamp, & Sharma, 2009).

To reduce the costs of lending by managing the financial risk of the country and reducing the current high levels of non-performing loans. There is an urgent need to reach a sustainable government debt and ensure that monetary policy achieves price and financial stability, to allow lower interest rates on loans.

Moreover, regulators and liquidity providers should address the high levels of non-performing loans (NPLs) accumulated in bank balance sheets. An initial step is to define non-performing loans at national level and to monitor their developments. Then, to create bad banks or asset management companies to resolve legacy asset issues in order to enhance of the asset quality of banks, which in turn will lead to higher levels of credit supply. Additionally, insolvency legislation and judicial systems need to be improved, reducing the cost of lending. Also, MSMEs should engage in improving their level of reporting and bookkeeping, thus improving the level of transparency in lowering their cost of financing.

To widen the access to affordable financial services to MSMEs and households by creating or developing existing credit registries and promoting the role of guarantee schemes for MSMEs.

Credit registries (for households and MSMEs) reduce the informational asymmetry and ensure higher transparency. Guarantee schemes, when well-designed and functioning, allow MSMEs to borrow at lower costs so that they can grow and develop their economic activity, partly solving the issue of costly access to finance (Ayadi & Gadi, 2013). Previous experiences have shown that successful guarantee schemes have coverage ratios of between 60 and 80 percent, therefore encouraging MSMEs to borrow and, at once, limiting the moral hazard (Levitsky. J., 1997). Guarantee fees must be low enough to ensure the participation of lenders and borrowers, but

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high enough to cover administrative costs (De Gobbi, 2002). Involving donors, the private and public sectors are beneficial for guarantee schemes and they ensure the sustainability of guarantee funds (OECD, 2010). To be effective and grow, guarantee funds need high quality rating, a robust legal framework and a competitive banking sector (Levitsky. J., 1993).

The use of information technology has been shown to be a driver for financial inclusion by providing alternatives of funding and saving (Ayadi & Makni, 2019). The experience of mobile banking in Egypt has proven its reliability for access to a bank account and much work is being done to further develop these digital financial services to accelerate the financial inclusion of both households and MSMEs (Ayadi, Mouelhi, et al., 2019). Moreover, post offices, as well as ATMs, can play an important role in financial inclusion; they are present across the country and can be established and staff can be trained inexpensively in order to provide basic financial services. Also, policy makers should require banks and insurers to provide basic (digital) financial services accounts at affordable prices, whilst they keep monitoring the impact this has on financial stability.

Finally, financial literacy initiatives engaging all financial development actors are required. They should be implemented in schools, universities, in urban and rural areas and promoted via media campaigns. Also, e-learning platforms should be developed for the basic use of financial services.

To enhance financial system diversity allowing efficient lending, thus fostering investment and growth. This diversity makes it possible to supply a variety of financial services that can respond to a variety of market demands.

At a system level, it includes the creation or development of existing financial markets; debt markets as well as financial intermediation institutions. At an institutional level, diversity ensures the presence of alternative regimes to commercial and state-owned banks such as credit unions, mutual insurers, microfinance institutions, Islamic finance etc. Regulators should encourage diversity and institutional diversity at a system level by developing legislative regimes for alternative financial sectors and providers. Diversity can also occur in different types of investment funding, such as private equity, venture capital, business angels or crowdfunding. Also, new technologies (e.g. blockchain, AI, IoT, data analytics) provide the possibility of

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accelerating financial development. In particular, several new technologies and types of hardware provide the opportunity for reducing costs, improving the efficiency, safety and user-friendliness of financial services and financial intermediation. These new technologies are likely to be adopted, because of the self-interest of financial service providers. In parallel, SEMC legislators and supervisors can also promote the adoption of new technologies by making their legislation technology neutral and providing opportunities for financial institutions to test new technologies, such as adopting regulatory sandboxes. They allow the testing of new business models that are not protected by existing regulation or supervised by regulatory institutions whilst keeping the client protected.

THE ROLE OF THE EU

The EU employs significant financial instruments in SEMCs, with several EU institutions[4] and other European bilateral investment institutions[5], alongside different actors at regional and international level. Other than political, economic and humanitarian interests, the EU invests in SEMCs to promote stability in view of the migration crisis. These financial instruments aim to foster sustainable growth, deal with climate change, migration and economic integration. However, a clear assessment of their impact is needed and synergy of different instruments can be beneficial and increase their impact (De Groen, Kilkoffer, Busse, & Alcidi, 2019)

Amongst these key instruments is the External Investment Plan (EIP), a new initiative by the EU Commission, designed to attract more investment, in particular from businesses and the private sectors in the EU neighbourhood and Africa. It aims to create jobs, support entrepreneurs and enable growth. Its main component remains the financing element, through the creation of the European Fund for Sustainable Development (EFSD) providing guarantees and blending instruments. The guarantee scheme enables the mobilisation of private investment, especially for MSMEs and projects in rural areas. The EIP also engages in technical assistance for SMEs to develop their projects and for governments to improve regulations, and dialogue with different

[4] European Investment Bank (EIB), European Bank for Reconstruction and Development (EBRD) and EU Commission with the External investment plan
[5] German KfW and the French AFD

stakeholders for an improved investment environment. Such initiatives are very important to promote sustainable financial development but much work is still needed in this area.

On the three pillars of funding, assistance and expertise, the EU can provide further instruments. On funding, by developing the EU-MED guarantee fund, covering up to 80% of losses of defaulted loans (with no cap at portfolio level), and fund financial literacy initiatives. On assistance and sharing expertise, the EU should step up its efforts to assist the development of a long term action plan for financial market integration, especially EU-MED banking/financial integration and to develop alternative financial instruments that already exist in the EU which can be adapted for the neighbourhood countries. It can also contribute to the reduction of lending costs by encouraging countrywide economic reforms, and institutional environment upgrading.

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Policy agenda for promoting financial development that is job creating and inclusive in SEMCs

Key challenges	Policy actions	Key actors				Potential EU contribution
		Regulators/ supervisors	Liquidity providers	Lenders	Borrowers	
Absence of financial system diversity and lending efficiency - **Limited lending to private sector (In particular to HH and MSMEs)** - **Large liquidity and mainly lending to the public sector** - **High share of state-owned banks in the market share (less efficient than commercial banks)**	**Increase institutional diversity and lending efficiency**					
	• Encourage the development of financial markets	X	X	X	X	• Develop a long term action plan for financial market integration • Initiate and develop alternative financial instruments
	• Encourage institutional diversity by developing legislative regimes for alternative organisational structures (with different incentives) of financial institutional	X				
	• Create legislative regimes encouraging the adoption of new technologies	X				
High costs of lending - **High interest rates (risk premium -> high non-performing loans**	**Reduce the lending cost**					
	• Allowing for country risk	X				• Assist in country reforms, and legislative framework
	• Reduce the high level of NPLs	X	X	X	X	
Limited access to affordable financial services for both households and MSMEs - **High collateral requirements (registration of assets, judicial system)** - **Information asymmetry** - **Limited access to basic financial services (bank account, savings, micro finance, insurance)** - **Strong reliance on cash (->informality)** - **Lack of financial literacy**	**Widen the access to affordable financial services for both households and MSMEs**					
	• Develop credit registries and guarantee schemes for MSMEs	X	X	X	X	• Develop an EU-Med guarantee initiative covering up to 80% of new loan issuance • Cooperate with financial literacy initiatives
	• Develop digital financial services and increase the role of post offices for provision of basic financial services	X	X			
	• Require banks/insurers to provide basic financial services accounts	X	X			
	Undertake initiatives to enhance financial literacy	X	X	X	X	

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EMNES areas of research include the role of institutions and institutional reforms, macro-economic policies, private sector and micro, small and medium sized enterprises and employment creation, role of education, innovation, skill mismatch and migration, finance, regulation and the real economy and regional integration.

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